ECONOMICS

February 03, 2017

BRAZIL – Credit Market

Will Deleveraging Limit Credit Growth?

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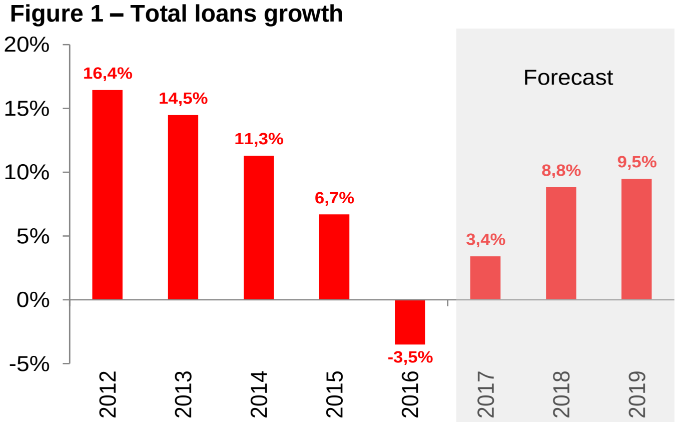
- **Declining interest rates are expected to contribute decisively to the Brazilian economic recovery, especially due to the positive impact on investment. However, there has been some skepticism towards the potential of rates as a driver of growth, which could be limited by the excessive leverage of companies.**
- **We believe this skepticism is somewhat exaggerated: in our view, most of the deleveraging process by firms has already taken place, which should enable resumption of credit growth in 2H17 and some acceleration in 2018.**
- **This opinion is based on five main arguments: (i) strong cyclicality of companies' revenues and financial indicators, which tend to recover quickly once the economy recovers; (ii) as interest rates have a larger impact on total debt service (compared with other countries), declining interest rates helps in Brazil more than in any other country; (iii) strong cyclicality of durable goods and investment, which are highly correlated to credit demand; (iv) banks are well capitalized, so the credit supply will increase when they become more comfortable that delinquency rates are under control; and (v) falling inflation and interest rates, together with some indicators pointing to the beginning of a recovery, will likely reignite confidence.**
- **Regarding the credit package announced by the government last December, we do not see it helping in the short term, but the measures are beneficial, and may be important in the medium term.**

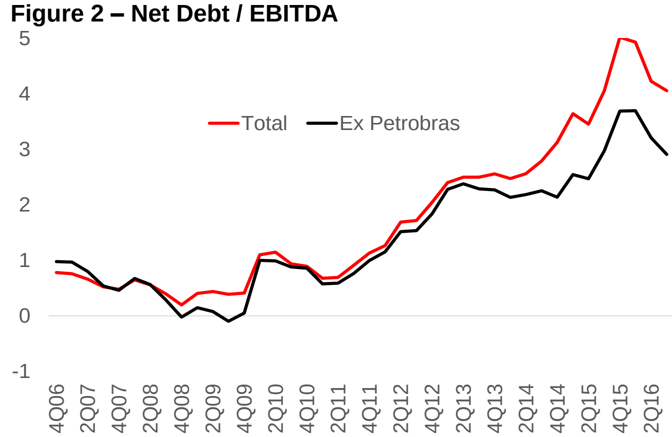
One of the most interesting aspects of Brazil's current economic backdrop is the rapid and substantial cut expected in the target overnight rate (Selic), which we and most market participants see reaching single-digit levels by year-end 2017. The potential impact of such monetary easing on growth depends on the extent to which it will be transmitted to lending rates, and on the pace of credit expansion under the lower interest rates – and these two points depend, ultimately, on the readiness of firms and individuals to take on new loans. In this regard, some analysts argue that the effect of lower rates on growth will be muted by firms' excessive leverage, which would heavily constrain credit expansion. We see merit in the argument; however, we are more optimistic than most analysts: in our opinion, that high leverage will limit, but not prevent, credit market expansion. In fact, we expect that total loans will increase again this year (although perhaps not in real terms), and accelerate in 2018.

Figure 1 – Total loans growth



Sources: BCB and Santander.

