



actis

Macro Forum insights
and perspectives

September 2016

Welcome

In this issue of our Macro Newsletter, we will share some more insights from the Actis Macro Forum, a group composed of professionals from across our regions and from each of our three business units, Energy and Infrastructure, Private Equity and Real Estate. The focus this time is on Brazil and India, but we will be re-visiting Africa in our next issue when we hope there will be more clarity around the situation in Nigeria and South Africa, two markets seeing significant political and FX volatility at this point. As usual, we conclude with an update on our perspectives on EM FX post Brexit.



Andrew Newington
COO,
London



Ali Mazanderani
Financial Services,
London



Bruno Moraes
Energy,
Brazil



Pratik Jain
Financial Services,
India



Stuart Jackson
Knowledge & Information,
London



Sherif Elkholy
Consumer,
Egypt



Max Lin
Consumer,
China



Janet Van Niekerk
Knowledge & Information,
South Africa



Hilaire Dongmo
Real Estate,
London

Brazil

Plus ça change...

Bruno Moraes

Energy, Brazil

bmoraes@act.is



*"Those who do not remember the past are condemned to repeat it",
George Santayana*

On Wednesday, August 31st, 2016, after a 3-day session, and with a clear majority of 61 votes to 20, Brazil's Senate officially impeached Dilma Rousseff, making her the second President in Brazil's history to be removed from office. Mrs Rousseff had been suspended from her presidential duties in May 2016.

The impeachment proceedings were based on allegations that Mrs. Rousseff committed fiscal crimes when she (i) amended certain decrees without Congressional approval, which sought to provide more budgetary flexibility and (ii) adopted certain accounting practices that concealed Brazil's worsening fiscal deficit.

The impeachment process attracted widespread public support, particularly after Judge Sergio Moro unveiled the "Car-Wash" (Lava Jato) scheme, the largest corruption scandal to hit Brazil, involving state-owned companies, political parties, local conglomerates, pension funds and other related entities.

Temer's three pillars

Following the President's suspension in May, Vice-President Michel Temer took on the Presidency on an interim basis, and will now serve in that office until the expiry of Mrs Rousseff's original mandate in 2019.

Mr Temer's government program is anchored on 3 main objectives:

1. Maintenance of social benefits for lower-income people
2. Coordination of fiscal and monetary policies
3. Recovery of market confidence.

On his first day as president, Mr Temer declared full support for continued investigation of the Car Wash scandal and appointed Henrique Meirelles (former president of Brazilian Central Bank) to head the Ministry of Finance. Mr. Meirelles promptly pulled together a respected technical team to execute the reform plans, which local markets took to calling the "Dream Team".

In a first step towards reducing public expenditure, the number of Government ministries has been reduced by over 30%. Temer and his new finance minister have also sent to Congress a constitutional reform bill, which aims to limit the rate of annual public spending growth to the previous year's inflation rate. Simultaneously, the finance team also started working on Social Security reform, the main goals being to increase the retirement age and decouple social benefits from the official minimum salary. All of this has helped forecasters to estimate a 20% decline in the annual budget deficit from 2016 to 2017.

The reaction to the Car Wash scandal has been seen in zero public tolerance for corruption, with new laws passed imposing tighter rules on procurement and bidding processes carried out by state-owned companies as well as prohibiting the appointment of politically connected persons as officers for such companies.

Positive Market Reaction

On the ground and in the response of the capital markets, the various initiatives we have seen to date have contributed to a return of some optimism to the country. Risk perception has decreased substantially. Brazil's sovereign bond has seen a notable yield compression, the BRL has also seen a significant recovery, and so has the Bovespa index, which has returned to the 55,000+ level, representing an increase in USD in excess of 50% YTD. Inflation is expected to end the year at around 7.5%, which is a significant reduction from the 10.7% at end of 2015, providing room for interest rate cuts from 2H16 onwards.

