

Brazil: The Virtuous Circle

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The last couple of years have witnessed a remarkable maturing process towards the adoption of better corporate governance practices in Brazil. Early sceptics no longer have grounds for doubting that market standards have been set and it is very difficult to imagine the country deviating from the virtuous circle initiated three years ago. The country is reaching a new stage for capital markets.

As opposed to some other markets, reform in Brazil is being driven by the pursuit of firms' value maximisation. Companies are not revising their process and practices just to be compliant with regulations. Instead, they're looking for the premium that the market pays for well governed companies. An unequivocal sign of the strength of recent developments is the performance of Novo Mercado, the special listing segment of BOVESPA (the Brazilian Stock Exchange) where companies voluntarily commit themselves to higher corporate governance standards beyond those already established under current regulation.

This market had a sluggish take-off back in 2000 when it was launched but now accounts for the vast majority of new listings. Companies listed in the three special segments which present different levels of governance requirements – Novo Mercado, Level 1 and Level 2 – account for 60% of the total market cap and daily traded volume.

The first listing under the Novo Mercado rules came in 2002, nearly two years after the exchange introduced the regulations. The turning point was in 2004, with the IPO (initial public offering) of Natura, the leading Brazilian cosmetics company that became a huge success. Natura raised R768M (about US\$ 350M at that time) in April 2004 in a deal that was ten times oversubscribed. Almost all companies that have listed since then have followed Natura onto Novo Mercado, with 62 listings from 2004 to April this year, 51 being on the Novo Mercado. The companies with IPOs with lower levels of corporate governance requirements (Level 1 and 2) have only done so due to legal industry restrictions. This was the case, for instance, for Gol, the first publicly traded low-cost airline, which is not allowed to sell control to foreigners and for this reason choose to list on BOVESPA's Level 2. Besides the IPOs and what are called new companies in the local market, there are a relevant number of firms that have decided to migrate from traditional listing onto Level 1 only. Their reasons for doing this were not due to any legal restrictions. They simply decided not to go any further with governance improvements, at least for the time being.

As part of the listing rules of Novo Mercado, companies commit to issuing only common shares – all shares with the same voting rights – and to maintaining a minimum of 25% of free float. They also accept that they need to offer tag-along rights (mandatory bid rules) in the event of direct or indirect transfer of the control block, to enhance disclosure procedures, and to broaden the minority shareholders' rights.

In the beginning of 2006, BOVESPA updated the listing rules sharpening governance requirements. The new rules included board composition of a minimum of 20% independent directors and also introduced the definition of diffuse control, a new phenomenon in the country. It was only in July 2005, that Lojas Renner, a retail chain, became the first Brazilian company to have no controlling shareholder or group of shareholders. With a few peers, they form a very small group of companies in a kingdom of concentrated ownership. But the door is now open.

The driver for all this is that Brazilian companies have come to recognise the benefits of improved corporate governance on share prices and for debt issued. Regarding the former, companies listed on the Novo Mercado have outperformed those listed on other market segments by 25%. Regarding the latter, firms with better corporate governance practices received better credit ratings and issued long term securities, reducing their cost of debt.

One can say that stock market performance could be driven by broader market factors but certainly there is no doubt that Brazil would not have experienced the volume and diversity of companies accessing the markets if progresses in governance had not been made earlier. There is a transformation happening in the way companies finance their growth.

Standing the Trials

There are a number of examples where the strength of governance standards has been proved and two examples of the maturing nature of governance development were the recent cases of Telemar and Arcelor-Mittal.

Investor activism and the positioning of CVM (Comissão de Valores Mobiliários), the Brazilian market regulator, prevented the country's widely-held telecommunications group, known as Telemar, from implementing its plan to eliminate certain non-voting share classes in an attempt to increase control of the voting stock for the company's controlling shareholders. While the plan would have eliminated certain stock classes of the company to simplify the corporate structure, it would



have effectively doubled the controlling shareholders' stake. Telemar proposed to dilute preference shareholders substantially from 71.5% to 45.4% (each voting share of the controlling shareholders would be converted to 2.6 shares of the new firm). The plan caused further controversy because of the mechanism by which it would be approved or rejected. The CVM ruled that controlling shareholders could not vote their shares on matters that directly benefited themselves at the expense of non-controlling stockholders. At the end of last year, shareholders in Telemar rejected proposals to streamline its capital structure and take its shares onto the Novo Mercado. If Telemar had succeeded, other big Brazilian companies may have considered conducting operations involving similar erosion of the interests of minority shareholders.

Another demonstration that good governance is taking root in the country is the long battle being fought by Arcelor-Mittal, the world's biggest steel company and the minority shareholders of its Brazilian subsidiary. The CVM regulator has ruled that minority shareholders in Arcelor Brazil should have been offered a payment on the same basis as that received by investors in the whole of Arcelor when Mittal Steel acquired Arcelor last year. At an auction on the São Paulo Stock Exchange in June, about 90 per cent of minority shareholders accepted the revised offer of R\$53.89 per share, much better than the R\$ 32,00 initially offered by the controlling owners who were not even granting tag along rights in the beginning of the saga. This is a key example of the increased strength of governance in Brazil.

The Sheriff Assuring Market Trust

Since the change of the corporate law in 2001, strengthening the role of CVM and enhancing its independence, the regulator has been playing an essential role in solidifying the base for progress. Its firm and prompt action has led to levels of trust necessary to see market develop. Today a company will think twice before embarking on initiatives that could harm investors, as it is known that there is a sheriff in place diligently doing his duty. Besides, CVM has implemented taskforces to improve efficiency and velocity in judging the cases and deploying supervisory activities. Last year, CVM broke a number of records for analysing and registering tender offers despite the fact that the number of tender offers has increased unprecedentedly.

Another sign of market vigour is the activity of the Instituto Brasileiro de Governança Corporativa (IBGC), the leading organisation focused on governance in Latin America. Since its inception in 1995, the organisation has been

instrumental in providing market guidelines and has been the point of reference for best practices in the region. Reaching a membership of more than 1,000 individual associates (early 2007 data), IBGC reflects the interest of the market in governance by the number of people trained since 1998, when training programmes were launched, 2,300 people attended a programme during that period, with 414 people attending last year alone.

Brazil has come a long way. It has been through a startling corporate governance transformation and is now recognised as Latin America's market leader. The governance infrastructure is now above average in emerging markets. Our experience shows that good corporate governance attracts investors, improves top level decision making, opens the prospect of cheap finance and holds out hope for the development of genuinely useful capital markets.

But there is still a long way to go. Improvements in regulation and a better judicial system are points that will have to be addressed if we don't want to see the effectiveness of enforcement weapons reduced. The improvements initiated by the regulatory body have to proceed and increase. Investors have a responsibility to play their part scrutinising offerings to assure a market where bad apples remain out of the basket. Nevertheless, and more importantly, the good news is still restricted to a tiny number of companies if one considers the size of the economy. The huge majority of 15 000 big companies in the country have not even considered the introduction of good governance practices in their businesses. We are still transforming the top of the pyramid and there is colossal challenge ahead of us. What is in our favor is that we have a reasonable number of agents in place steadily doing their part to transform the business environment. So, even better news is to be expected in the future. ●

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