Project Blue

Capitalising on the growth and global interconnectivity of the emerging markets: Financial services in Brazil

Reaping the rewards of the new global economy

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Foreword

Welcome to 'Capitalising on the growth and global interconnectivity of the emerging markets: Financial services in Brazil'. The paper is a Brazil-focused companion to our global paper: 'Capitalising on the rise and interconnectivity of the emerging markets', the latest viewpoint in our Project Blue framework.

Project Blue explores the major trends that are reshaping the competitive environment for financial services (FS) businesses worldwide. Our clients are using the framework to help them judge the implications of these developments for their particular business and look at how to take advantage of the changes ahead.

The rise and interconnectivity of the emerging markets of South America, Asia, Africa and the Middle East (together these regions form what PwC terms 'SAAAME') is in many ways the most far-reaching of the developments facing the FS sector. Trade within SAAAME is growing much faster than the developed-to-developed and developed-to-emerging market flows.

As Brazil's economy grows and its businesses reach into new markets, FS organisations are following suit. Brazil is building the capacity to become an FS hub for South America and businesses within the sector are aiming to extend their footprint not only into US and Europe, but also into Asia, Africa and selected South American countries.

At the same time, there are key challenges that Brazil's FS environment presents to foreign institutions which are reassessing their potential within the SAAAME region. First is how to break into the market when acquisition costs are increasing, competition is so strong and there are several barriers to entry. The second is differentiation, both in how products and services are developed and distributed, and how banks, insurers and asset managers engage with an increasingly demanding client base.

Opportunities for growth will continue to exist in different sectors. The underlying challenge is that the Brazilian FS sector will need to undergo significant changes to prepare itself for a lower interest rate and spread environment.

I hope you find this paper interesting and useful. If you would like to discuss any of the issues raised, please feel free to contact either me or one of my colleagues listed on page 13.

Alvaro Taiar
PwC (Brazil)
Financial Services Leader

What do we mean by SAAAME?

'SAAAME' refers to South America, Africa, Asia and the Middle East. SAAAME doesn't include Japan as this is a developed G7 economy. Mexico is excluded as it trades mainly within the North American Free Trade Agreement zone and less with SAAAME. For now, Russia and the Commonwealth of Independent States (CIS) are also excluded from SAAAME, as trade is largely internal or with Europe.

Section one: Emerging superpower

Why Brazil is so pivotal in the rise and interconnectivity of the emerging markets and what the accelerating shift in global economic power means for your business.

Financial crisis accelerates Brazil's economic rise

Already growing strongly in the lead-up to the global financial crisis, Brazil's move to economic superpower status has accelerated since.

Of the all BRICs (Brazil, Russia, India and China), Brazil has the most developed capitalist system in terms of market liberalisation, openness to foreign investment and the stability of its democratic and legal institutions (Figure 1 outlines the key strengths and challenges of this fast growing market).

Figure 1: Snapshot of Brazil

In Brazil, we have:

- Nearly 200 million people; demographic bonus
- Portuguese as single language despite being a 'melting pot' society
- Clean and renewable energy sources (hydro, ethanol, wind and solar)
- Will become net exporter of oil (pre-salt layer)
- GDP of nearly US$2.3 trillion, 32 million new consumers over last 5 years; 5.5% unemployment rate
- Net foreign creditor: US$355 billion of reserves
- One of the most internet-connected countries (over 67 million people wired)
- Sophisticated financial services sector and regulatory system
- Strong and stable democratic institutions

In Brazil, we do not have:

- Border conflicts
- Major natural disasters
- Ethnic/racial/religious tensions/terrorism or conflicts

However, we still have:

- Social inequality
- Education challenges
- Slow judicial decisions
- Bureaucracy
- High interest rates
- Complex tax environment and heavy tax burden
- Infrastructure gaps

Source: Banco Central do Brasil statistics and Instituto Brasileiro de Geografia e Estatística

Brazil is the sixth largest economy in the world and is expected to rise to fifth by the end of 2012.[1] Despite the prospect of a weaker global economy, it is possible for Brazil to expand at long-term rates of 4% a year, based on the still strong domestic market and the realisation of the many investment opportunities.[2] A further boost in investment and international profile will come from the World Cup in 2014 and Olympics in 2016.

On the world stage, national champions such as Vale, JBS, Embraer, Odebrecht and AMBEV are becoming multinational companies as they expand across SAAAME and non-SAAAME markets.

Domestic potential

In terms of demand, products, technology and regulation, Brazil has one of the most advanced FS sectors in SAAAME. Its banks are highly profitable and well-capitalised (17% average capital ratio[3]) and have suffered little impact from the global financial crisis.

