BRAZILIAN CAPITAL MARKET BOOM

1. Introduction

On the high liquidity observed across the world, Brazilian Capital Market is flourishing at an unprecedented pace in the country. Taking advantage from macroeconomic stability, built after years of prudent fiscal policy, cautious monetary stance (inflation 2004-06 averaged roughly 5 % and 3.1% in 2006) and a strong export driven external sector (trade surplus av. USD 37.7 bn in 2003-06 and recorded USD 46.1 bn in 2006). Tandem with sound institutional aspects, Brazilian companies are facing a new paradigm as they now prefer to tap domestically instead of doing it in foreign markets.

On the blink of achieving the investment grade, where US pension funds could partially channel their USD 10 trillion portfolio, the anchors that partially prevented the private sector from launching itself from non-official financing sources were lost as capital market potential is being fulfilled. An unseen wave of IPO`s, a vibrant stock market, a growing fixed income private market, and a strong real estate sector account for quick changes in capital markets linking private savings to the production sector and expanding potential economic growth.

Similar activity level was once observed dated from the Asian crisis in the late 90`s. This time around, issues have been of a markedly higher quality than in the past. Standards of corporate governance among issuers, for example, have been of the highest level. Retail formerly unseen investors, are engaged in the business and are avid for most issuances [Wheatley, J. (2006)] .

Taking a step backward in time, it is worthy to make a brief retrospective overview on Brazilian domestic capital market. Reforms on legislation in the late 1980s and in the 1990s stroke mainly on a couple of subjects. The first referred to liberalizing previous binding inward capital controls and the second remits to modernizing the domestic corporate governance regime. With inflation control while subsequent fiscal equilibrium and supporting the balance of payments were of overriding concern, regulators such as the Central Bank and the Brazilian Securities and Exchange Comition (CVM)[1] implemented overwhelming pragmatic changes that would constitute the foundations of the market booming experienced today.

Apart from the introduction, this report presents an outlook on the stock market, private bond market (debentures) and shed some light on real estate market, followed by a short conclusion.

2. Capital Market Overview

Stocks

The market capitalization of emerging countries has more than doubled over the past decade, growing from less than USD 2 trillion (tr) in 1995 to almost USD 5 trillion[2] in 2005. As a percentage of world market capitalization, these economies are now more than 12.0% and steadily growing.

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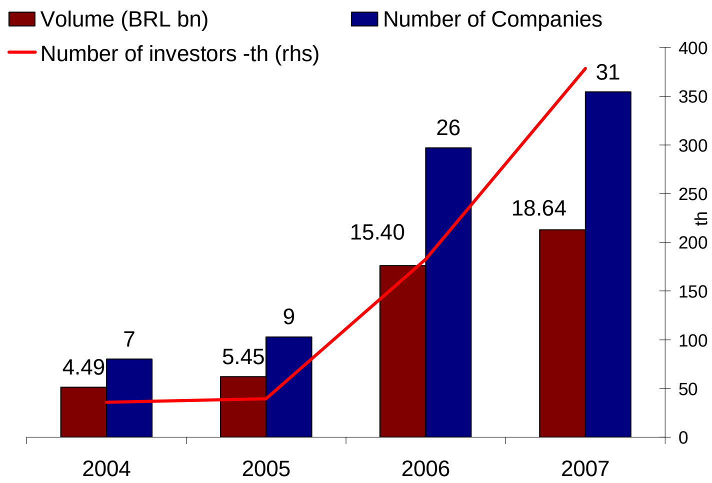
[1] It is likely that international actors and forums, particularly the multilateral agencies, private institutional investors, and the International Organization for Securities Commissions apparently have been quite influential in Brazilian capital markets reform.
[2] Source: Standard & Poor's *Global Stock Markets Factbook 2005*.

Brazilian capital markets are, and have long been, very large within the context of developing countries. Brazilian market capitalization as a percent of GDP in 1998 (20.67%) was slightly below the median for the set of important emerging countries (21.99%), but this ranking is partly due to the very sophistication of Brazilian financial markets [Wheatley, J. (2006)].[3] As of Jun-07, the value of opened companies has reached nearly 100% of GDP[4], comparing to 38% in 2000 and 19% in 1998[5]. Between 2000 and 2005, this ratio increased from 32% to 70% in India and from 15% to 72% to Russia, for instance.