Cleaning up the "Car-wash"

As Eisenhower warned, **"a people that values its privileges above its principles soon loses both"**. The Federal Justice Department has certainly taken this maxim on board in the way it has sought to tackle the corruption exposed in the Car-Wash scandal. In March 2014, Federal prosecutors and Federal Judge Sergio Moro started investigating a chain of car service stations suspected of money laundering activities, but soon afterwards expanded their enquiry to become the largest corruption investigation in Brazil, looking at over BRL6bn in alleged bribes, money laundering and contractual fraud benefiting individuals, companies and certain political parties.

Over the past 2 years, the prosecutors have traced the sources and uses of funds, both in Brazil and abroad, which has led to the arrest of several CEOs, officers and directors of some of the largest Brazilian conglomerates, as well as former executives of state-owned companies and politicians. Other important public personalities, including former president Luis Ignacio "Lula" da Silva, have been taken in by police for questioning and remain under suspicion.

Altogether, 166 people have already been arrested, out of which 56 have agreed to plea bargains and 5 companies have agreed to leniency agreements after the payment. A total of BRL37.6bn have been applied in fines, out of which BRL2.9bn have already returned to the Government.

The Olympic effect

The eyes of the world turned to Brazil in August, as the country hosted the Olympic Games, the first in South America to host the Games. Although surrounded by scepticism and doubt from the outset, Brazil delivered 2 weeks of thrilling competition and its trademark hospitality. While Rio may not have followed Beijing and London in attracting the traditional IOC send-off as the “best games ever”, there is no doubt that it significantly exceeded both domestic and international expectations. And for the local population, Brazil registered its best performance ever in the Olympics with 18 medals, 7 Gold, 3 Silver and 8 Bronze including winning the football gold to complete the picture.

What comes next?

Optimism remains high that after a very difficult period, Brazil will emerge from its current economic problems and return to strong growth. This is not going to be simple, and the next 12-18 months are likely to continue to be challenging, and pressures on the consumer are evident in the performance of many businesses in Brazil, including some of our own investee companies. However, the emergence of an educated and more affluent middle class continues, and we see this in increased enrolments in our education businesses and in growing demand for consumer credit and investment management services in our investments in the financial services sector. The change in leadership, together with the achievement of substantial progress in the program of fiscal and social security reforms, as well as the conclusion of the “car-wash” operation can put Brazil firmly back on track, but we know there will be plenty of bumps along the road to a full return to health and prosperity.



Editorial Credit: Aleksandar Todorovic

India

A beacon of hope and stability

Pratik Jain

Financial Services, India

pjain@act.is



As we highlighted at our Annual Investor Meeting back in April, India has been enjoying a period in the limelight as a beacon of hope and relative stability in a global economy that has seen a significant uptick in political volatility through the course of 2016. The economy is growing strongly, with forecast GDP growth for 2016 at 7%+, and with a reform-minded Government and a results-oriented Prime Minister in place, India certainly seems to merit some of these plaudits.

It was certainly reassuring to see the uncertainty surrounding the leadership of the Reserve Bank of India resolved with the appointment in late August of Dr. Urjit Patel to succeed Rajan. His appointment should help in maintaining the RBI's credibility as an independent central bank with a clear focus on the management of inflation in the economy. From the Actis perspective, we see the economy remaining finely balanced with declining exports, weak investment growth, continued concerns around non-performing loans in the banking system and inflationary pressures, which we hope to see mitigated through declining food prices resulting from this year's better monsoon season.

Over the next 3-4 years, we see GDP growth continuing in the 6-7% range driven by themes that are familiar across many of our markets – favorable demographic trends, the emergence of the middle class and continued export growth as India remains competitive in international markets as labour costs continue to rank among the lowest of the major growth economies.

Will GST finally arrive?

One of the most significant recent reforms has been the introduction of the new federal Goods and Services Tax (GST), which is planned to come into effect with the passing of the GST bill in April 2017. India currently has a complex indirect taxation system with multi layered taxes on interstate movement of goods, which distorts incentives and creates inefficiencies for businesses. Successive governments in India have tried to introduce a uniform GST, which is a national Value Added Tax.