While a number of international FS groups have been able to establish a strong position in the Brazilian market, domestic financial institutions are taking advantage of the significant retail growth over the past decade and using their dominant distribution networks to create a high barrier to further outside entry.

FS in Brazil is now entering the next phase of its development, creating both challenges and opportunities. While relatively high by South American standards, credit penetration is less than half of major Asian economies such as South Korea,[3] highlighting the potential for further growth as aspirations and affluence increase.

More long-term finance is needed to meet the increasing retail demand for mortgages and durable goods consumption, and meet the corporate and infrastructure investment requirements. In turn, the capital markets will need to mature and expand by providing more debt instruments, increasing their market liquidity and by enhancing the sophistication of the stock market.

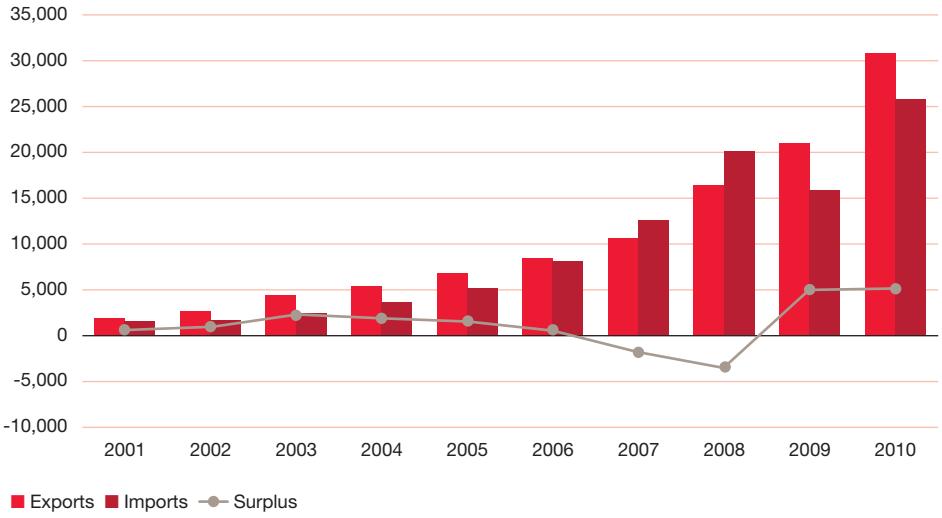
Saving for retirement is a further growth area. The country has more pensioners for every 100 contributing workers (35) than the US (34) and the government spends more on pensions as a percentage of GDP than Germany, France, or Japan.[4] The private savings and pensions sector will need to grow quickly to relieve the pressure on the public purse and provide for an ageing population – the government has already begun to put a cap on its liabilities.[5] While assets under management are the highest in the region,[6] the market is still weighted towards the institutional sector, opening up considerable opportunities on the retail side. In the past, asset managers were able to rely on the country's high interest rates to deliver good profits and returns for investors. But as interest rates fall, asset managers may need to diversify their portfolios, both through fixed and variable rate instruments and, in time, more foreign investments.

Both life and non-life insurance sectors achieved double digit growth in 2009.[7] At 3.1%, however, insurance spending as a percentage of GDP is lower than China (3.8%) and India (5.1%), highlighting the room for further growth as the economy expands and affluence increases.

The main challenge is how to make sure market growth is sustainable. Rapid expansion could create asset bubbles. While overall debt is low, household debts are rising to levels that are beginning to cause concern. FS businesses will also need to look at how to improve efficiency and control costs now they can no longer rely on high interest rates to sustain margins and returns.

1 IMF World Economic Outlook
2 Brazil Ministry of Finance, February 2012
3 Banco Central do Brasil statistics, 30.06.11
4 Economist, 24.03.12
5 Bloomberg, 29.02.12
6 FTSE Global Markets, 08.02.12
7 Swiss Re Sigma, World Insurance in 2010

Figure 2: Brazilian trade balance with China (US$ million)



Source: Secretariat for Foreign Trade (SECEX)/Ministry of Development, Industry and Foreign Trade (MDIC).

Growing global interconnectivity

While Brazil's domestic potential is considerable, the country's position at the epicentre of intra-SAAAME trade opens up even greater opportunities for its FS sector.

The trading relationship between China and Brazil exemplifies the growing interconnectivity of SAAAME. China has now overtaken the US as Brazil's biggest trading partner, with trade growing exponentially in recent years (see Figure 2).