Initial Public Offerings – IPOs

Starting with the stock market, there have been impressive improvements in its performance. As of Jul-07, around BRL 23 bn (roughly USD 12 bn) of IPOs were launched to the market in the past 12 months[6]. In 2004, seven companies performed IPOs amounting BRL 4.5 bn while for 2005 these figures were respectively eight and BRL 5.4 bn. As for 2006, a sharp rise was observed both in the number of companies accessing the equities market when around BRL 30 bn was tapped using this type of instrument. IPOs responded for BRL 15.4 bn (about USD 7.5 bn) and 26 enterprises with 174.8 thousand investors, in contrast with 5 th averaged for the previous two years. This represented an overall record in terms of capital raised in BOVESPA since the early 1990's. This activity ranked the Brazilian Stock Exchange as second in terms of capital raised activity among emerging markets. In 2007, already 31 business have gone public, raising about BRL 18.6 bn as of Jun-07, attracting 378 th investors[7] and many more are about to come. Graph 1 shows this performance.

Graph 1: IPOs* in Brazil



Source: Bovespa
*2007 as of July. Estimates for number of investors.

Besides the IPOs, Brazil's had an important secondary offerings activity. In 2006, a total of USD 16.5 bn were raised, number that placed Brazil on the top of the capital raising activity among emerging market exchanges, according to the World Federation of Exchanges' statistics. By the end of the year, the market capitalization of BOVESPA's 394 listed companies amounted to BRL 1.54 trillion or USD 723 bn. The number represents a 50% rise with regard to 2005 and the highest level ever in the Brazilian capital market[8].

[3] Historically, instruments are sophisticated among the users, but these do not represent a large share of total users. In sum, the ranking accounts for the intense use of markets in a relative concentrated context.
[4] This figure was as much as 74% in Apr-07.
[5] This figure doesn't include other portfolio financial assets, such as corporate bonds and commercial paper, public debt securities, and the derivatives traded on Brazil's Mercantile and Futures Exchange (Bolsa de Mercadoria e Futuros, known as BM&F).
[6] According to Bovespa http://www.bovespa.com.br/Empresas/InstInfoEmpresas/AberturaIPOsRecentes.asp?tit=5#
[7] Estimates.
[8] Recently, a local private bank was the first private institution to reach BRL 100 bn-market value.

Total trading value increased 66% in 2006, compared to 2005, reaching BRL 599 bn, the highest ever registered. The new market raised the daily average to BRL 2.4 bn, 51% higher than the BRL 1.6 bn registered in 2005 and stands at BRL 4 bn in Jun-07 The number of trades increased 39% leveling 21.5 mn last year, against 15.5 mn in 2005.

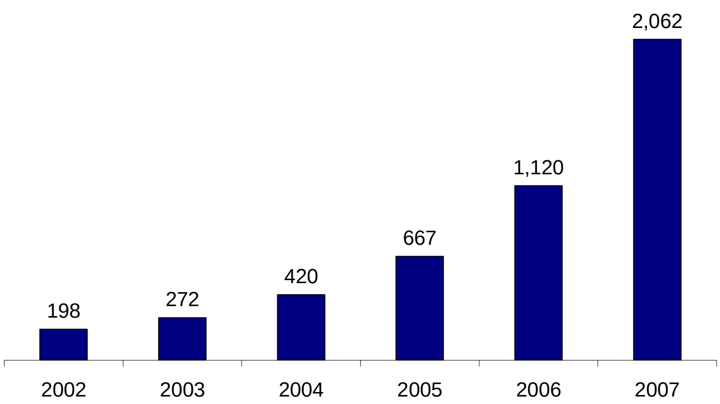
Table 1: Recent evolution of BOVESPA

Average Daily Taded Value	Jun-07	2006	Evolution 2005/2006
BRL mn	4,000	2,435	51%
USD mn	2,041	1,12	68%
Trading Values by Types of Markets -USD mn	Jun-07	2006	Evolution 2005/2006
Cash	-	246,565	69%
Options	-	19,83	33%
Forward	-	9,225	70%
Total	-	275,621	66%
Important Figures	Jun-07	2006	Evolution 2005/2006
Number of Listed Companies	419	394	1%
Market Capitalization -USD bn	1,052	723	50%

Source: Bovespa

Impressive performance has been observed also in intra-day deals. The activity has augmented signaling that participants are taking advantage from arbitration derived from market opportunities. The graph below describes this feature.

