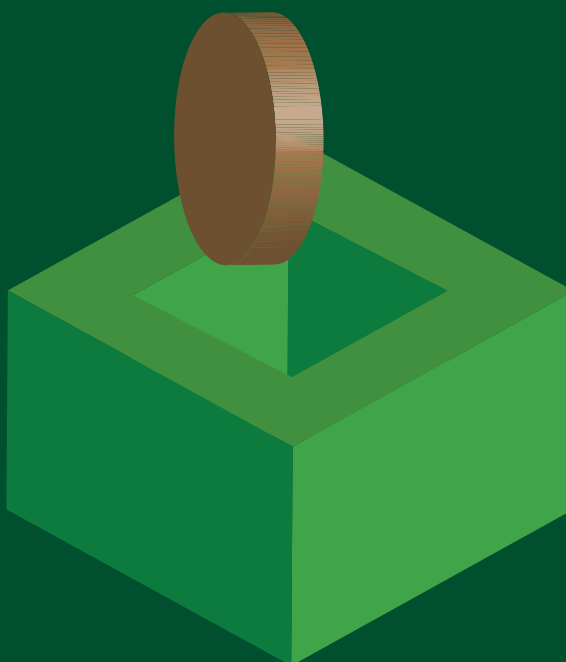
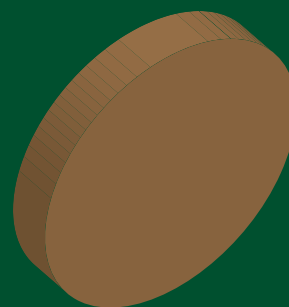
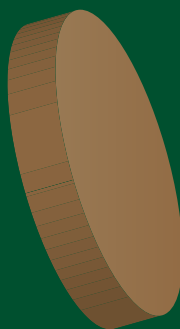
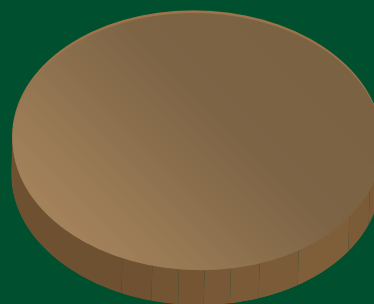


Interesting times to invest in Brazil

An outlook on political and institutional risks



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Its unique approach towards private equity and private credit investment opportunities is based on promoting positive change in the fundamentals and operations of companies and assets. Through the engagement with the broader financial markets, we strive to turnaround businesses, innovate and promote a more sustainable form of capitalism.

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Interesting times to invest in Brazil

An outlook on political and institutional risks

In his first year in government President Bolsonaro maintained consistency with his campaign making clear that he was always showing his true colors¹

He split the cabinet among three main groups: former military, politicians or political appointees from his main support groups (BBB: Biblia, boi e bala – Bible, cows and law and order) and delegated the choice of the economic team to Mr. Paulo Guedes as his Economy Minister. And as the months went by, there was a succession of acrimonious internal disputes in which, invariably, those not aligned with President's Bolsonaro and his sons² were substituted, including several in what was hoped to be a more moderate group of former military.³

As we had pointed in our letter at the beginning of last year, President's Bolsonaro was unable to effectively use his three main thematic coalitions (agribusiness, conservative evangelical right and law and order) to develop a cohesive bloc in Congress and PSL, although the second largest party in Congress, was still far from dominant in a very fragmented political system.

And also in line with his past of limited party allegiance, following a dispute for control of PSL and its funds for the 2020 municipal elections, last November President's Bolsonaro left PSL and announced he was creating a new party (Aliança pelo Brasil/Alliance for Brazil) making it the 8th

time he changes political party.

This has shown that there was too much wishful thinking in the hope that the practicalities and needs of governing and the reality of negotiating with Congress would lead to significant compromises and a change in style and approach more becoming to the protocol and traditions of the presidency.

The very contentious and antagonistic campaign strategy pitting the president and his followers against all dissenting voices through quarrels in social media was adopted as the “new normal” for the presidency and even expanded to include foreign presidents and authorities, NGOs and Hollywood actors during the Amazon fires crisis. Any hopes that the polarization seen in the campaign would wane were also dashed.