Landmark deals include the memorandum of understanding between the Shanghai Stock Exchange and Brazil's BM&F Bovespa exchange, which could eventually pave the way for the cross-listing of stocks.[8]

At present, only around 5% of Brazil's trade is with Africa and the next stage of development for FS and Brazilian companies as a whole will be building up these links. The importance of Africa–Brazil trade to the government's plans was highlighted by President Rousseff's extensive tour of the continent in 2011 and the creation of a high level 'Africa Group', led by the country's trade and industry minister.[9]

8 BBC News Online, 18.02.11
9 Reuters 17.11.11

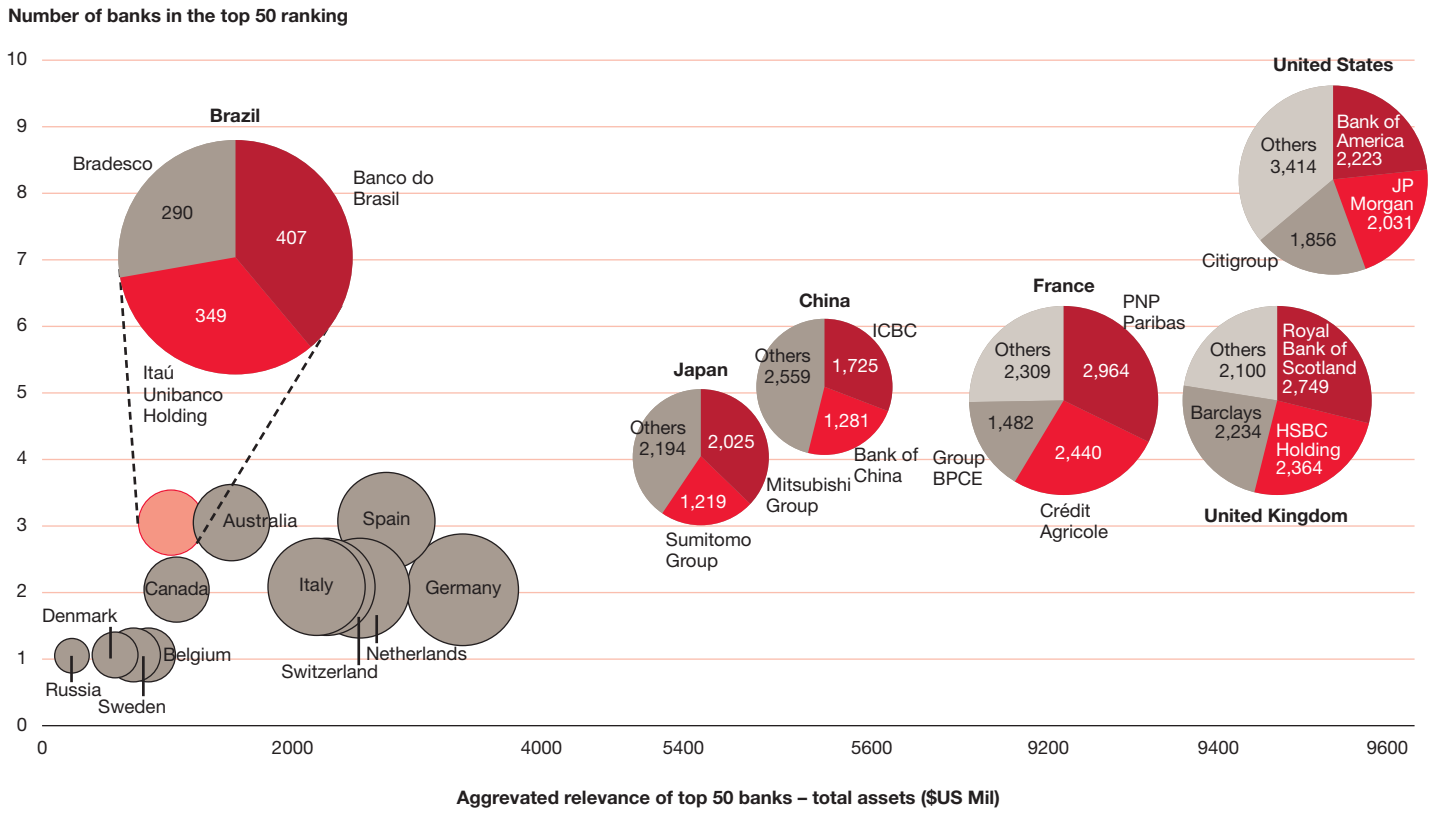
Major player on the world stage

The expansion of Brazilian financial institutions abroad is going to be complementary to their local strategy and business focus.