Figure 2 – Net Debt / EBITDA

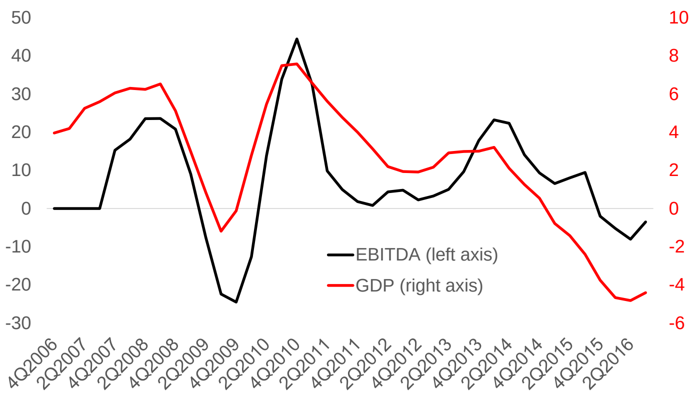


Source: BCB and Santander.

There are five main reasons why we think credit growth will accelerate faster than other analysts are expecting:

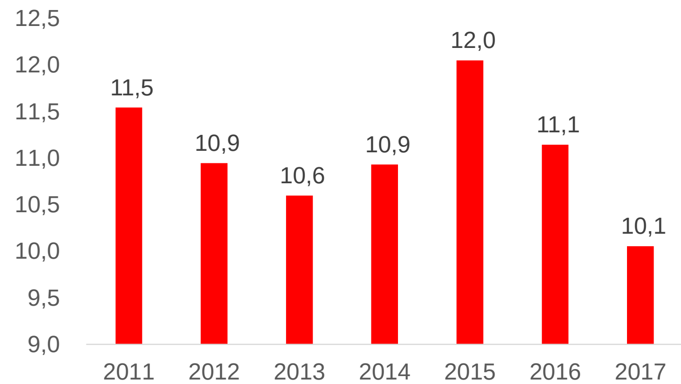
(i) Increased leverage is normal during crises due to the strong impact of the macro scenario on companies' revenues (which has an even greater impact on profits), especially in scenarios where interest rates are increasing (which was happening until 2015, when leverage reached its peak). Rising interest rates and declining revenues and profits led to deterioration in credit ratings which, in turn, have impacted credit conditions. Looking ahead, however, the ongoing decrease in interest rates combined with a cyclical recovery in revenues will cause, in our view, a rapid recovery in the financial indicators (for example, the ratios Net Debt/EBITDA and Debt Service/EBITDA), reversing this vicious cycle and allowing companies to contract new loans. The chart below shows the high correlation between EBITDA and economic activity for a sample of 30 companies, which is not a perfect proxy but helps to illustrate the point. In order to measure the impact on the financial indicators of both the expected cyclical recovery and the cuts in interest rates, we have forecasted the evolution of the debt service as a percentage of the Industry Revenues[1]. To do this, we have considered our hypotheses for credit expansion, industrial growth and the Selic trajectory. The result suggests that this ratio may decrease to a six-year low by year-end 2017. Indeed, according to our estimates, this indicator is already decreasing, as outstanding credit to Industrials contracted by some 10% (in nominal terms) last year.

Figure 3 – EBITDA X GDP (annual growth)



Sources: Economatica, IBGE and Santander.

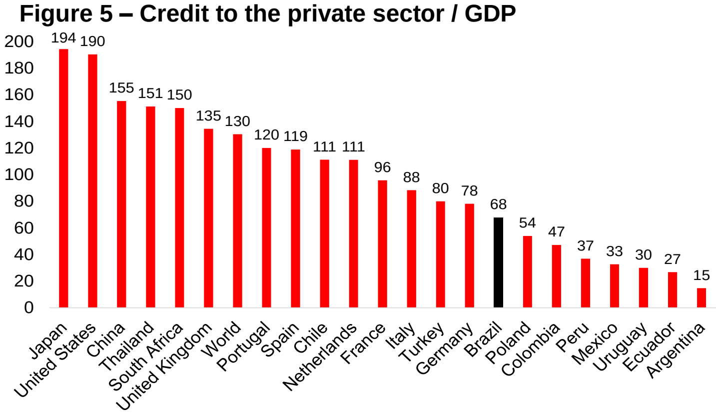
Figure 4 – Industry revenues burden with debt service (%)



Source: BCB, IBGE and Santander.

