



FUND LAUNCHED

**2005**

FUNDS UNDER MANAGEMENT

**£542.5**  
MILLION

NET ASSET VALUE PER SHARE

**381.6%**  
SINCE INCEPTION\*



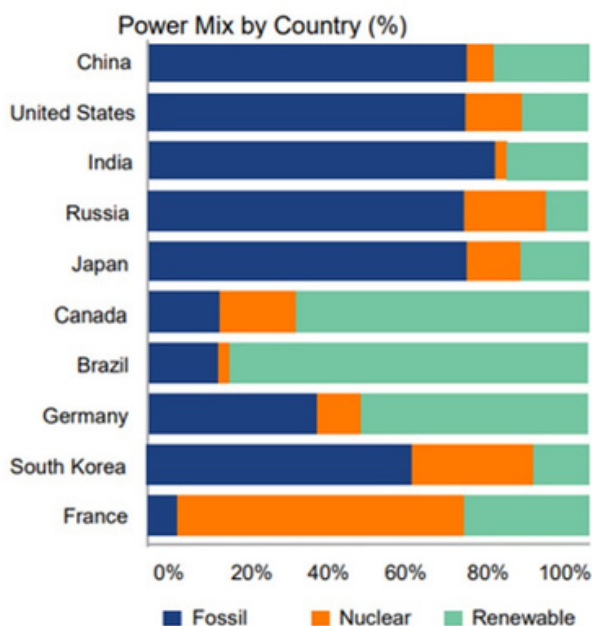
# Brazil: Abundant resources, abundant opportunities

April 2023

With a population of over 214 million people, Brazil is the most populous country in Latin America, providing a large market for goods and services. Combined with abundant resource, a robust financial system, and sound regulatory frameworks, Brazil offers significant investment opportunities.

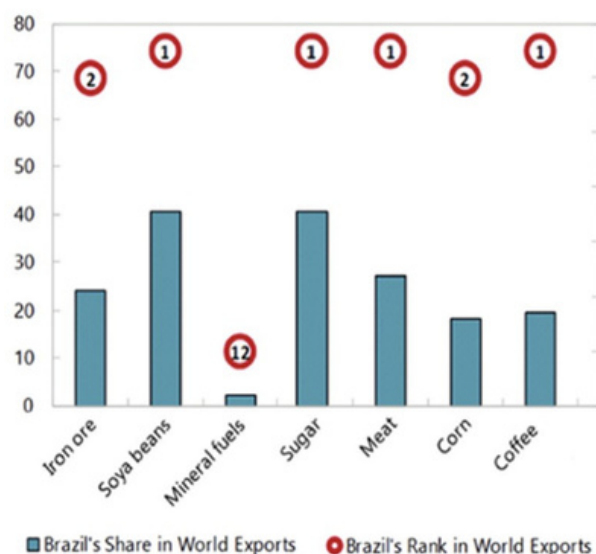
Brazil is already playing a key role in world decarbonization given that its energy matrix is 60% hydro, 11% wind, 8% biomass, 3% solar and only 18% thermal.<sup>(1)</sup> Brazil's plentiful natural resources enable it to generate electricity primarily from clean and cheap renewable energy sources, and it is expected future capacity growth will be concentrated primarily in wind and solar, furthering this trend. Material investment in renewable energy provides significant opportunities for infrastructure investors, not only in generation but also in transmission assets.

**Breakdown of Generation Capacity**



Source: Rystad Energy, Itau BBA

**Brazil's Share in World Export**



Source: UN Comtrade, ResearchGate, OCE, USDA

Brazil is also a major player in the commodities sector and one of the world's largest producers and exporters of agricultural products, such as soybeans, corn, coffee, sugar, and beef. It has significant reserves of minerals, including iron ore, gold, and bauxite, making it a leading exporter of raw materials. Brazil's vast natural resources, abundant land area, and favourable climate provide it with a key natural advantage in producing these commodities. To support the increased production and exports of these commodities there is a need for considerable investment in infrastructure such as roads, rail and ports. These can offer compelling investment opportunities for infrastructure investors like UEM.

## A decade of ups and downs

Over the past decade, Brazil has undergone significant economic and political changes. After weathering the Global Financial Crisis in 2008 better than many other countries, Brazil was hailed as a poster child for economic growth and expected to become a rising global power. The country boasted a growing middle class, successful social welfare programs, and an expanding economy. However, Brazil struggled to maintain its momentum and, from 2013 onwards, faced a growing fiscal deficit, rising inflation, and a shrinking economy.