The international comparison in Figure 3 highlights Brazil's status as a major banking centre. Two of its banks already feature in the global top 20 in terms of market capitalisation and a number of groups are seeking to follow the country's multinational corporations by developing their presence in Asia, Africa and other parts of Latin America. Building on these strong domestic foundations and growing international presence, we anticipate that Brazil will have risen to fifth place in the global banking rankings in terms of assets by 2050.[10]

10 'Banking in 2050', 2011 update, published by PwC on 18.05.11

Figure 3: Comparison of global banking markets



Source: The Banker 2010, PwC analysis. Note: The ranking refers to the net equity values

The international ambitions of Brazil's financial institutions are exemplified by Itaú Unibanco's aim to be the 'global Latin American bank'.[11] Itaú Unibanco is consolidating its position in Brazil as a leading institution among high-income customers and middle to large corporates. Its expansion abroad is building on these local foundations as it develops a niche position in selected South American economies, as well as Asia, Europe and the US.

Banco do Brasil is establishing operations in Asia, Africa and other parts of South America[12] as it follows Brazilian capital investment and corporate expansion abroad.

Bradesco has developed a strong distribution network, especially among lower and middle income retail customers and small- and medium-sized businesses. While consolidating its growing strategy in Brazil, it is looking to expand selectively in niche segments in South America, Africa and Asia as it seeks to evolve the international presence needed to support its clients.

Following its tie-up with Celfin, a broker dealer in Chile, BTG Pactual wants to be the 'leading Latin American investment bank'[13].

11 Itaú Unibanco www.itau.com, 24.05.12
12 Banco do Brasil www.bb.com/br, 24.05.12
13 BTG Pactual www.btgpactual.com, 24.05.12

Section two: A new model of growth

As many Brazilian FS businesses look to be regional and pan-SAAAME leaders, they will need to find ways to differentiate and make themselves relevant within their target markets and trade routes.

Developing a pan-SAAAME footprint

Prior to the global financial crisis, a number of FS groups from Europe and North America were able to make multiple acquisitions to rapidly build up their international footprint in SAAAME markets. The challenge for Brazilian groups looking to follow suit by extending their international presence is that this type of fast acquisitive growth is now much more difficult, at least within the most attractive SAAAME markets.

Prospective entrants may face restrictions on foreign ownership, China and India being notable examples. Even in open markets, there may be little market share for sale and it may be prohibitively expensive if it is. Entrants may also face entrenched competition from dominant local rivals. In some cases, the markets are less evolved and an entry strategy may consider participating in the development of the financial system as a whole.

A more targeted growth model could emerge as a result, in which the ability to differentiate, develop niche segments, seek out untapped geographical markets and gain access to new digital distribution networks is critical.

In many of the hard-to-access markets, the main route to entry would potentially be to form joint ventures. With many local businesses already having established partnerships in a number of areas, incoming organisations will need to think about what distinctive attractions they can offer that competitors cannot. It might be product or credit risk expertise. It might also be complementary international coverage. Very few groups are going to be able to cover all the key markets. So collaboration between competitors – 'co-opetition' as it's sometime called – is going to become evermore common.

Reinventing the organisation

Designing the organisation of the future will be crucial as Brazil's FS businesses seek to create more nimble and adaptive operational capabilities and make sure their talent, structure and governance reflect their increasingly international horizons.

Operating models will need to reflect the changing geographical focus of the business. They will also need to deal with more extensive partnership and co-opetition arrangements, and be sufficiently agile to respond quickly to unfamiliar market conditions, distribution channels and cultural preferences.

Businesses also need to contend with a more complex risk profile. SAAAME countries have varied legal and regulatory frameworks, political systems, business ethics and cultures. It is important for Brazilian institutions to make sure they understand the ways of working required to operate in these jurisdictions.

In turn, reporting will need to be upgraded to reflect these more extended operations. For Brazilian businesses, the particular challenge is that many of the measures used in its FS sector vary from international norms, which can make it difficult to track performance across borders.

The underlying challenge is the need to train, hire or relocate unprecedented numbers of skilled people in SAAAME markets where suitably qualified and experienced people may already be in short supply. Short-term and reactive approaches, be this seeking to lure key people from competitors or bringing in large numbers of expatriate personnel, are likely to prove excessively costly and may still fail to provide the people needed to meet strategic objectives. A more systematic and forward-looking workforce plan capable of anticipating and meeting skills' needs could reduce costs and enable FS organisations to build a more sustainable platform for business development.

Where next?

As Brazilian FS groups look to follow their corporate customers into new markets and take advantage of their increasing financial strength, the key questions are where, how and how quickly they should grow.