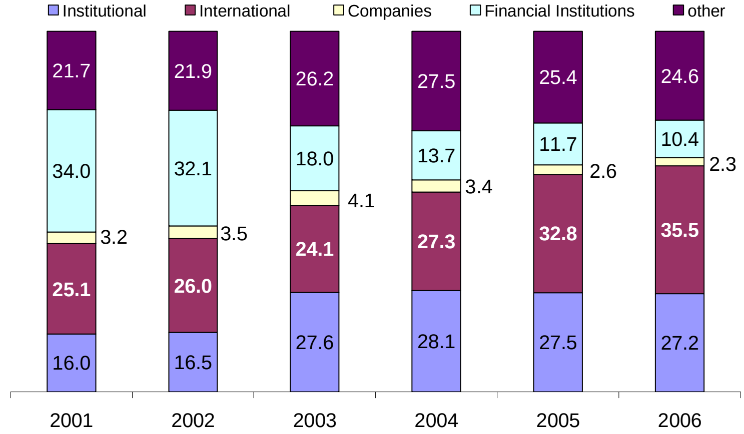
Graph 2: Bovespa´s Daily Average Trading Volume – USD mn*



Source: Bovespa
* as of Jun-07

BOVESPA´s foreign investment balance stood at USD 846 mn in 2006. This figure includes the net inflow of USD 496 mn in December, resulting from purchases of USD 9.8 bn and sales of USD 9.3 bn. Foreign investors share has grown, but there are opportunities for higher participation.

Graph 3: Bovespa´s Total Trade Value - Evolution of Investors Share (%)



Source:Bovespa

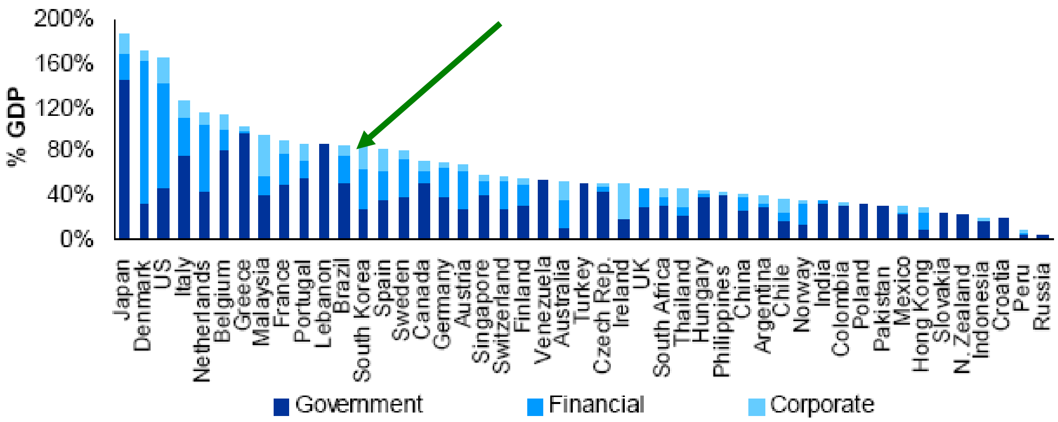
Self Regulation

According to the local legal framework, BOVESPA, which is a non for profit organization owned by brokerage firms, is allowed to self-regulate its own activities. Rules and procedures can be established including those related to conduct of market participants, and monitor the compliance thereof by brokerage firms, issuers and investors. Noncompliance with the rules and procedures established, nor the rules entrusted to supervise (also encompassing non equitable practices and any modality of fraud or market manipulation), subjects the infringing party to severe penalties. This, in addition to CVM and Central Bank's supervision, provide a safer, a more stable and a well-defined legal and institutional framework that ensures the functioning of this market and discourage unwanted practices.

Bond Market - Corporate Fixed Income Issuances

As it was preceived in stock markets, fixed rate intruments are growing faster mostly due better macroeconomic environment, pillared by sound fiscal policy and improvemnts in public debt profile, plus a strong external adjustment and also tamed inflation. Aside from that and, once again, regulatory changes and self-regulation played a key role[9].

