StepStone
inside private markets

Bolsonaro's Rise:

Reading the Mate Leaves

While most developed countries have experienced robust economic growth, Latin America has faced strong headwinds. A variety of internal and external factors are to blame for slower GDP growth and depreciating currencies. Corruption and fluctuating commodity prices played their roles.

But things may yet improve. On October 28th, Brazil became the latest Latin American country to elect a new market-friendly leader. After a bout with stagflation and a corruption scandal that toppled the last three presidents, *Brasileiros* are hungry for change. In many ways, this election was a referendum on the Workers' Party (PT) that dominated Brazilian politics for much of this century.

Jair Bolsonaro's ascension to the presidency may give Brazilians the opportunity to turn over a new leaf, but it is not without risks: his bona fides as a free-market champion are unproven, and the durability of his relationship with his economic adviser, Paulo Guedes, has come into question. That Congress has shifted to the right should be reassuring. To accelerate Brazil's economic recovery, the president-elect will need to build a coalition to quickly pass the reforms that are his mandate.

It would be easy to reduce Mr. Bolsonaro's victory to yet another manifestation of the world's disenchantment with conventional politicians. But changes of this magnitude are only possible with a functioning democracy. StepStone remains sanguine on private markets in Brazil. Beyond the resiliency of its institutions, many of the factors that have long made us bullish on the world's ninth largest economy are still in play.

November 2018

The Recovery

The largest economy in Latin America was hit by a perfect storm. Dilma Rousseff's questionable fiscal and monetary policies resulted in a significant budget deficit, rapid increase in public debt and increasing inflation. Amid a self-inflicted fiscal deficit and a corruption scandal that eroded the public's confidence to the point that Congress impeached her, the economy bottomed out in 2016. Since then, economic growth has returned, and base interest rates and inflation have fallen (**Figure 1**).

The IMF predicts that Brazil's GDP will grow by more than 2% per year between 2019 and 2021. That should help Mr. Bolsonaro well into his first term, but he and his cabinet should look to move quickly to make the changes that are critical to the country's long-term prosperity.

First, although the new legislature is better aligned with his agenda, after nearly three decades in Congress he ought to know firsthand just how fickle his former colleagues can be. In such partisan times, even a whiff of wrongdoing can be ruinous.

Second, the IMF's outlook is just as rosy for the US and other developed markets. As the US dollar grows stronger, Brazil will have to work hard to reform its economy into a more stable and solid market that can better withstand external volatility.

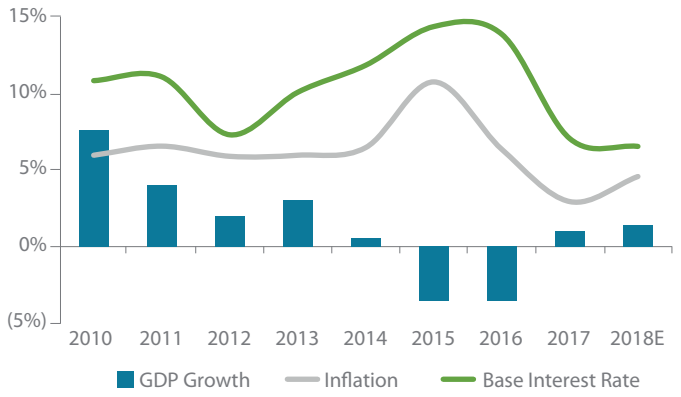
The Brazilian real already lost a lot of value versus the US dollar (**Figure 2**). Now that the elections are over, it should be more stable. Ample currency reserves should help further (**Figure 3**).

Bolsonaro's Rise

From relative obscurity, Jair Bolsonaro emerged from a field of 13 candidates to defeat PT candidate Fernando Haddad in a run-off election, winning 55% of votes to become Brazil's 38th president. Despite being a seven-term congressman, Mr. Bolsonaro was not a household name—a fact that may have helped him remain beyond the purview of the Car Wash investigators who brought down darlings of the PT, former presidents Lula da Silva, Dilma Rousseff, and Michel Temer.

