

# panorama

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## Brazil Insolvencies



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Activity in Brazil remains lackluster, inflation stands above the target, interest rates are among the highest in the world, confidence remains at a low level across a variety of indexes and the well-known low investment ratio continues to deteriorate. What is the impact on companies' payment capacity?

The aim of this report is to measure insolvency in Brazil, extract evidence of increasing cases and to verify which are the more sensitive segments. It is worth noting that we use Chapter XI as the parameter throughout this report. Chapter XI was established in the country in 2005, through the New Law of Bankruptcies (number 11.101) and emphasizes the uplift of viable businesses that are experiencing difficulties and trying to avoid bankruptcy (Chapter VII).

Firstly we will present a general overview of the macroeconomic scenario in Brazil. The figures from the first half of 2014, along with forecasts for the upcoming months, will help in understanding the insolvency panorama and the country's insolvency behavior.

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

Finally, we will conclude this report with our expectations for the short and medium terms, with Coface's forecast in terms of GDP and, in particular, our ex-

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# Activity is not taking off

The economy fell into a technical recession in the second quarter of the year. GDP fell by 0.6% compared with the previous quarter, while it dropped by 0.2% in the first quarter. On the demand side, the private segment was mainly responsible for the weak performance. Household consumption increased by 0.3% only against 4Q2013, after a negative print in Q1 (i.e. the first one since 2011). The main reasons were lower consumer confidence and high pressure on prices (12 month accumulated inflation was at 6.15% in March 2014). The rise in interest rates also played a negative role, increasing the cost of new loans.

Moreover investments fell strongly, dropping by 5.3% compared to the previous quarter. This is the most worrying point, as Brazil already holds a low ratio of investments per GDP. It fell from 18.4% in 2013 to 17.7% in the first quarter of 2014. Admittedly this disappointing Q2 figure partly reflects temporary factors, as many workers stayed home to watch the football world cup, but this highlights structural weaknesses as well. The country has serious bottlenecks in its infrastructure and improving investments is key to its strong and sustainable growth rhythm. The recent deterioration is explained by low savings rates, the decline in business confidence, the rise in interest rates and the presidential elections in October. Elections usually cause uncertainty among entrepreneurs, due to their concern over possible changes in economic policies.

On the supply side, the agro segment posted positive growth (+0.2% q/q), thanks to record crops and higher cattle production. But on the other hand, services reported a fall of 0.5% q/q, while industry contracted by 1.5%. Industry in the country has long been suffering from high levels of bureaucracy, poor infrastructure and fierce competition from imported products.

However, the first figures for the third quarter show signs of a weak recovery. For example, industrial production increased by 0.7% m/m in July, after having contracted by 1.4% m/m in June 2014 and by 0.6% in May. The government recently decided to maintain some tax incentives for some sensitive industries, such as automobile and furniture, but the positive effect of this measure will probably be offset by low consumer confidence and deteriorating credit conditions. For instance, inflation continues to accelerate on a 12 month accumulated basis, surpassing the target ceiling of 6.5% in June.

Credit growth has been slowing down, achieving 11.8% over the 12 months accumulated until June 2014, against an average of 19.3% over the last six years. This behaviour is mainly explained by the rapid growth observed in recent years, rising interest rates (Selic rose 3.75 p.p. in one year), lower investment rates and declining consumer confidence.

According to the Brazilian Central Bank, the corporate average delinquency rate stood at only 3.4% in June 2014 (+0.3 p.p. in the year). Considering individual delinquency, it was 6.5% in June 2014 (0.2 p.p. in the year).

It is worth noting that the credit delinquency rate is not a good proxy for our type of business. The reason is that banks are usually the last ones to be affected by companies with financial stress, as the cost of late payment is much higher than the conditions normally imposed by suppliers.

