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PANORAMA

COMPANY INSOLVENCY TRENDS IN BRAZIL

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Ongoing economic scenario in Brazil remains sensitive, Coface expects GDP to break even in 2014 and activity should contract by 0.5% in 2015. Industry dropped by 3.2% in 2014 and will probably record another negative year in 2015. The year has just started, but it may reserve some negative surprises. Brazil has been facing droughts in the last two summers, so the probability of water and energy rating has been increasing in the later months. What explains the current lackluster scenario and how has this scenario impacted on companies payment capacities? Does it have an impact indeed on the corporate insolvency trend?

The aim of this report is to measure insolvencies in Brazil, extract evidence of increasing cases and to verify which the most sensitive segments are. Firstly we will review the economy recent performance as well as the expectations for 2015. The year began with President Dilma Rousseff taking office of her second mandate. She reported the smallest advantage in the country electoral history, with 51.6% of the votes against 48.4% of the from the centre-right Brazilian Social Democracy (PSDB) in runoff elections. Now Dilma will need to show ability to put economy back and to recover entrepreneur's confidence.

Secondly it will be discussed delinquency in Brazil in 2014, with 11 segments under consideration, notably: 1) Automotive and

Transport; 2) Chemicals; 3) Construction; 4) Distribution; 5) Electronics and IT/Telecoms; 6) Food Industry; 7) Textiles and Clothing; 8) Services to individuals; 9) Other services; 10) Paper/Wood and 11) Minerals.

Despite the deterioration in economic fundamentals in 2014, insolvency decreased by 15.6% in the period. Minerals and chemicals were outlier segments and reported an increase in insolvency cases of, respectively, 54% and 65% in 2014. This unexpected result could be read as a short term relief after years of strong growth in delinquency, but this resiliency should not last this year, against the backdrop of a worsening economic situation.



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COMPANY INSOLVENCY TRENDS IN BRAZIL



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NEW MANDATE AND OLD CHALLENGES

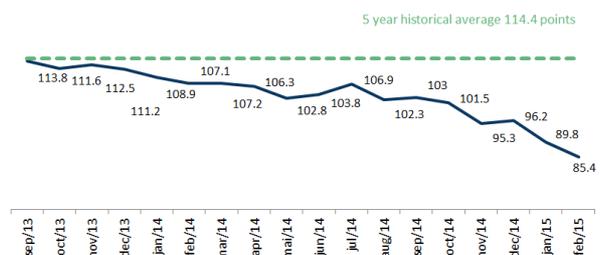
Dilma Rousseff's second mandate has started with three considerable challenges: the stagnating activity, her weak majority in Congress and the rationing risk that has been increasing in the later months. The last four years were marked by a rising lack of commitment with the primary surplus target, not only by imposing lower reference values to be achieved, but also through mechanisms to increase the total amount to be deducted. This behavior together with Brazil's low investment rate has contributed to pressure prices up. Inflation ended 2014 in 6.41% close to the target's ceiling of 6.5%. Government now needs to recover commitment with fiscal policy and to readjust repressed fixed prices.

In this manner, the new Finance Minister Joaquim Levy, who was welcome by the market due to its pro-business image, has already announced some tax increases. Meanwhile, Central Bank raised Selic (reference interest rate) by 1.75 p.p. (currently at 12.75% a.y.) since President was reelected in end October 2014. This may be a necessary bitter pill to swallow in order to put economy back on track, to recover entrepreneur's confidence and to ward off country's rating downgrade to speculative risk by the three main rating agencies. However in the short term, no big improvements are expected. Consumer confidence as well as business confidence remains well below the 5 year historical average (see chart 1). It is also worth noting that in addition to the increase in Selic rate, banking spreads¹ also rose in 2014 (+ 0.5 p.p. for business and +1.8 p.p. for natural

person YoY), reflecting higher risk aversion despite stable delinquency rates in the same period (3.4% for business credit and of 5.5% for natural person).

For many years household consumption drove activity in the country, based on increasing wages and improvements in credit access. Notwithstanding favorable conditions are reverting. Job openings deteriorated (net creation of -81.8K payroll jobs in January 2015, worst result for the month since 2009), the high inflation has been impacting on real wages, interest rates are increasing and government raised financial transaction tax on consumer loans from 1.5% to 3% in January 2015. In this manner, outlook is neither bright for consumption.