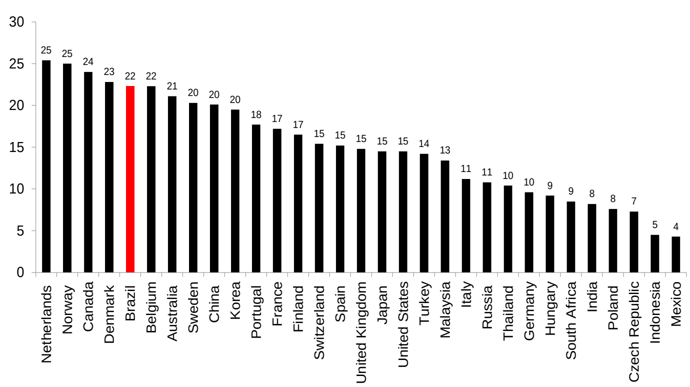
(ii) The process of deleveraging in Brazil may be shorter and less intense than in other countries for two main reasons. First, overall indebtedness is not particularly high, as can be noted by a comparison of outstanding credit to the private sector across several relevant countries. Second and also important, the debt burden in Brazil is more impacted by [very high] interest rates than it is in other countries. In fact, using households as an example, **interest payments account for 50% of total debt service in Brazil (versus an average of less than 20% in other countries), which suggests that the decrease in interest rates will have a bigger positive impact here than it would elsewhere.** It is also important to note that, when compared to other countries that have undergone sharp deleverage, interest rates in Brazil have a much higher starting point and a lot more room for cuts, which reinforces our view that an improvement in firms' and families' financial position tends to be less dependent on reductions in indebtedness.

Figure 5 – Credit to the private sector / GDP



Sources: World Bank.

Figure 6 – Debt service ratio (%)

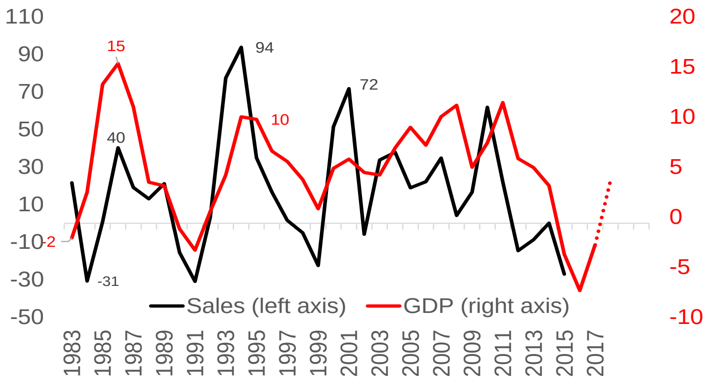


Source: BIS.

[1] We show the results for Industrials because it is the most leveraged sector, but we have found similar trends with the other sectors.

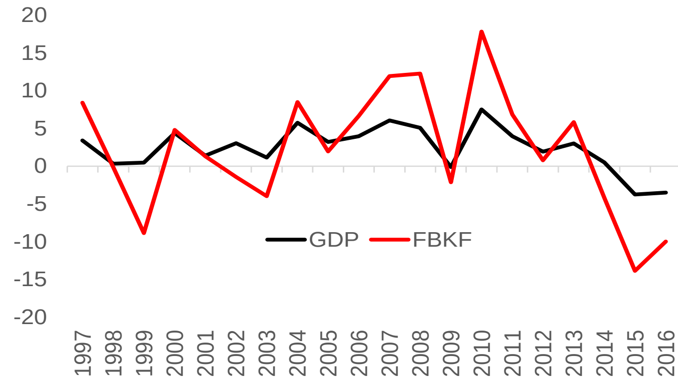
(iii) Two of the segments that represent a large share of the demand for credit – consumer goods and investments – are highly cyclical, which suggests that credit to these segments tends to respond well to any expected economic recovery in the coming quarters.

Figure 7 – GDP X Auto Sales (% cumulated in 12 months)



Sources: IBGE and Anfavea.

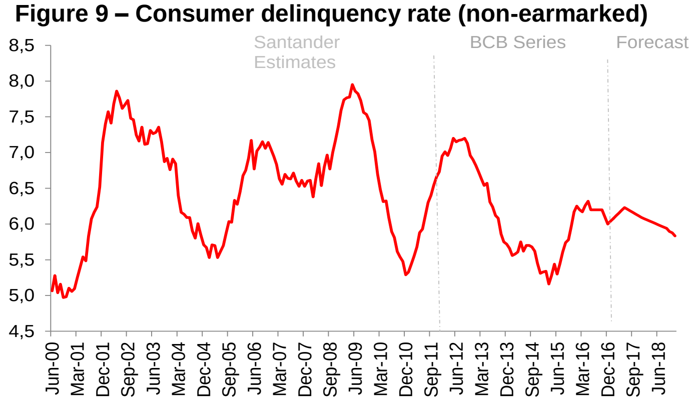
Figure 8 – GDP X Investments (annual growth)



Source: IBGE.