Graph 4: Bond Markets Profile



Source:BIS, National Treasury, Central Bank and Andima
Elaboration: Itaú Corretora

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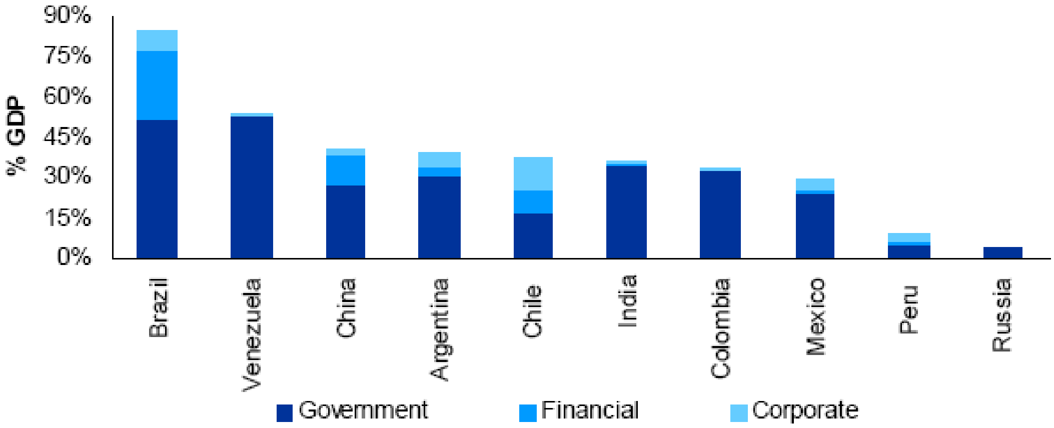
[9] To see more on this subject, see Wheatley 2006.

Brazilian bond market is the tenth largest in the world, similar to G7 countries. However, it is dominated by public securities, but now, at a less extent than in the past. Domestic private bonds represented only 2.6% of the GDP in 1992, while they reached 15% of the GDP in 2005[10] [Leal, R., 2006] and continue to grow. International private bonds (issued abroad) also increased significantly from 0.1% of GDP in 1987 to slightly above 7% of GDP in 2006.

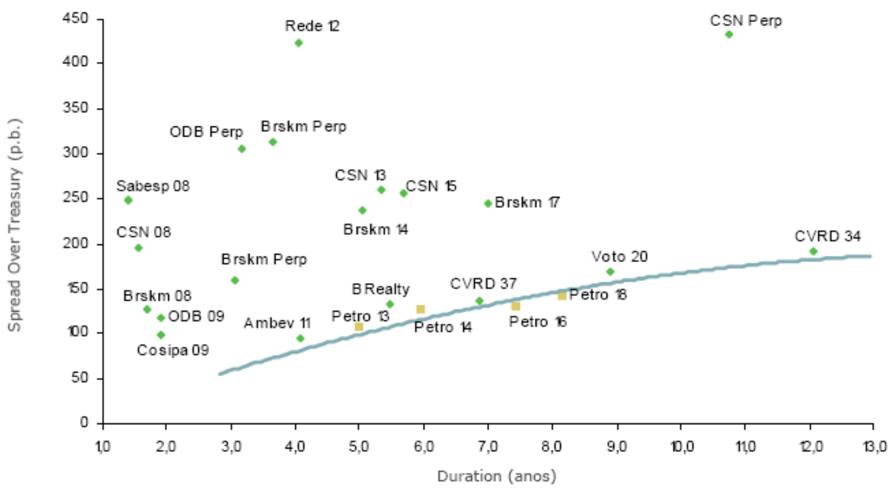
In fact, Brazil has one of the world's largest domestic bond markets with around USD 800 bn (83.7%) of GDP. Public securities respond for 50.9% of GDP and private bonds account for 32.8% of GDP[11] [Itaú Corretora, 2007].

Graph 5: Brazil and Peers – Bonds Market



Source:BIS, National Treasury, Central Bank and Andima
Elaboration: Itaú Corretora

Graph 6: Corporate and Sovereign Bonds (USD)