Mr. Bolsonaro made a name for himself due to his tough stance on crime, jarring views towards women, Afro-Brazilians and the LGBT community, and his resolve to put an end to the palm-greasing that has eroded public confidence in the

FIGURE 1 | GDP GROWTH, INTEREST & INFLATION RATES (%)

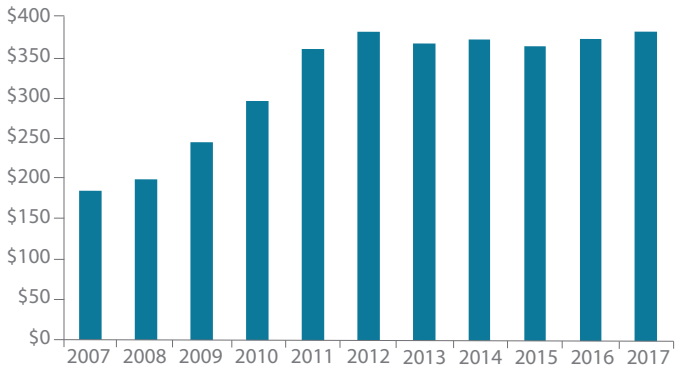


Sources: IMF, Brazilian Central Bank, IBGE, October 2018.

FIGURE 2 | BRL VS. USD (% CHANGE VS. 2013)

Source: S&P Capital IQ, October 2018.

FIGURE 3 | BRAZILIAN CURRENCY RESERVES (US$ BILLIONS)



Source: World Bank, October 2018.

government. Still, many question whether he is the champion of free-markets he claims to be.

Not only does he appear to have a chilling admiration for the military dictatorship that ruled Brazil from 1964 to 1985, but he admittedly knows little about economics. Despite his recent speeches, his time in Congress suggests a preference for statist economic policies. Many credit the man Mr. Bolsonaro has chosen to be his economic "super minister," Paulo Guedes, for his victory. The recipient of a PhD in economics from the University of Chicago, Mr. Guedes is a renowned supply-side reformer and the architect of the president-elect's economic agenda.

TIGHT FISCAL POLICY

Mr. Bolsonaro's economic program will seek to reduce Brazil's fiscal deficit by eliminating some corporate tax exemptions and reducing government waste, among other initiatives. The TCU, Brazil's federal accountability office, estimates that tax exemptions to certain sectors are more than twice as large as the annual deficit (excluding interest payments). To reduce excessive spending, Mr. Guedes would implement a strong fiscal agenda.

PRIVATIZING SOEs

The Bolsonaro Administration would also seek to privatize most of Brazil's 140+ state-owned enterprises (SOEs). It proposes to use the proceeds from the privatization process to further reduce costs. By reducing public debt, the interest expenses should shrink markedly. The program would exclude banks and Petrobras' upstream business.

PENSION REFORM

Brazil's pay-as-you-go social security system is responsible for most of the country's fiscal deficit. Although the plan to fix it is still under development, initial discussions have included increasing the minimum retirement age and introducing a new system based on individual capitalization. Proceeds from the privatization program would help fund the transition.

TAX REFORM

Mr. Bolsonaro also wants to simplify one of the most complex tax codes in the world. Making it simpler, he reckons, would lessen the heavy operational burden on businesses. The World Bank estimates that companies in Brazil spent nearly 2,000 hours preparing their taxes in 2017—more than eight times the world average.

As the deficit shrinks, he would look to reduce tax rates further and offer more exemptions to low income families.

One of the main risks related to Mr. Bolsonaro's candidacy was his potential lack of support in Congress. That may have changed in the general elections when his Social Liberal Party surged in the polls to become the second largest party in the Chamber of Deputies, Brazil's lower house. Only the PT is larger. Parties that lean right have more than 60% of the seats in the lower house. They are not all likely to back Mr. Bolsonaro, but the fact that he has already won over the all-powerful agricultural, evangelical and law enforcement bloc (i.e., the "bullet, beef, and bible caucus") means he may have more clout than predicted.

Although some fear that Mr. Bolsonaro could seize control of the government, we believe these concerns lack merit. Nearly 70% of Brazilians believe democracy is the best form of government. Moreover, in 1964 elected officials and a large part of the population backed the military coup. A coup today would not reflect the will of the people.

Greater Transparency

In addition to reforming the economy, Mr. Bolsonaro has vowed to put an end to the culture of corruption and increase support for Operation Car Wash. By choosing Sergio Moro to be his minister of justice, the president-elect may achieve both.

As leader of the sprawling four-year corruption probe, Mr. Moro excelled, convicting more than 140 politicians and business leaders. He stands as a testament to the strength and independence of the judiciary that will eventually choose his replacement. Any judge that works for the southern district can volunteer for the position, but the courts will likely choose whomever has the longest tenure. Car Wash should remain in able hands.