(1) Selic is the reference interest rate controlled by Central Bank

(2) Delinquency rate: operations with delays longer than ninety days

# Insolvency

Chapter XI was established in Brazil in 2005, under the New Law of Bankruptcies (number 11.101). It is a measure for trying to avoid Chapter VII<sup>(5)</sup> 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 gives the dispatch. The company then has 60 days to submit a recovery plan to the justice department. The judge then discloses the details of the plan to the creditors, who then have 180 days to approve or reject it. If approved, the debtor gains Chapter XI status. The company continues to operate normally during this recovery period.

Chapter XI closes when the company meets all the requirements laid down in the recovery plan. However the statistics show that few companies are able to rebuild themselves. According to a study published by Corporate Consulting in 2013, it is estimated that from around 4,000 companies that filed for Chapter XI since the law entered into force, only 1% have actually emerged from the recovery process. Just over 10% became bankrupt (Chapter VII) and the remaining ones continue to operate with weak financial health. Experts believe that two years is a reasonable period for a company to complete a Chapter XI, but there are companies that remain in recovery for eight years.

As can be observed in chart 1, the number of companies that filed for Chapter XI has grown significantly in recent years. Due to the country's low level of activity and the difficulties faced by industry to remain competitive, Chapter XI has become an increasingly used mechanism by companies in different sectors.

In 2012, when industry contracted by 0.8%, there was a growth of 49.5% in the number of companies that filed for Chapter XI. During 2013, this increased by a further 17.2%. The data for the 12 months accumulated up to April 2014 shows a decrease of 11.5%, however it is still too early to consider a rebound. The economic indicators lead us to forecast a continuing weak scenario for enterprises.

Chapter VII cases that had been falling since the creation of the new Bankruptcy Law grew significantly in 2009 and then fell again until 2012. In addition to Chapter XI, bankruptcy also began to increase again and closed 2013 with a high of 5%. In the 12 months accumulated until April 2014 was observed a high of 3.1% compared to the period immediately before. The recurrent growth since 2012 is also influenced by the number of cases of companies that remained in Chapter XI for years and failed to recover.

CHART 1



Source: Serasa

(5) 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.

# Sector Analysis

The marginal fall in the total number of companies that filed for Chapter XI in the year until April 2014 does not reflect the situation in all sectors. Chemicals, the food industry, textiles and clothing and services to individuals observed increasing insolvency in comparison to the previous period.

TABLE 1

Chapter XI			
Sector	Number May 2013-April 2014	Change	Share
Automotive and Transport	109	-12%	12%
Chemicals	49	4%	6%
Construction	52	-2%	6%
Distribution	168	-9%	19%
Electronics and IT/Telecoms	12	-57%	1%
Food Industry	76	46%	9%
Textiles and Clothing	30	7%	3%
Services to Individuals	259	2%	29%
Other Services	24	-	3%
Paper/Wood	69	-3%	8%
Minerals	34	-15%	4%
Total	882	-3%	100%

Source: Serasa

## Automotive and Transport

Chapter XI filings are not very significant, as they correspond to only 12% of all cases and especially when considering the high representation of the automobile industry in the Brazilian industry as a whole. According to ANFAVEA<sup>(6)</sup>, the segment accounted for 21% of industry GDP in 2012. Nevertheless the drop of 12% should not be observed in the next period. The sector has been facing difficulties since the beginning of 2014, due to the rise in vehicle prices (new security measures and taxes reinstatement), less favorable credit conditions and the international reserves crisis faced by Argentina (the main destination for the sector's exports).

## Chemicals

The number of companies that filed for Chapter XI is not very representative, as it is the second in importance in the country's industrial GDP (only 6% of the total cases). The high of 4% observed in the period is in line with increasing difficulties faced by this industry. For instance, its production decreased by 7.07% in the four first months of 2014 and the chemical trade deficit reached 14.3 billion USD

in the first half of the same year. The main reasons were the high dependence on imported natural gas, the shale gas revolution in the USA and Brazil's relatively high energy costs. Competitiveness gains are not expected in the medium term and companies will continue to face tight margins in order to maintain sales.