Chart 1: Consumer Confidence Index



Source: FGV

¹ Banking spreads: the difference between the interest rate charged on a bank loan and the lender's cost of funds.

Chart 2: Industry Confidence Index



Source: FGV

The sensitive scenario faced by the industry has been known for some time and is associated with the lack of competitiveness of the local product. It is difficult to be competitive with a poor transport infrastructure, high bureaucracy and high and complex tax burden. The expensive credit also plays a decisive role. Only a few are able to access subsidized rates. In addition, the industrial negative result expected for 2015 may further deteriorate, if confirmed the water and energy rationing. In that case, sector would be once more the most impacted, due to the intensive dependence. Notwithstanding, segments will not be impacted in the same intensity. For instance steel, appliance and apparel tends to be more exposed. Up to now the only certainty is that energy tariffs will continue to raise.

Last but not least, Congress is extremely fragmented in Brazil and government’s official coalition obtained 60% of the Lower House seats and 65% of the Senate’s seats. To accomplish a reform three-fifths of votes in both houses is required, which means that president will have a small positive margin. Currently government is trying to get the approval in Congress of a package that reduces labor and social security benefits and that should generate a saving of 18 billion reais in 2015 (roughly 6.8 billion USD or 0.35% of GDP). Despite that, it allies and even members of the government party began to mobilize to stop or mitigate the impact of fiscal adjustment measures proposed. In summary, 2015 should not be better than 2014. This reflects in the insolvency scenario for this year. Indexes should not improve in the short term.

Insolvency

Chapter XI is relatively new in Brazil. It was established in 2005, under the new Law of Bankruptcies. It is a measure to try to avoid Chapter VII² and is applied when a company loses its ability to pay its debts.

How does it work? The company files for Chapter XI. The judge analyses the documentation and if it is complete, he

² Chapter VII: The owner is withdrawn from its activities and an administrator is appointed by the judge to take care of the process. All assets are sold and the collected resources are used to pay off debts.

gives the dispatch. Then the company has 60 days to submit a recovery plan to the justice. Once with the plan, the judge discloses the same to the creditors. They hold 180 days to approve or disapprove the plan. If approved, the debtor gets in Chapter XI. During recovery the company continues to operate normally.

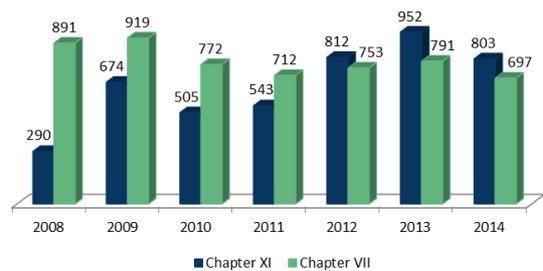
Chapter XI closes when the company meets all that was laid down in the recovery plan, but few were able to rebuild up to now in Brazil. Legislation is very benevolent in the country and many companies are over eight years under Chapter XI protection. Grace period may achieve two years, to start paying in endless installments and with high discounts. Many law offices saw an opportunity on these cases and started to specialized themselves on these issues.

Chapter XI reported strong growth from its implementation in 2005 until 2009. In 2010 a sharp decrease was noted, in line with economy’s robust growth that year (GDP +7.5%). However the index restarted to deteriorate in 2012, as activity was already weak and industry contracted. Many companies invested hardly during 2010-2011, got leveraged, but started to face financial difficulties as it failed to get return. One of the rationales behind the slowdown is well known in Brazil and was already explained in the previous section: the lack of competitiveness of local industry.

No relevant improvements were done, industry contracted by 3.2% in 2014, but despite that total number of companies that filed for Chapter XI dropped from 952 cases to 803 cases (-15.6%). The decline is more associated with a short term relief after years marked by strong growth of Chapter XI requests.

It is worth noting that insolvency data in Brazil is still very limited. Information such as company’s segment, its number of employees or the amount/cost involved in an insolvency case is not easy to access or publicly available.

Chart 3: Number of chapter XI requests vs number of declared chapter VII



Source: Serasa

2 SECTOR ANALYSIS

The fall in chapter XI in 2014 does not reflect the situation in all sectors. According to the table below minerals and chemicals reported strong growth in the number chapter XI requests.