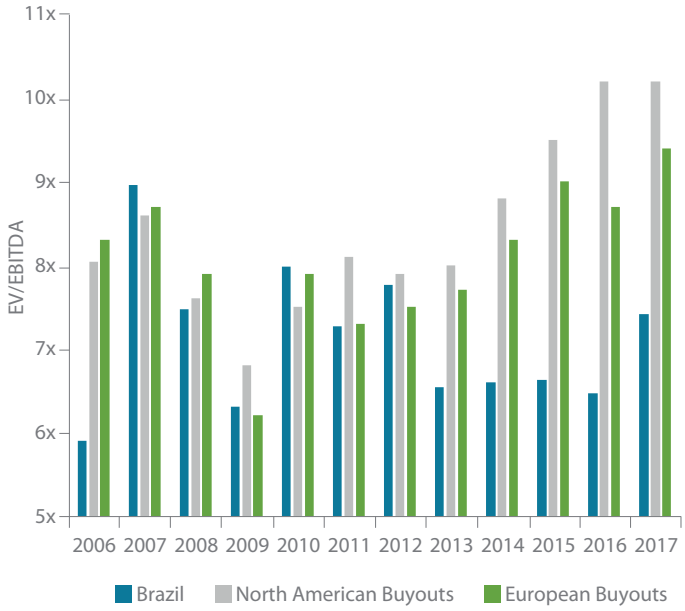
After working closely with the federal police, Mr. Moro could soon be their boss. With a R$12 billion budget (2015) at his disposal, he would have plenty of resources to advance Car Wash and root out corruption more broadly. Whether he can be a shrewd political operator remains to be seen. To be successful, Mr. Moro will have to work with Congress. Though he has surely made some enemies, some members of the incoming class owe their political careers to him.

Outlook for Private Markets

In 2016, Latin America had its worst fundraising year in almost a decade. Brazil's recession and political crisis were at a nadir while the rest of Latin America experienced slower growth rates. One year later, fundraising improved as large managers raised new funds from local and foreign investors alike (**Figure 4**). In contrast, investment and exit numbers were somewhat stable in 2016 and 2017, staying above their 2015 levels.

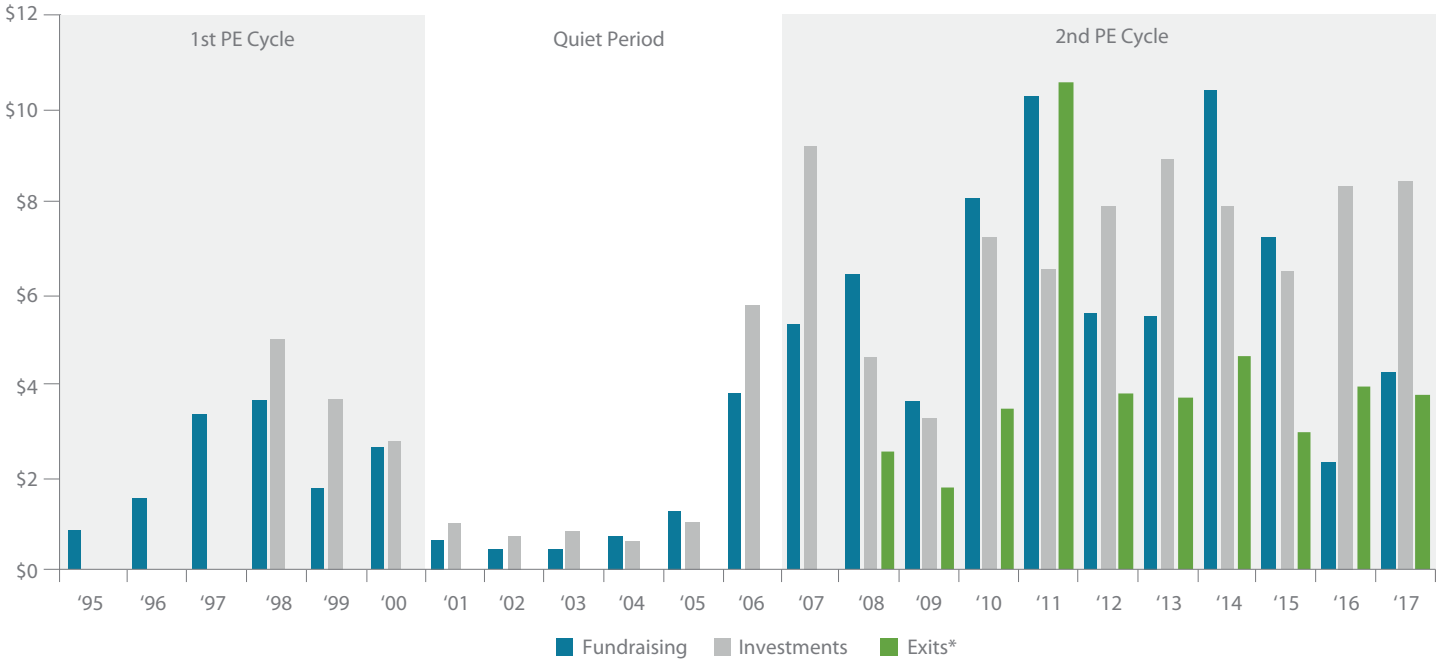
We also believe that private markets in Brazil will continue to be a bastion for value investors. Entry multiples are still well below what they are in more developed markets (**Figure 5**).