## Construction

Chapter XI cases fell by 2% between April 2013 and April 2014, remaining virtually stable in the period. The segment observed highs of 1.4% and 1.7%, in 2013 and 2014 respectively. Despite this, the figures for the first quarter of 2014 reveal a contraction of 2.3% in comparison to the period immediately before. It has lost dynamism due to the delays in infrastructure works and lower business confidence. No significant improvement is expected in the upcoming periods. In the first half of 2014, sales of construction materials contracted by 3.5% compared to the same period of the previous year. The high release inventory has also worried housing constructors. In São Paulo, the biggest city in the country, inventory reached 19,982 units in May, with a high of 16.3% in the interannual comparison. In the meantime, sales of new homes and releases accumulated decreases of 41.4%

(6) Anfaeva is the Brazilian National Association of Automobile Manufacturers.

and 14%, respectively. This movement has also impacted the average price per square metre of real estate in Brazil. It decelerated for the sixth consecutive month in May 2014, a 12 month accumulated decrease of 11.38%, according to the FipeZap index.

## Distribution

This segment includes a significant range of companies, so the high representation (19% of total cases) is within the expected figures. Despite the decline of 9% during the period analyzed, the trend should not be maintained (a stability scenario is most likely). Distribution also covers companies in the retail segment, which for many years grew at a very fast pace but has decelerated in recent months. The main reasons for this are pressure over prices, higher commitment of labor income and increasing interest rates.

## Food Industry

Despite the low representation of companies in this sector that filed for Chapter XI in comparison with the weight of this sector to the economy, the high observed in the period was important, growing by 46% in one year. The explanation for this is linked to the increasing number of companies using this mechanism as an alternative to financial imbalances. For instance, the agro sector has been performing well since 2013, with record harvests and no major weather problems.

## Textiles and Clothing

This segment observed a high of 7% in the period and its share in the total cases is in line with its role in the country's economic activity. Over the following periods, insolvency may remain high. 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. The high tax burden on domestic producers also plays a significant role against local industry. Many producers have started to export their operations abroad, for example in Paraguay, to seek better business conditions.

## Service Sector

The service sector is by far the most representative one and

this result is in accordance with its meaningful weight in the country's GDP composition. Services are responsible for 59% of Brazilian activity. The depreciation observed in the period may be associated with the decline of the GDP growth rate, the high participation of small size companies (usually the first ones to be impacted by slowdowns) and higher interest rates. Insolvency is not expected to decline in the short term.

## Paper/Wood

Insolvency observed a slight decrease and its representation should be taken into account. Brazil is a significant global 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 should remain stable.

## Minerals

Covers a large portfolio of companies and its low participation in the delinquency rate may be explained by the fact that this segment includes big economic groups. These are usually less affected than smaller companies, as their bargaining power is higher and they can negotiate better credit rates and payment plans. Brazil is a major producer of iron ore and steel. Iron ore has been performing well, but international prices are not as strong as they were when China was growing by 10% a year. As concerns steelmakers, they have been facing the same difficulties as their international peers. As China is responsible for 50% of the world's steel production and consumption, the country determines prices, making it very difficult to compete with them. Insolvency should remain stable.

# Conclusion

GDP forecasts for 2014 have been declining on a weekly basis. Activity is not gaining momentum and is expected to increase by only 0.4% in the year. Admittedly a slight pickup in growth is expected in 2015, but its level will remain well below its long-term average.

Independently of who wins the presidential elections, next year will probably be marked by a series of adjustments to the economy's relative prices. Interest rates may be raised again to compensate for higher pressure over prices, arising from the reposition of oil prices and energy tariffs. Brazil's infrastructure needs to rebound in 2015, in order to increase activity in the medium term, while the economy should remain in slow mode for the present.

In accordance with the scenario presented above, insolvency is not expected to relent in the near future. Industry will remain the most affected side of the economy, as interest will probably experience further rises and the country's competition conditions are still very weak. Industrial production is forecast to contract in 2014.