Source: Unibanco

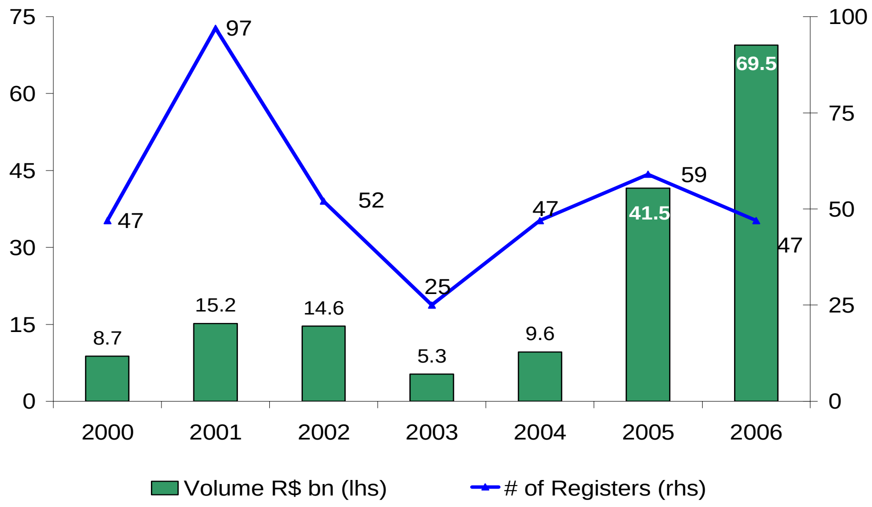
Benefiting by public debt management focusing on qualitative foreign issuances, corporate issuers have become increasingly active. Graph 6 above displays a few important corporate foreign taps. The trend line refers mostly to big Brazilian companies.

Tenors of corporate debt have lengthened substantially, to be counted in years instead of months. Companies that would previously have issued bonds overseas now choose instead to tap the home market in order to complement their financing needs and providing additional

[10] For 2006, outstanding debentures is estimated in 7% of GDP – Source: www.debentures.com.br
[11] Financial and Corporate bonds respond for 24.8% and 8.0% of GDP, respectively.

flexibility. There has even been progress towards that holy grail of Brazil's capital markets, the development of a secondary market in corporate debt.

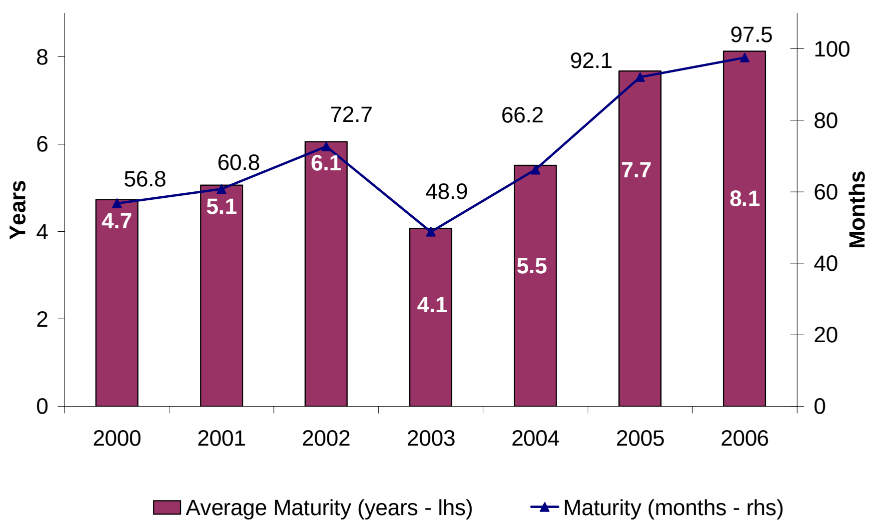
Graph 7: Brazilian Debentures – Size and Registers



Source: CVM. Elaboration: National Treasury

To highlight that, the graph above shows the remarkable increase in debentures volume, measured in Brazilian Reais. It was increased by nearly 12 times last year relative to 2003. However, it is still concentrated in floating rate instruments, as DI (Inter-bank Deposits) share reaches 91% of debentures outstanding registered in SND[12], while inflation linked and FX-linked instruments respectively account for 5% and 3% only. This seems somewhat surprising if one considers current public debt profile, which has fastly changed from mostly floating rate indexed to fixed rate[13]. At the same time, inflation linked shares increased considerably and they now jointly represent about 60% of domestic debt.