FIGURE 5 | AVERAGE PRIVATE EQUITY ENTRY MULTIPLES



Source: SPI, StepStone Analysis, September 2018.
Brazil: Average TEV/EBITDA multiples from 168 private equity transactions.
U.S. and Europe: Average LBO purchase price/EBITDA multiples.

FIGURE 4 | LATAM PRIVATE EQUITY TRENDS (US$ BILLIONS)



Source: LAVCA Industry Report 2018.
*Some exits amounts were not accounted due to confidentiality issues.

Brazil is also an underpenetrated market (**Figure 6**). The fifth most populous country, Brazil is home to 2.76% of the world's population but less than 0.5% of total private equity fundraising.

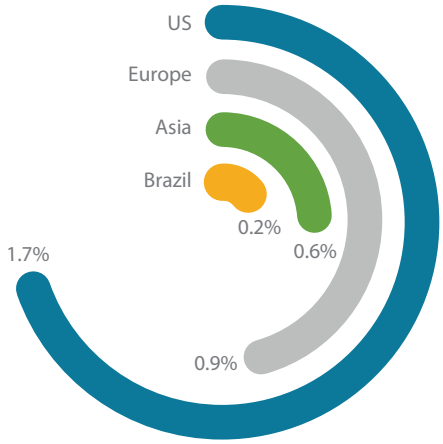
Following the last downturn, most private equity managers shifted away from cyclical sectors like real estate and basic materials, opting instead for defensive industries with simple business models and little to no leverage. This tactical adjustment proved prudent—agribusiness, food and beverage (F&B), and health care have outperformed the broader economy.

- According to Brazil's agriculture ministry, the agribusiness industry grew by 13% last year, 12 percentage points higher than overall GDP.[1] This trend should continue as the market for inputs (e.g., seeds and fertilizers) is projected to grow into next decade.[2]
- F&B has been resilient and delivered growth. Between 2010 and 2017, sales grew 25%; they are projected to grow another 14% through 2020.
- While the broader economy languished, spending on health care grew by 32% between 2014 and 2017.

In 2018, political uncertainty had taken a toll on private markets in the region. That all changed on October 28th. Not only does Mr. Bolsonaro's victory give Brazilians the opportunity to move past the PT's checkered reign, but the managers who opted to postpone their activities until after the election are going to pick up where they left off. Pan-regional funds should return to market next year. This break notwithstanding, the Brazilian Private Equity and Venture Capital Association (ABVCAP) estimates that Brazilian managers had accumulated R$36 billion (US$9 billion) in dry powder as of July 2018, which implies a 17% increase year over year.

Venture capital and growth equity have been persistent. Last year, 113 VC deals closed on US$859 million, more than three times the amount invested in 2016. Special situation managers have also grown more active as they look to capitalize on the glut of opportunities that have surfaced since Brazil's recession ended in 2016. More than 1,400 companies have filed for bankruptcy (twice the number in 2014), and Brazilian banks have over US$120 billion of nonperforming loans on their balance sheets, 20% of which is corporate debt.

FIGURE 6 | INVESTMENTS AS % OF GDP (2017)



Source: EMPEA 2017 Industry Statistics, Bain & Company Asia-Pacific PE Report 2018, LAVCA Industry Report 2018, IMF October 2018.

Conclusion

Jair Bolsonaro may be far removed from Brazil's political heterodoxy, but after more than a decade of PT rule, *Brasileiros* are willing to embrace change. He's neither the first to surround himself with capable technocrats, nor is he the first to have a Congress ripe for coalition building. That he was one of the only politicians to not be tied to a corruption scandal, however, speaks volumes.

In light of the positive macroeconomic outlook, a president who promises to reform Brazil's corpulent public sector, and a more mature and diverse private markets landscape, StepStone believes that the next four years will be good vintages.

[1] Ministério da Agricultura, Pecuária e Abastecimento.
[2] L.E.K. Consulting.

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The Firm creates customized portfolios for many of the world's most sophisticated investors using a highly disciplined, research-focused approach that prudently integrates fund investments, secondaries and co-investments.

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