However, the 2016 impeachment of President Dilma Rousseff marked yet another turning point for Brazil. Her removal from office followed a long-standing economic and political crisis and widespread public protests over corruption and mismanagement. Her successor, Michel Temer, implemented market-friendly policies and reforms, including a labour reform and a constitutional amendment capping public spending. The latter aimed to stabilise the economy and restore investor confidence, after seeing the country's debt-to-GDP ratio increase from 51.5% in 2013 to 73.7% in 2017.<sup>(2)</sup>

In 2018, Jair Bolsonaro, a right-wing politician, was elected and continued the market-friendly reforms initiated by Temer, pursuing a range of economic policies to promote growth and reduce government intervention. These policies included a major pension reform, the independence of the Central Bank, a privatisation program, and a series of measures to reduce bureaucratic red tape and promote investment in infrastructure. These include:

- Water Reform - promote private investment in the sanitation sector by establishing clear guidelines for public-private partnerships and concessions. Universalisation goals set for 99% access to potable water (vs. 84% today) and 90% sewage collection (53% today) by 2033. It is estimated that Brazil will need over USD 160bn in investments to reach this target, and in the first two years of this framework, USD 16bn in private investments was secured.<sup>(3)</sup>
- PPI, or the Investment Partnerships Program, initiative to attract private investment in infrastructure projects, including the auctioning of concessions for highways, airports, ports, and other infrastructure projects. In 2022, PPI recorded 48 completed projects, resulting in over USD 20bn in investment. This included the privatisation of Eletrobras (held by UEM), the largest energy company in Latin America, and the seventh round of airport concessions which resulted in USD 3.4bn in private investments for the airports sector.<sup>(4)</sup>
- BR do Mar - despite Brazil having almost 8,000km of coastline and 80% of the population concentrated in coastal regions, coastal shipping represents only 11% of the cargo transported in the country. Law No. 14,301 included a series of measures aimed at increasing the participation of this transportation method in the national logistics matrix from 11% to 30%, fostering growth opportunities in local container terminals.<sup>(5)</sup>

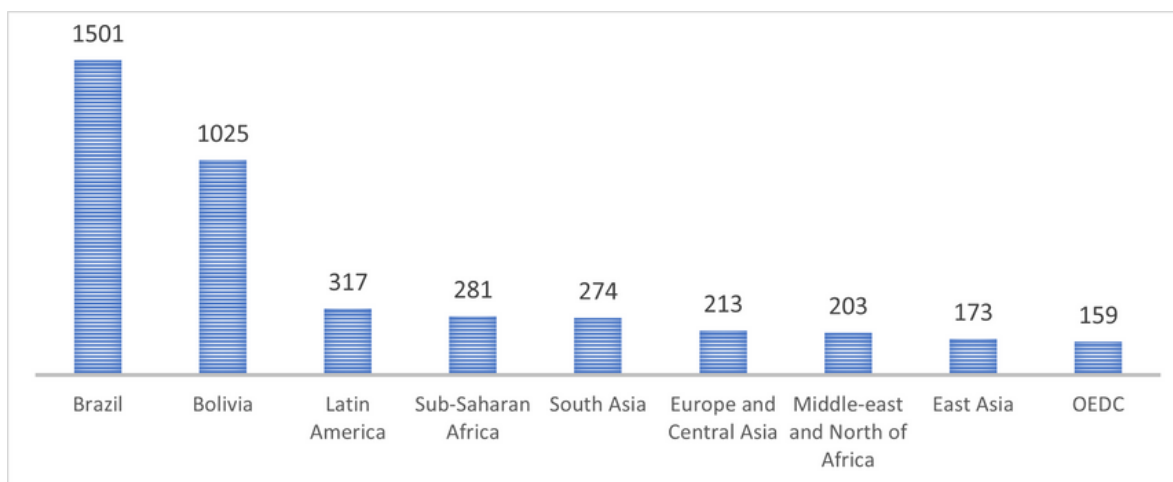
In October 2022, Brazil held its presidential, congressional, and gubernatorial elections, revealing a deeply divided and polarised country, particularly in the presidential race. Ultimately, former President Lula won the election with 50.9% of the votes, while centrist and centre-right parties secured a majority in Congress, crucial for maintaining checks-and-balances.

Within weeks of the election, market sentiment was roiled by Lula and the new government as it made negative statements on the previous reforms, in particular attacking the spending cap framework. The appointment of politically-aligned individuals to technical positions and the approval of fiscal packages to expand social programs raised concerns about the country's fiscal accounts, causing the local market to fall by over 10% in Q1 2023. Expectations of interest rate cuts were pushed back, leaving the country with one of the highest real interest rates in the world. However, this is having a noticeable effect on inflation, and with rates at 13.75% there is significant scope for interest rate cuts which could lead to the equity market rerating.

## Tax reform – the one to watch:

The most significant reform under discussion this year is on taxation. The Brazilian tax system is an extremely complicated, costly and inefficient mess. Brazilian companies spend 1,501 hours per year preparing and paying taxes, much more than the average in Latin America (317 hours) or OECD (159 hours).<sup>(6)</sup> This is highly inefficient and directly impacts private investment and ease of doing business.