While the April 2017 deadline appears challenging, the introduction of this tax is a strong indication of the Government's commitment to reform, and of the importance of addressing the bureaucratic obstacles that exist to the creation and exploitation of a unified domestic market in a country with a population rapidly closing in on 1.5bn people. If and when implemented, GST will move the basis of taxation from the state of manufacture to the state in which the sale takes place, thereby hopefully improving collection rates and shifting the tax burden to India's wealthier states. At the same time, it should eliminate some of the reasons behind the development of India's unwieldy logistics network that today sees warehouses and supply chains planned to meet the requirements of the tax system rather than to optimize distribution efficiency. From the consumer perspective, the biggest advantage would be in a reduction in the overall tax burden on goods, which is currently estimated at 25%-30% leading in turn to an increase in consumer demand and helping to mitigate inflationary pressures.

Implementation is not without its challenges though, and while our portfolio companies are preparing for the new regime, they are evidently in a minority, with recent surveys suggesting that less than a third of Indian companies are currently getting ready for the implementation of GST. We do see evidence of efforts by the Government to address this evident lack of urgency, but with Infosys still to demonstrate that they will be in a position to implement the national IT infrastructure in time for the 2017 deadline, many Indian businessmen remain highly sceptical and have adopted a "wait and see" attitude.

When it rains it pours...

With almost half of the country's farmland being rain fed, the June to September monsoon is critical for the health of Indian agriculture. India receives 80% of its total rainfall during the monsoons and two consecutive years of poor rainfall have led to a drought in many Indian states and negatively impacted rural incomes and consumption.

Happily, 2016 has seen above-average rainfall, in line with the Meteorological Office forecasts of 107% of the long term average. A normal monsoon, besides boosting rural incomes and keeping food inflation under check has multiple flow through benefits including boosting credit demand, vehicle sales and consumer sentiment in the country, and we are already seeing this in the strong performance of our industrial companies, notably Endurance with its dependence on the two-wheeler market.

So on balance we see valid reasons for optimism. Supply-side bottlenecks in key sectors such as energy do continue to pose a risk to the continuation of India's improved economic growth, but these also present opportunities for those in a position to capitalize on the Government's emphasis on reform in these sectors. Through our existing Ostro investment and now as we look ahead to the next generation of investments from our new Energy funds, we will continue to invest in India's energy infrastructure to help address this constraint.



Editorial Credit: NOWAK LUKASZ / Shutterstock.com

Predicting everything but the future

Ali Mazanderani

Financial Services, London

amazanderani@act.is



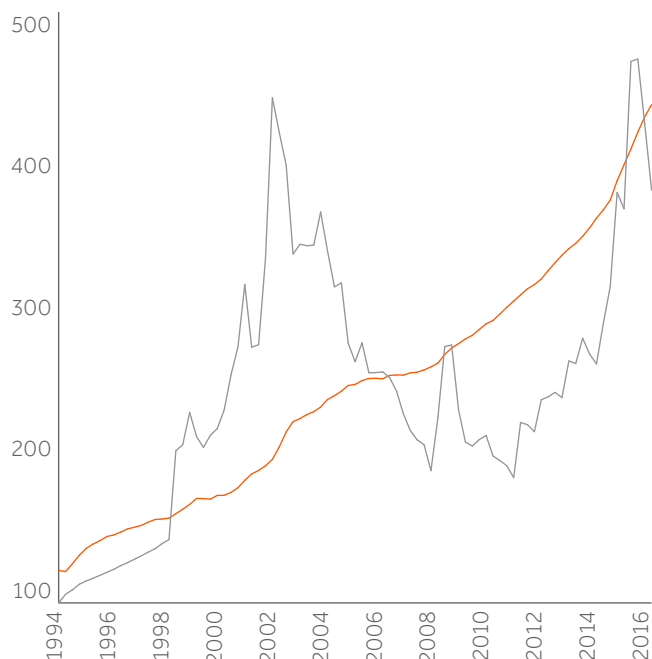
On the 24th of June, the experienced growth market investor could not help but feel a little bemused at the number of shellshocked faces around the post-Brexit breakfast table. The 30% nosedive in the Nigerian Naira, just 4 days prior to the Brexit referendum, made the 10% decline in Sterling seem positively subdued. However, it certainly served to remind us all that foreign exchange dislocations are not the exclusive preserve of growth markets, and at the same time reinforced our conviction in the value of anchoring our perspectives on foreign exchange on longer term fundamental value.