The ability to adapt and take advantage of technology and economic interconnectivity will be the key differentiators for FS businesses in the new global economy.

We believe that there are four key questions that FS businesses should consider as they look at how to gear their strategy and operations to the rise and interconnectivity of the SAAAME markets:

- How are your corporate clients following the shift in the focus of global growth and how can you help them to respond more effectively?
- If you can't develop a pan-SAAAME presence, what specific sectors or regions could you target as you look at how to build on your strengths and existing relationships?
- How can you use technology to provide customer access and financial services in different parts of the world?
- How will you need to adjust your risk management capabilities, talent management and operating model (more joint ventures, longer lines of communication etc.) as you extend your international presence?

Making sense of an uncertain future

We're working with a range of FS organisations to judge the impact of the mega-trends shaping their industry, and where and how they can compete most effectively. If you'd like to discuss any of the issues raised in this paper, or the impact of other trends examined in Project Blue, please contact either of those who are listed here, or your usual PwC contact.

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Project Blue framework

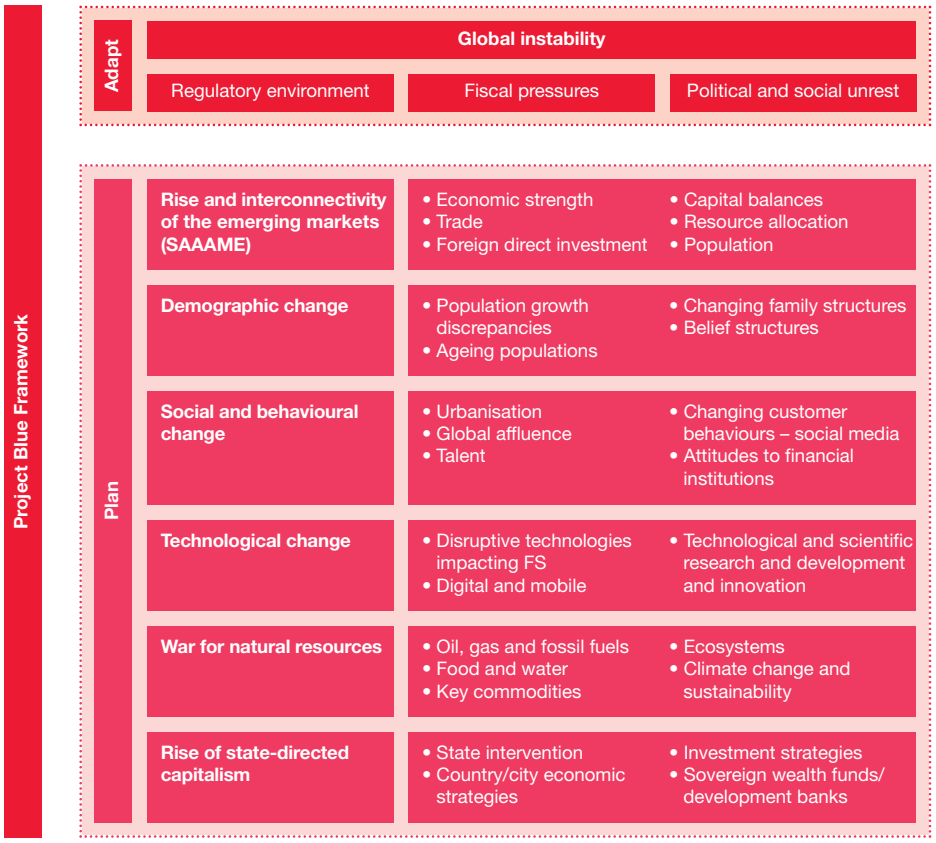
The Project Blue framework considers the major trends that are reshaping the global economy and transforming the behaviour of consumers, businesses and governments.

The Project Blue framework seen here begins with the considerations needed to adapt to the current instability. It then goes on to assess what FS businesses need to do to plan for, and ideally take advantage of, the changes ahead.

One of the main things we've been looking at is the extent to which these developments could disrupt existing business models. We've also been looking at how these trends are feeding off each other. A clear case in point is the extent to which rapid growth in emerging markets is spurring a mass influx of people into the cities.

Our clients are using the framework to help them judge the implications of these developments for their particular business, and look at how to take advantage of the changes ahead. Will business and operational models still be viable in this new landscape? What strengths within the business would allow it to develop a leading position? What talent and investment will need to be put in place now, to prepare for the changes ahead?

Figure 4: The Project Blue framework



Source: PwC Project Blue analysis

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