Graph 8: Debentures Average Maturities



Source:CVM
Elaboration: National Treasury

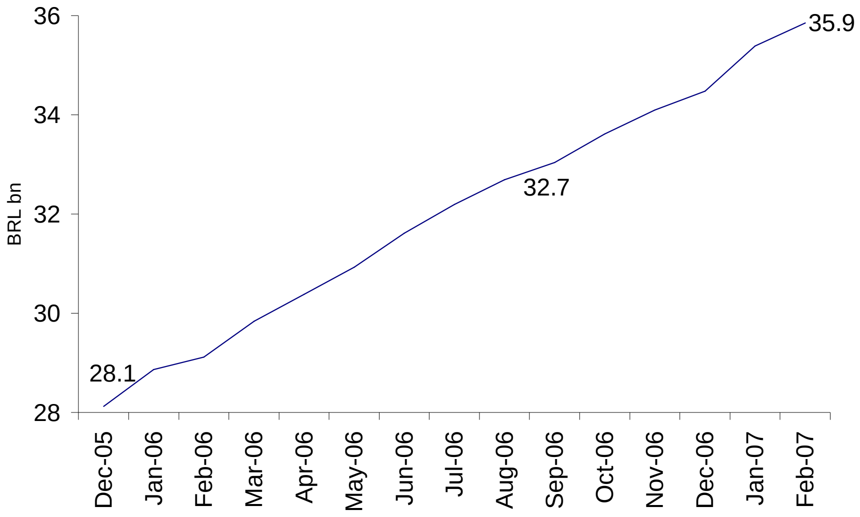
[12] http://www.debentures.com.br/ - National Debentures System, as of Jun-07.
[13] Floating debt switched from 61% in 2002 to roughly 36.7% of domestic debt in May-07

Prospective for bond market developments are optimist as Brazil recognizes its importance. Banks provide underwriting services, distribute products among a set of channels, works as primary dealers and also buffers liquidity for secondary market. Robust market structure such as strong clearing systems, efficient electronic trading platforms and custodial play a huge roll on market development. Years of high volatility and hyper-inflation and indexation were fundamental to strengthening a well sophisticated bank and financial system[14]. Brazil currently gathers all the necessary conditions and benefits from that, besides macroeconomic stabilization.

3. Real Estate Market

Like the capital market as whole, real estate market and construction has benefited from new regulatory framework, fiscal performance and a sharp credit increase resulted in significant improvements in its fundamentals. This is materialized in more housing construction and credit while issuers' credit in this sector has strengthened. There has been focus on lower and medium income borrowers, due to the high deficit observed in this segment.

Graph 9: Housing Credit



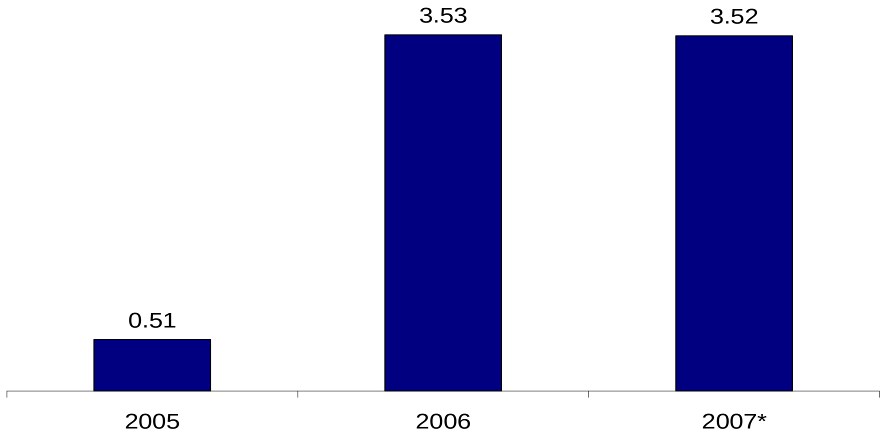
Source: Central Bank

Legal enforcements given to creditors' claims and the implementation of risk segregation instruments coupled with easy-access real estate warrants led banks to take initiatives aiming at enlarging credit channels and increasing their portfolio. With more diversified instruments and more flexible conditions they have been able to increase the (borrowing)/(real estate value) ratio.

Big construction companies have launched primary shares on stock market raising important resources and are now more prepared to face new capital and liquidity requirements to face demand shifts and operational deficits that's come along in initial years, as can be seen below.