From south to south, the second quarter of the year saw EMFX movements significantly influenced by political developments, albeit that unlike the previous few quarters, this time the yo-yo went up as well as down. Both of our more liquid currencies, the Brazilian Real and South African Rand appreciated strongly, both from undervalued positions, buoyed by signs of improving democratic accountability in the respective countries. The renewal of optimism linked to the Rousseff impeachment in Brazil covered elsewhere in this issue, contributed to the Real going from R\$4 to R\$3.2, and the Democratic Alliance's success at local elections in South Africa under-pinned a recovery in the Rand from ZAR16 to ZAR13.2. The subsequent standoff between President Zuma and his finance minister has reversed some of the gains in the Rand, which our model suggests remains one of the most under-valued currencies in our markets.

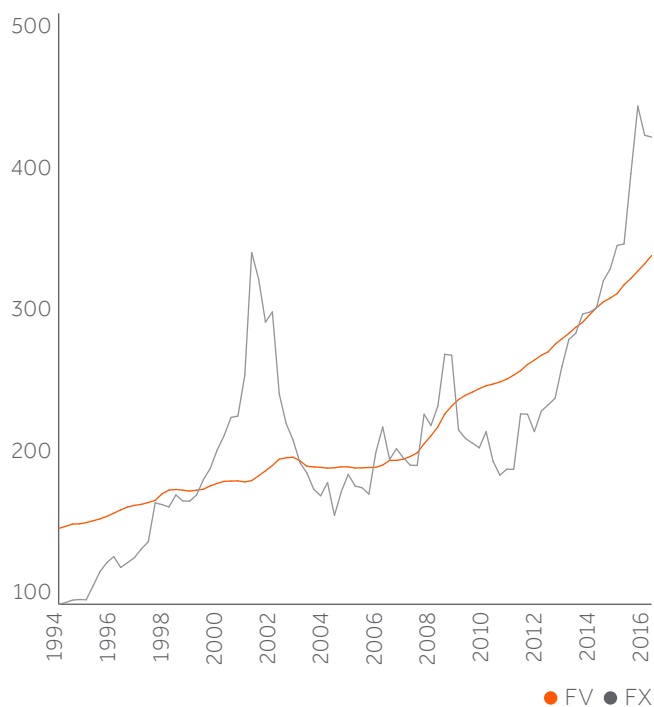
Q2 also saw the continued build-up of pressure on the Nigerian Naira and the Egyptian Pound, both of which have been defiantly overvalued for some time. While Bukhari reluctantly but sensibly accepted the inevitable and bowed to this pressure, his counterpart in Egypt, President Sissi appears intent on sticking it out for now. Our model suggests the Naira is now approaching its fundamental value, while maintaining the Egyptian Pound at current levels will require the IMF and the Gulf States to bridge the black market spread, a tricky circle to pyramid.

The Yuan and Rupee will both make for intriguing watching over the coming months. Rajan passing the baton to Patel reinforces the importance and focus on maintaining the Reserve Bank of India's inflation discipline, potentially increasing pressure on the Rupee. Meanwhile, a move in US interest rates will likely put increased pressure on the Yuan, compounded should China report slowing growth. However, and just as Sterling felt the impact of political upheaval in the aftermath of the Brexit vote, we continue to believe that the Federal Reserve will have difficulty justifying an increase in interest rates in the immediate short term. This is less as a function of disappointing seasonal jobs data and perhaps more as a reflection of the risk of any tightening in US monetary policy being decisively Trumped in November.

Real



Rand



Source: Bloomberg and Economist Intelligence Unit

For more information, please contact:

Stuart Jackson

+44 (0) 207 234 5154

sjackson@act.is



- Actis office
- Countries in which Actis has invested since 1998
- Other Actis target markets since 1998

