

Brazil Strategy

Getting real on earnings

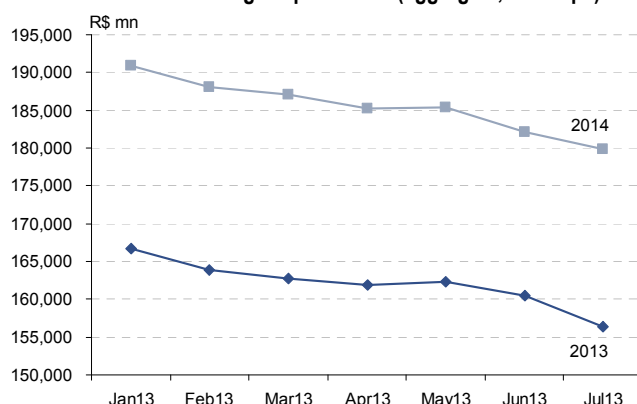
- **Street gets ready for weak 2Q** – The graph below shows the drop since January of this year of average 2013 and 2014 sell-side earnings expectations for Brazilian stocks. This doesn't count the drop that was already occurring in those same expectations during the second half of last year.
- **FX hit** – The biggest reason for the 2013 hit is not the soft Brazilian economy per se, but the (related) soft Brazilian currency. About 43% of debt of listed corporates in major indices is denominated in foreign currencies, mostly the dollar. The 12% drop in the BRL since early June means an equivalent translation loss on those debts.
- **Operating doubts** – Still, economic activity in the direct sense isn't helping. Expectations of 2013 GDP growth have dropped from the area of 4% to the area of 2% since mid-2012. Citi's is now at 2.2%. The growth-expectations erosion was visible well before the eruption of protests in June. But those have disrupted business activity in the short run, put some investment decisions on hold, and increased concern over macro policy affecting future growth.
- **Do Brazil consensus P/Es already reflect weakening 2013 "E"?** – Still only partly, in our view. Yes, the slope of the 2013 expectations line steepened recently. But spot checks tell us analysts are still updating models to prep for 2Q earnings season, and that includes June, when Brazil's currency dropped 9% against the dollar. The consensus Brazil 2013E P/E is now **10.1X** (using MSCI Brazil for global comparability), but the reality is probably closer to **11.0X or even 11.5X**. Still, that's below global MSCI at 13.7X, Asia ex-Japan at 11.8X, and Latin America ex-Brazil at 15.5X. Only CEEMEA is cheaper, at 7.9X.

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Figure 1. Brazilian overall market earnings expectations (aggregate, Ibovespa)



Source: Bloomberg, and Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Only two sectors escape earnings cuts

The only Brazilian stock groups for which 2013 earnings estimates have risen since the beginning of the year are Pulp & Paper and Utilities.

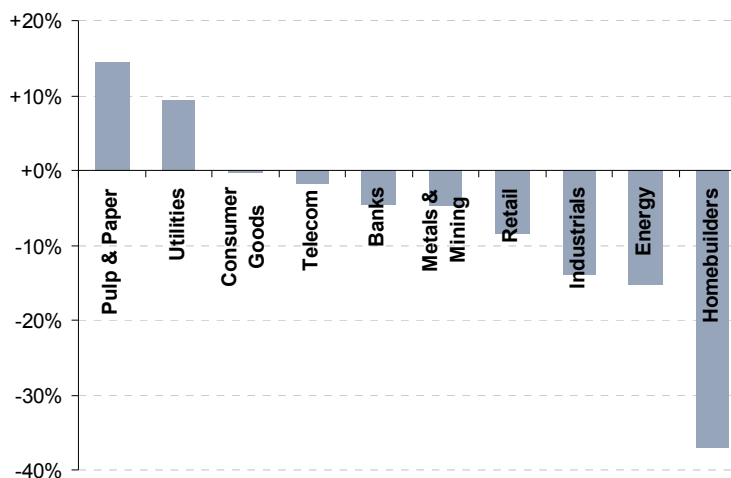
Pulp & Paper includes exporters, namely **Fibria** and **Suzano**, which benefit from Brazil's weakening currency. Global pulp prices have meanwhile stayed high relative to earlier expectations.

Estimates for **utilities** (a sector without much dollar debt) rose because:

- 1) Doomsday scenarios around low hydroelectric reservoirs in early 2013 proved wrong. Hydro generators found themselves less short on contracts and distributors buying less fuel-fired expensive power than expected.
- 2) During the months when fuel-fired plants were dispatched heavily, the government helped muffle the immediate shock to distributors, which would in any case eventually be made up in pass-through of the cost to consumers.
- 3) Inflation has stayed high, and distributors' pricing is adjusted for inflation.

Figure 2. Changes in 2013 earnings expectations since Jan. 4, 2013, by sector

Consensus, local currency, aggregate for each sector, Ibovespa index components



Source: Bloomberg, Citi Research

Homebuilding and energy worst

Every other sector has seen cuts. Total expectations for 2013 earnings of **homebuilders** have fallen 37% since the beginning of the year. While early indicators for the second quarter have been mixed to positive (for a tiny sample so far), first-quarter earnings disappointed almost across the board. Builders launched fewer projects, sold less, and suffered more sales cancellations than analysts expected.

The second biggest hit has been in Energy, which is to say mostly **Petrobras**. The surprisingly sudden slide of the Brazilian real would normally hit the company's balance sheet, with its \$50 billion of un-hedged dollar-denominated debt. However, about two-thirds of this is likely to be reversed as Petrobras reports actual 2Q earnings, since the company has now announced a shift to hedge accounting. That

allows it to not book all the unrealized FX impact on its debt in any given period because its oil reserves and future exports are also dollar-denominated.

The treatment is reasonable and allowed, considering that the natural hedge of oil reserves is the reason Petrobras is comfortable holding so much un-hedged foreign-currency debt in the first place. But the timing was bad. Announcing the change for 2Q13 reporting purposes ten days after the end of that quarter, during which the BRL dropped sharply, has the appearance of choosing the most aggressive accounting treatment after the fact. The company claims the new accounting was in place internally since May. Furthermore, higher earnings at Petrobras mean higher potential dividends (and possibly higher taxes) to the government, the largest shareholder. At a time when the government has been critiqued for its own creative accounting to reach fiscal targets, this looks like more of the same.

Also cut have been **banks** (worries that the spike on long-term interest rates means hits to bond positions), **retailers** (softening consumer demand and disruptions from protests), and **metals & mining** (dollar debt and China-related concerns on pricing).

Of the sectors with earnings downgrades, the most modest have been in **consumer goods**. These include producers of small-ticket staples (**Ambev, Brasil Foods**) whose sales weren't much disrupted by protests, and exporters of proteins (**Brasil Foods, JBS, Marfrig**) helped by the currency move.

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Appendix A-1

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