Table 1

Chapter XI			
Sector	Number of cases 2014	Change YoY	Share
Automotive and Transport	105	-18%	13%
Chemicals	52	63%	6%
Construction	45	-17%	6%
Distribution	149	-20%	19%
Electronics and IT/Telecoms	18	-28%	2%
Food Industry	64	-14%	8%
Textiles and Clothing	24	-31%	3%
Services	290	-19%	36%
Paper/Wood	13	-59%	2%
Minerals	43	54%	5%
Total	803	-16%	100%

Source: Serasa

Automotive and Transport

2014 was a year to forget for the automobile industry in Brazil. Production contracted by 15.3% and sales dropped by 7.1%. The weak performance is associated with taxes hikes, higher interest rates, stronger imports barriers in Argentina (the main destiny of the auto exports) and the deterioration of the Brazilian economic scenario. The latter one negatively impacted over consumer confidence, reducing propensity to purchase durable goods. However an increase on insolvency cases was not reported. This can be explained by the segment's good performance in the previous years, which may have helped to bear the challenging year. For 2015 production as well as sales should recover a little, as the drop in 2014 was really strong. Despite that the current scenario of steady growth, high inflation and increasing interest rates should prevent a stronger recovery. Against this backdrop, insolvencies could rise in the sector in 2015, as more corporate would suffer from a second challenging year in a row.

Chemicals

Competitiveness has become a key issue through time, due to high dependence on imported natural gas, the shale gas revolution in the USA and Brazil's relatively high energy costs. Apparent consumption reported marginal increase in 0.8% in 2014, while the variables inserted on this account

had behaved as follows: production contracted by 4.5%, exports rose by 1.4% and imported volume increased by 9.3%. In the face of this result, the imported product participation over local demand reached 35.6% in 2014, the highest percentage already observed. Trade balance recorded deficit of 31.2 billion USD and the capacity utilization annual average stood at 79% (below 80% for the first time in 7 years). Before this scenario, the strong increase in insolvency cases (+63%) is not exactly a surprise. Industry has long been suffering and 2015 should not be different. Country has been facing serious water shortage, which causes impacts through higher energy tariffs and also through the usage of natural gas by thermal plants. It is worth noting that the recent free fall in oil prices should contribute to the industry in 2015, even though naphtha's local prices have not been reviewed downward yet.

Construction

Insolvency contracted by 27%, despite a year of poor performance (-3.3% in 9M2014 YoY). Segment was impacted by lower investments associated with presidential elections and World Cup (-7.4% in 9M2014 YoY). The weak economic performance coupled with the deterioration of agents confidence also help to explain the contraction of 5.1% in construction activity verified in the first three quarters of 2014. A high release inventory has worried constructors of corporate as well as housing segments. The remaining deteriorated construction confidence (90.8 points in January 2015, well below the 5 year historical average of 122.2 points) make us believe that the scenario should not significantly improve in 2015. Furthermore, the recent corruption scandal involving Brazil's state owned oil giant Petrobras showed a possible connection of country's biggest construction groups. This should negatively impact on construction activity at least in the short term.

Distribution

The segment includes a big range of companies, so the high representativeness (19%) was already expected. The number of companies that filed for Chapter XI decreased by 20% in the period, but this tendency should not be maintained. Distributors usually work with lower margins and the scenario of low activity and higher interest rate represent a challenge to the segment. They also cover companies at the retail market, which for many years grew at very fast pace, but ended 2014 with the worst result in 12 years (+2.2% YoY). The depreciation of the Real (-13.7% in 2014) also increases the cost of imported products. 2015 should report an increase in insolvencies.

Electronics and IT/Telecoms

Representativeness is low when compared with the size of the segment. Demand for electronics was boosted in 2014 by rapid growth of smartphones and tablets sales, PC upgrades and TV to watch the FIFA World Cup in Brazil. This contributed to offset the currency depreciation and the slowdown in activity. Despite that, the same fundamentals will not repeat in 2015, insolvency should report some increase based on higher interest rates, further exchange

rate depreciations and lower consumer confidence. Big- ticket credit purchases should be the most impacted (for instance tv sets and computers).