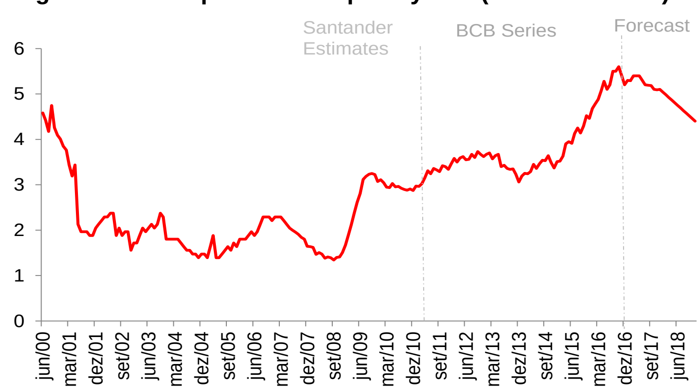
(iv) Banks are well capitalized, so there are no constraints for credit expansion on this side of the equation; we believe credit supply will increase when banks become reassured that delinquency rates are under control – in our opinion, this is likely to happen during the second quarter, as we expect the economy to resume growth in the first quarter.

Figure 9 – Consumer delinquency rate (non-earmarked)



Sources: BCB.

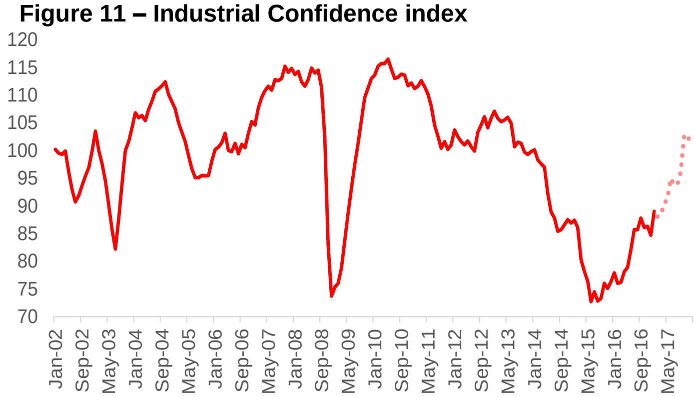
Figure 10 – Companies delinquency rate (non-earmarked)



Source: BCB.

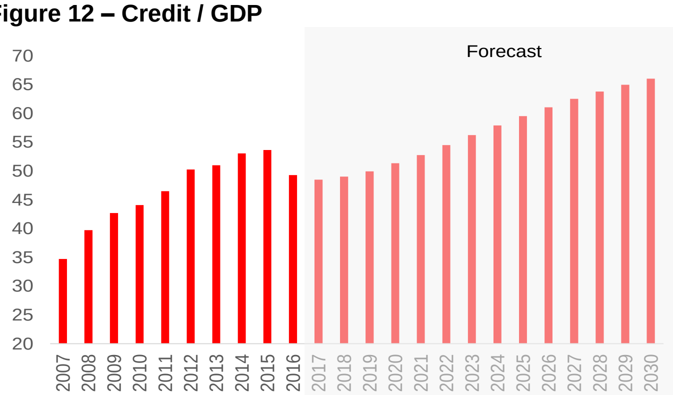
(v) Business and consumer confidence – a key ingredient for credit demand – will likely pick up, responding to lower inflation, declining interest rates, a stronger BRL and the early indications of an economic recovery. A leading indicator of confidence, which is already signaling a recovery, is the financial market: our model correlating some financial indicators (CDS, interest rates and BRL) with the industrial confidence index points to a strong recovery in the upcoming months.

Figure 11 – Industrial Confidence index



Source: FGV.

