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3 Changes in Brazilian Financials

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On a recent trip to Sao Paulo, Brazil, in June, I met with a wide range of financial companies—some venture-stage, private-equity-funded start-ups and some older, listed incumbents. They included merchant acquirers, software providers, credit card schemes, digital wallet providers, digital banks, and even a lender focused on financing the installation of solar panels. Here's what I learned.

Takeaway 1: Disruptors Abound—But It's a Difficult Business

First, competition is intense in payments and lending. For instance, Brazilians average five credit cards per person, and both challengers and incumbents are fighting for share of wallet. It was very common for the companies I spoke with to say, "We have 20 million customers but only 5 million are active."

This competitive environment is a consequence of the high number of players—in particular, financial technology (fintech) start-ups—that entered the market in recent years. Ten years ago, the Brazilian government started lowering the barriers to entry for fintechs with the goal of reducing borrowing costs and ultimately supporting economic growth. Before then, Brazil was a market with an inefficient financial system and a large underbanked population.

The strategy of fintechs was to focus on technology, innovation, and customer service. Technology allowed them to be more efficient and reach the underbanked population at a lower cost; innovation and customer service

allowed them to offer better products to customers. A good example is a 100% digital experience where you don't need to visit a bank branch to get a credit card or open an account.

With the rapid disruption coming from fintechs, the narrative got a bit ahead of itself with the idea that disruptors would destroy the returns of the incumbents in a very short period of time. That hasn't happened.

The reason is that the banking business is about more than just offering a great product at a low cost. A bank's main resource is money. A well-managed bank should be able to source money at a low cost, then lend the money and ultimately recover it from borrowers. But lending and getting the money back is not an easy task. fintechs say they have an advantage when capturing customer data, but it takes a lot of time to develop credit and risk models that work in every part of the economic cycle. Good credit underwriting is difficult; it requires comprehensive datasets and large, experienced teams.

Plus, higher interest rates can significantly squeeze net interest margins (NIMs) if the lender doesn't have a low cost and stable funding source.

And when the economy deteriorates and interest rates go up as fast as they have, problems arise. Asset quality starts to deteriorate and NIMs shrink. That's when a lot of these fintechs run into trouble, which is what we've seen.

With many fintechs running financial losses, funding for pre-profitable companies is becoming more challenging, and many of these will likely be acquired or simply go out of business.

Hopefully in the coming years, industry consolidation and the natural purge in the industry should lead to a more benign competitive environment. We believe Brazil still offers opportunities for fintechs because the banking sector remains inefficient; however, only a few winners will likely emerge.

Takeaway 2: Cheap Money Hurts Resource Allocation

The second takeaway is that abundant cheap money has led to a lack of financial discipline, with companies allocating capital to projects with uncertain returns.

In the past few years, money coming from venture capital funds was readily available. This meant that disruptors were able to launch multiple products, improve technology, buy other companies, and enter new markets without restriction.

Unfortunately, not all decisions led to value creation for shareholders. For instance, only a few months ago, many fintechs in Brazil were launching an e-commerce marketplace with the goal of attracting more users to their platforms. Launching this service is clearly noncore but can use a lot of resources.

This poor allocation of resources increased expenses and makes the road to profitability more challenging.

In the meantime, the already profitable incumbent banks haven't stood still. They're focusing aggressively on improving technology and customer service. Two traditional banks already have their own digital banks; others could do the same soon.

The industry narrative is interesting in how quickly it went from the idea that the start-ups would disrupt the

incumbents to the opposite of that. Now the incumbents are thinking they could pick up some cheap assets

Takeaway 3: Economic Weakness Remains

Of course, all of this takes place within a macroeconomic backdrop, and the overall message I got from the companies I spoke to is that economic growth remains weak but is not deteriorating.

Inflation and interest rates, as I alluded to above, are a big concern. Inflation likely peaked in the first half of the year, but there is a risk that it remains consistently above target. As a result, it’s highly likely that the Brazilian central bank will be more conservative, waiting until 2023 to start cutting rates. A lower interest environment is clearly beneficial for the economy as a whole and for some of these disruptors in particular.

This year is also an election year for Brazil, which has historically meant uncertainty and volatility—but this year may be different as the two candidates, Luiz Inácio Lula da Silva (Lula) and Jair Bolsonaro, are well known by the market, which likely reduces the odds of a left tail outcome.

We’re keeping an eye on the sector and are confident that our active approach will help us identify winners and losers regardless of the environment.

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