Food Industry

Insolvency contracted by 8% in 2014, this may be explained by record crops , food sales that verified marginal increase of 1.3% in the same period and the weak base of comparison (insolvency increased by 46% in 2013). Forecasts for 2015 show that another year of record crop should be achieved, but productivity should reduce due to droughts faced in the Northeast and Southeast of the country. Furthermore, imported fertilizers represent a good of some crops costs and the maintenance of the Real depreciation should further tighten farmers' margins.

Textiles and Clothing

Segment reported a decrease in insolvency cases, despite another year of weak performance. Production in volume reduced by 6.5% in 2014, by 1.7% in value and sales dropped by 1.1%. The Brazilian textile industry has been facing difficulties due to the increasing pressure from imported products- especially from China which accounted for over 50% of total imports. Penetration of imported product achieved 24.5% in 2014. The high tax burden on domestic producers also plays a significant role against local industry. However 2015 has started with some optimism. The devaluation of real has revived textile manufacturers that reported increase of 15% in retail orders in early 2015.

Services

The service sector is by far the most representative one and comprises all kind of services for individuals as well as for corporate. The result is in accordance with its meaningful weight in the country's GDP composition. Services are responsible for 59% of Brazilian activity. The decline in insolvency cases was in opposition to the lower growth rate (0.9% in the first three months of the year). The explanation is associated with the higher capacity of the service sector to adjust prices. The high competition of the imported product enables the industrial sector to realign prices in order to maintain its profitability, this does not happen in the service sector. For instance, the service sector 2014 inflation stood at 8.3% against 4.3% in the industrial sector. Despite the improvement reported in insolvency in 2014, it should stay stable, due to the lower activity rhythm. It is worth noting that in a scenario of rationing, the service sector would be less impacted than the industry, thanks to its lower usage dependence.

Paper/Wood

Insolvency reported a strong decline Brazil (-59% in 2014). Brazil is a significant player in this sector and has been shortening the production cycle and implementing new harvesting and wood processing systems and technologies. The main products are: sawn wood, pulp and paper. Insolvency may further decrease due to segment's good perspective. The significant demand and producers low

inventory level contributed to absorb the increase of \$20/t in hardwood pulp early this year.

Minerals

Covers a large portfolio of companies and the strong Increase of 54% in insolvency is in line with the weak result reported in 2014. Still the representativeness of only 5% can be considered low compared to industry's weight in the GDP. Brazil is a major producer of iron ore and steel. The first one saw its price dropping by 53% since the end of 2013. In counterpart this should have positively contributed to steel producers, but steel low international prices and the competition of the imported product played an important role. Production contracted by 0.7% and apparent consumption reduced by 6.8%. The scenario should remain weak in 2015, as its main consumers (auto, capital goods and construction industries) will not report big improvements in its activity this year.

Table 2

Sector	Risk
Automotive and Transport	Should increase
Chemicals	Should remain at the same level
Construction	Should increase
Distribution	Should increase
Electronics and IT/Telecoms	Should increase
Food Industry	Should remain at the same level
Textiles and Clothing	Should remain at the same level
Services	Should remain at the same level
Paper/Wood	Should remain at the same level
Minerals	Should remain at the same level

3 CONCLUSION

The year of 2015 has started in Brazil with many challenges. Country needs to recover commitment with fiscal policy, in order to improve confidence and together with a contractionary monetary policy bring inflation back on track. It takes time to see improvements over activity.

Coface expects GDP to contract by 0.5% in 2015. Therefore insolvency may report a new high this year. Industry will be once again the main impacted, due to the poor transport infrastructure, high tax burden and low competitiveness, despite a depreciated exchange rate (R\$ /US\$ expected to end 2015 at R\$/US\$ 2.90). The increasing possibility of energy and water rationing would need to review forecasts downward.

Taking into account insolvency, the decline reported in 2014 should not be repeated in 2015. The risk scenarios for all industrial segments remain sensitive and may only improve in 2016. The first figures of 2015 have already shown that the year will not be easy. According to Anfavea figures car production dropped by 13.7% and sales contracted by 18.8% compared with the same month of 2014. A new sharp decline and still based on weak database. Generally, risk should increase in the automotive and transport segment, in construction, distribution and in electronics and IT/Telecoms. The remaining segments should not report big changes in their risk level.

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