

Brazil's banking system 'strong despite slowdown', says Larson



In a world where much of the financial sector is in crisis, Brazil's banking giants Banco Itaú and Unibanco are merging from a position of strength, according to Urban Larson, manager of the F&C Latin American Equity fund.

Last week Banco Itaú and Unibanco – the country's second and third largest private sector banks respectively – announced their first pro-forma consolidated earnings after the Brazilian authorities approved their merger.

"The combined entity recorded good will was 12.9 billion Reais (US\$5.6 billion) on the merger, all of which was charged off immediately instead of remaining on the books to bolster capital, as is often the case in such circumstances" said Larson.

A further US\$3.1 billion in merger-related accounting gains was used to increase provisions for non-performing loans. Despite this, the newly formed bank has a capital adequacy ratio of 16.3%, including Tier 1 Capital of 12.5%, which is far above international standards. Additionally, the newly formed Itaú-Unibanco has 183% reserve coverage of its non-performing loan portfolio, allowing ample margin of safety should the slowing Brazilian economy lead to a further deterioration in credit quality.

"Despite what in a more normal environment would be seen as an excessively conservative balance sheet, Itaú-Unibanco

still managed to generate a pro-forma Return on Equity of 25% in 2008, not counting all of the merger related non-recurring items. Larson explains that Brazil is hardly insulated from the global recession, highlighting that the economy has in fact appeared to slow down dramatically during the last quarter of 2008.

"However the banking system remains solid and profitable", he adds. "The Brazilian banks learned the hard way about the importance of maintaining strong balance sheets during the country's bouts of hyperinflation, devaluation and other financial turbulence and could now emerge among the winners in the troubled global financial sector."

He concluded: "They may even be in a position to take advantage of their international competitors' weakness to buy attractive assets cheaply, should the likes of Citigroup or other global banks need to disinvest from Latin America".

Opportunities in convertibles after sell-off

Following the 2008 turmoil, convertible bonds are currently offering very compelling opportunities for investors, according to Anja Eijking, manager of the F&C Global Convertible Bond Fund. During 2008, hedge funds and banks sold off their holdings in corporate bonds, resulting in market prices falling to record lows. The convertibles market, as a result, has been repriced in an unprecedented manner. Against the background of huge selling pressure during September and October by predominantly convertible arbitrage funds, convertibles prices fell further than equity markets.

"Convertibles did not offer the downside protection one may expect based on their bond component", explained Eijking.

"However, the disappointing absolute performance of the asset class has its benefits as it now offers very attractive investment opportunities with limited risk and attractive upside potential in the wake of the sell-off."

Asian convertibles have also been strongly repriced.

"We have bought several interesting convertibles during the sell-off", commented Alan van der Kamp, Portfolio Marketing Manager at F&C.

One example is Cherating Capital, converting into equity shares of the Malaysian toll road company Plus Expressways. Although this convertible is not officially rated by the rating agencies, it is being guaranteed by Khazanah Nasional, the investment entity of the S&P A-rated Malaysian government. On the back of the market sell-off, this convertible lost 30% of its value in the two months ending October 2008, while the underlying shares fell by just 6%. The convertible was added to the portfolio in October at a price of 74.

"The yield-to-maturity of this convertible was approximately 14.7%, which is very high in comparison with Malaysian government bonds", Eijking added. These bonds were trading at a credit spread of 165 basis points. Additionally, the conversion premium was only 10%; the convertible was expected to participate in the underlying shares increase to a large extent.

"We like this company as it has a very stable profile", said Eijking. "Since October the convertible's price has appreciated by approximately 30%. The convertible is currently trading at a 7% yield-to-maturity, still relatively high in comparison with Malaysian government paper (2.8% yield-to-maturity). Given the conversion premium of 37%, the risk/reward profile of this convertible remains attractive."

F&C's convertibles team's strategy remains focused on adding convertibles to the portfolio with a similar attractive total return potential and limited risk. It also seeks to reduce exposure to low yielding convertibles that are trading near redemption price and with high conversion premiums. "The total return potential of our convertibles is very attractive with a yield-to-maturity of over 8% and equity market participation of ca. 35%", Alan van der Kamp concluded.

Press Contact: +44 (0)20 7011 4600

Jason Hollands (Corporate)
Tel: +44 20 7011 4168
jason.hollands@fandc.com

Paula Garrido (Institutional)
Tel: +44 20 7011 4190
paula.garrido@fandc.com

Jennifer Donohoe (OEICs)
+44 20 7011 5017
jennifer.donohoe@fandc.com

Véronique Sant (SICAVs)
Tel: +44 20 7011 4278
veronique.sant@fandc.com

Sarah Godfrey (Investment Trusts)
Tel: +44 20 7011 4215
sarah.godfrey@fandc.com

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