[14] Furthermore, the Brazilian Payment System plays a key roll on that an meets best international standards. On can get more information on this in a friendly format: www.bestbrazil.org.br/pages/publications/bcb.asp

Graph 10: Primary Stock Offers for Construction Companies (BRL mn):



*as of Mar-07
Source:Abecip

After years of stagnation, the construction sector[15], which includes housing, sanitation, infra-structure and transports expanded 4.6% in 2006, more than the 3.7% for total GDP growth in the same period. For the forthcoming, the package for growth acceleration (PAC) should positively affect the sector as it focus in infrastructure.

There are two main credit sources for the sector in Brazil: First, a labor originated fund (FGTS), mainly managed by an official bank (Caixa Econômica Federal - CEF) with a scope of low and medium financing values. This volume grew 24% in 2006 to BRL 6.8 bn, contrasting with a contraction of 12% back in 2003. Second, the Brazilian Savings and Loans System (SBPE), which includes Brazilian banks increased 93% last year totaling BRL 9.3 bn, while its size also contracted 5% in 2002. Still, it currently represents less than 1% of GDP showing that both sources are yet small [Fitch, (2007)].

The creation of the Securitization and Mortgages Company inaugurated a new era, placing Brazil on track with other countries that successfully cultivate this market segment, providing liquidity to housing financing. It can also integrate credit operations currently performed in real estate market.

Some optimistic forecasts state that this sector should be similar, in structure (Fannie Mae and Freddie Mac)[16], to the US market (USD 4.5 tn), with securitization companies, market makers for these securities and mortgages companies. In general, banks are clients from these institutions and may interact with each other yielding a stimulating environment for market development. The new real estate financing system search for instituting a mortgage secondary market through long term financing instruments, which acceptance will be affected by new legal measures that reduce financing risk to both creditors and debtors.

The following will shortly describe a few measures that revamped real estate market and provided agility to creditors claims and property transfers, mitigating risks and creating conditions for long term instruments.

- Fiduciary Alienation: Positive past experience for this type of warrant applied to other sectors allows the owner to recover his property more easily in cases of unperformed loans.

[15] This sector grew 1.5% in 2005 and 0.9% av. During 1999-2004.
[16] Fannie Mae - Federal National Mortgage Association - and Freddie Mac - Federal Home Loan Mortgage Corporation.

- "Affecting Ownership": Segregated the entrepreneur risk from the distributor. In the event of its failure buyers may continue with the project with another company.

- "Non-controversy": In the event of judicial contract questioning, the buyer must still face the credit principal value, as well as taxes involved in the property issue.

As perspectives for 2007, the FGTS[17] should finance BRL 8.1 bn, compared with BRL 6.8 bn in 2006, primarily to low and medium income housing purposes in big urban centers. Financial institutions have demonstrated that they are embracing more attractive financing modalities, especially regarding to longer maturities, besides fixed rate instruments, contracts standardization and costs reductions.

New advances in this sector depend on continuous increases in sales, additional cuts in domestic interest rate, economic growth, consolidation of legal instruments and legal safety to creditors and investors. Brazil is about to experience a stronger boom in real estate sector. There is demand both in housing and commercial segments. Market players are adjusting themselves, preparing to operate in a much more professional and diversified framework. The trend points to an increase in capital inflow and international know-how besides partnership creation to dispute the rising Brazilian market.

4. Conclusion

Despite the genuine depth and sophistication of Brazilian financial markets, Brazil's stock market can legitimately explore its possibilities. Not only its market turnover as share of market capitalization is low relative to US and European markets, but trading has been quite highly concentrated in stocks of just a few companies, even though this trend has been reverted lately, reflecting the fact that family groups (or, in the cases of recently privatized firms, small consortia of controlling shareholders), continue to control even most publicly traded private enterprises.

There is considerable potential for Brazilian corporate share and other capital markets development. It seems quite likely that Brazil will become/continue to be a leader among emerging market countries in corporate governance reform. As shown above, there are now enough domestic interests aligned so as to benefit from changes in this direction to keep pushing it forward. Brazil has some of the largest institutional investors, in terms of total assets, in the developing world, which is among the reasons that international corporate governance activists will continue to try to recruit Brazilian allies [Ness & Armijo, (2002)]. As minority investor protections continue to improve, foreign and domestic capital could find corporate shares more attractive.

Finally, there is a promising future for capital markets in Brazil as the general perceptions state that they are in their infant days. This remarkable ongoing flourishing period is based on strong institutions and an improving regulatory environment besides macroeconomic stability and positive perspectives for sustainable economic growth.

[17] Fund managed by an official bank (CEF)

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