## Number of Hours per Year Preparing and Paying Taxes



Source: Doing Business, The World Bank

The objective of the Consumption Tax Reform, which is expected to be voted on this year in the Brazilian Congress, is to simplify and rationalise taxation on the production and sale of goods and services. Currently, the Brazilian tax burden is at 32.4% of GDP, with industrial and commerce sectors the most affected. The proposal aims to consolidate taxable bases into two new taxes: (i) a tax on goods and services (IBS), similar to the value-added tax (VAT) in most developed countries; and (ii) a Selective Tax, which is a specific tax on some goods and services. It is estimated that the proposed changes could boost GDP by 12 - 20% over the next 15 years.<sup>(7)</sup> It is also expected that there will be an Income Tax Reform, which may see the creation of a tax on dividends, offset by a reduction in the corporate tax rate, incentivizing companies to invest more in the local economy.

## Outlook for Brazilian Equities

UEM has an overweight position in Brazil compared to MSCI EM, with exposure at the end of March 2023 at 20.9% versus the index at 4.9%. Despite Brazil's political and economic volatility, UEM's Brazilian holdings have consistently delivered strong results. We see promising opportunities for bottom-up, long-term investors in Brazil's infrastructure space, with over 80% of UEM's Brazilian exposure in comparatively defensive sectors or those tied to export-oriented infrastructure assets that have demonstrated solid operational results and robust growth potential.

UEM believes that Brazilian equities are trading at extremely attractive valuations, which will likely return to historical averages when investors become more confident in government policies towards the fiscal accounts, and the Brazilian Central Bank initiates an easing cycle. Currently, local interest rates are at 13.75%, implying an interest rate in real terms of over 7.5%,<sup>(8)</sup> which is among the highest in the world. These rates are detrimental to economic activity, which should help to control inflationary pressures and allow the Brazilian Central Bank to signal a change in monetary policy in the coming quarters.

While UEM recognises that there is significant political and economic uncertainty in the short term, the Brazilian market offers substantial upside in the long term due to a combination of attractive valuations and strong company growth dynamics. If there is an improvement in the macroeconomic scenario, these holdings should see further upside that is not factored into our base case.

UEM's three largest Brazilian holdings exemplify the attractiveness of infrastructure investments in this country:

### **1- Alupar (#3 of UEM portfolio – Mar/23):**

Alupar is a private power transmission company with 30 transmission assets and a 7,964km electricity network. About 90% of Alupar's revenue is related to transmission which is remunerated by 30-year fixed revenue concessions with annual inflation adjustments, providing predictable long-term cash flows. The company also has 674MW of hydro, wind, and solar generations assets. Alupar has three projects under construction and is well-positioned to benefit from upcoming transmission auctions, with a solid track record in capital allocation and a robust balance sheet.

### **2- Orizon (#4 of UEM portfolio – Mar/23):**

Orizon is a leading waste management company in Brazil that operates 15 sophisticated landfill sites called "ecoparks" offering biogas extraction, recycling, materials processing, and waste-to-energy services. It generates carbon credits due to its collection and use of biogas, which significantly reduces greenhouse gas emissions. Orizon's core business of waste processing has high barriers to entry for new competitors, and significant growth opportunities with the recently approved Sanitation Legal Framework requiring that cities properly dispose of their waste. About 40% of solid waste generated in Brazil in 2020<sup>(9)</sup> was still disposed of in ways that do not comply with applicable regulations. Orizon is one of the few operators with the skillset and capacity to invest in upgrading facilities to the required standards. Orizon expects to process 10 million tons of waste by 2024, which represents over 10.2% of market share in this highly fragmented market.

### **3- Rumo (#14 of UEM portfolio – Mar/23):**

Rumo is the largest railway operator in Brazil, with 13,500 km of rail network through 5 concessions operating primarily in the states of Mato Grosso and São Paulo, where it serves as the best logistics solution for agricultural exports. Over the past two decades, Brazil has consolidated its position as a major producer of agricultural commodities becoming a top-5 producer of 34 commodities and the largest net exporter in the world,<sup>(10)</sup> with export growth typically correlated to global growth, especially from China. Brazil is also the largest country in arable land and is among the few countries with the potential to increase agricultural productivity,<sup>(10)</sup> meaning that Rumo will be well placed to benefit from this in the future. Furthermore, Rumo continues to expand its network (constructing the Lucas do Rio Verde rail extension of the Paulista concession) with phase 1 is under construction to build 211km of track, taking 3 years until 1Q26, which will capture additional volume from Mato Grosso state, Brazil's largest producer of corn and soybeans where over 60% of its production is exported.<sup>(11)</sup>

## Eduardo Greca

18 April 2023

Source Data: ICM Limited. Factset as of March 31st 2023, Rumo/Alupar/Orizon website as of March 31st 2023.

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\*Total return is calculated based on undiluted Net Asset Value, plus dividends reinvested and adjusted for the exercise of warrants and subscription shares

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