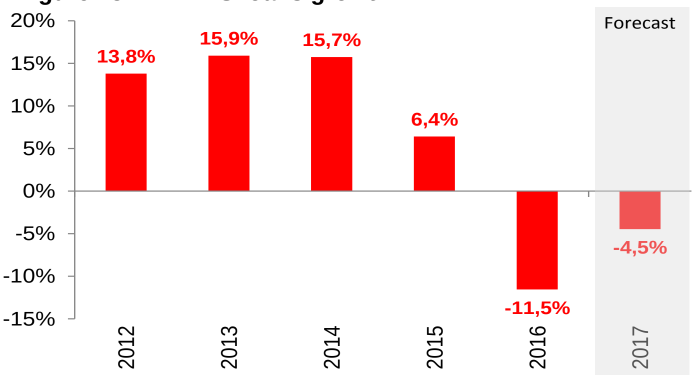
Figure 12 – Credit / GDP



Source: BCB.

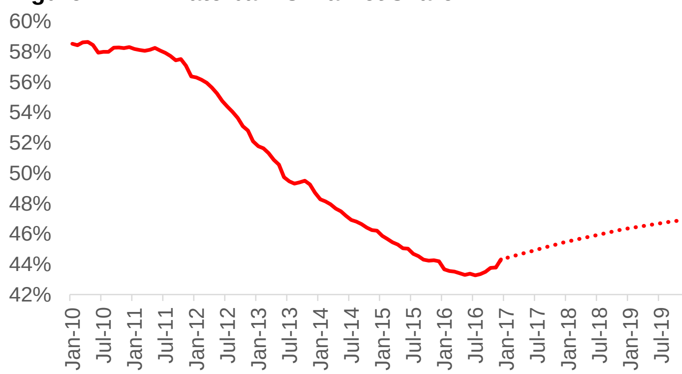
That said, it is important to reiterate that we are not declaring the deleveraging process to be over, but merely arguing that most of the impact was already felt in 2016. Indeed, total credit to GDP decreased 440 bps in 2016, and for 2017 we expect this ratio to decrease by another 80 bps, with an advance expected at some point in 2018. Also, in our view, public banks tend to be the most impacted by additional deleveraging, particularly BNDES, which will likely continue to see a decline in its credit portfolio. Thus, we expect that private banks will start recovering (albeit at a moderate pace) some of the market share lost over the last few years.

Figure 13 – BNDES loans growth



Source: BCB.

Figure 14 – Private banks market share



Source: BCB.

In terms of GDP growth, increased demand for credit is unlikely to have a large impact in 2017, considering not only the lagged effects of interest rates but also the fact that the ongoing monetary easing, as bold as it is, will only bring real interest rates to a point close to what is deemed as neutral at the end of this year. Therefore, we see reasons to expect most of the impact of the cuts in rates on GDP growth to materialize in 2018 – which is one of the reasons why we see a 3% GDP expansion that year.

Credit measures package:

In December, the government announced some measures addressing the credit market. These seem to be well conceived, in the sense that they may contribute to reducing the main problem in credit markets: asymmetric information. In our view, increasing information availability (accelerating the positive bureau implementation) or increasing collateral supply (implementation of the Interbank Payment Chamber) could play an important role in the reduction of Brazilian spreads in the medium term. Nevertheless, in the short term these measures are unlikely to have meaningful impact.

Regarding the new ceiling for credit card interest rates, we do not expect a significant impact on the credit market because: (i) it accounts for only 2.5% of the credit to consumers; (ii) interest rate elasticity on the demand for credit card is close to zero, so lower prices will not increase the demand. In fact, the zero elasticity of the demand for this product accounts for a large share of the explanation for the elevated interest rates, which is further explained by the 36% delinquency in the modality of credit. Thus, thinking as a policy maker, it is reasonable to consider some kind of pricing control for this specific market, with the only caveat that control has to be calibrated to reduce the impact of the zero elasticity without reducing the supply of the product by the banks.

In short, the existing levels of leverage will limit the pace of the recovery in demand for credit in the short term, but we believe that the lower interest rates, combined with some rebuilding of confidence and together with the beginning of the cyclical recovery of revenues, will allow companies to begin borrowing again. Recovery in corporate credit should be accompanied by some improvement in credit to individuals, who will also benefit from lower rates and the ensuing lower debt burden, especially in the second half of 2017 and beyond. The credit-oriented measures announced at year-end 2016 do not play an important role in this short-term dynamic, but are another positive aspect of the outlook for credit in Brazil over the medium term.

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