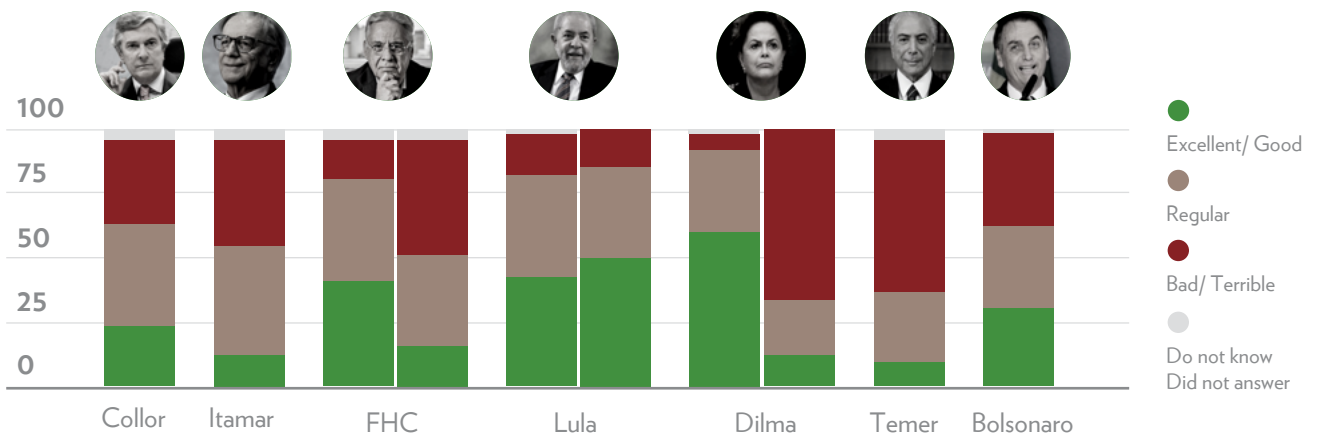
The consequence has been that the President's overall approval levels fell relatively more than those of his predecessors at the end of a year in office but a drill down in the pools also shows that he has a consolidated core constituency of 25-30% that combines the religious right, higher income and southern voters. Not a majority but good enough to guarantee a place on second round presidential elections in 2022 and make a second term for President's Bolsonaro a concrete possibility.

1. In the Age of Sail (mid-16th to mid-19th century) a naval warfare tactic would be to approach an enemy ship flying a friendly flag only to hoist the “true colors” of your country flag right before opening fire.

2. Senator Flavio Bolsonaro, Rio de Janeiro City Councilor Carlos and Federal Congressman Eduardo Bolsonaro.

3. Presidential Secretary General Gustavo Bebbiano who was the president of PSL, President Bolsonaro's party at election. A few months later Bebbiano's substitute former General Floriano Peixoto, Education Minister Ricardo Vélez Rodríguez, Minister in charge of the Government Secretariat former General Santos Cruz, Secretary for Tax and Revenues Marcos Cintra, BNDES President Joaquim Levy, President of the foundation in charge of Native Brazilian affairs (Funai) former General Franklimberg Ribeiro de Freitas, President of the Mail Company former General Juarez da Paula Cunha.

Brazilian Presidents' approval during first year of government in %



Source: Datafolha

President Bolsonaro's approval during first year by gender and education

	Gender		Education		
	Masculine	Feminine	Basic	High School	Superior
excellent/good	35%	26%	29%	29%	35%
regular	33%	31%	30%	35%	29%
bad/terrible	32%	41%	39%	35%	36%
do not know	1%	2%	2%	1%	1%

Source: Datafolha

President Bolsonaro's approval during first year **by region**

	Region				
	Southeast	South	Northeast	Midwest	North
excellent/good	32%	40%	20%	31%	35%
regular	34%	31%	28%	31%	34%
bad/terrible	33%	28%	50%	38%	28%
do not know	1%	2%	2%	0%	3%

Source: Datafolha

President Bolsonaro's approval during first year **by income**

	Income			
	until 2 M.W.	More than 2 to 5 M.W.	More than 5 to 10 M.W.	More than 10 M.W.
excellent/good	22%	35%	44%	44%
regular	33%	33%	24%	28%
bad/terrible	43%	31%	31%	28%
do not know	2%	1%	1%	0%

Source: Datafolha

M.W. = Minimum wage

President Bolsonaro's approval during first year **by religion**

	Region					
	Catholic	Evangelical	Spiritist	Afro-Brazil.	Atheist	Agnostic
excellent/good	29%	36%	34%	25%	34%	20%
regular	32%	35%	29%	20%	13%	27%
bad/terrible	38%	27%	37%	55%	53%	52%
do not know	1%	2%	0%	0%	0%	0%

Source: Datafolha

However, the institutions have shown adequate resilience and despite the turbulence caused by the President, the political system has accommodated to this “new normal” and even been productive on some topics.

Both the Legislative, led by the presidents of Congress and Senate, and the Judiciary have in effect blocked President Bolsonaro’s more controversial proposals with illiberal characteristics on culture and costumes, as well as attempts to create bypasses to due legal process and civil liberties with authoritarian bias. At the same time the Congressional leadership has taken the initiative of pushing forward important parts of the economically liberal agenda of the Economy Ministry and the crucial Social Security reform was approved in October.

Main proposal currently in Congress

Proposal	Brief summary
Tax reform	Two different proposals in the congress for the simplification and reduction of the tax compliance costs in Brazil
Administrative reform	Change in the wage scales, career progression and employment stability of public servants
New Sanitation Law	Stronger incentives and enablers for the privatization of state-owned sanitation companies, some oversight of state and municipal agencies by the federal water regulatory agency and more safeguards to private investment
New Concession and PPP Law	Reform and consolidation of the two main laws governing concessions and PPPs
“Plano Mais Brasil”	Three proposed amendments to the Constitution decentralizing and giving more flexibility to the allocation of public budgets while at the same time reducing the level of financial support of the federal government to states and cities
Labor reform	Flexibilization of the Consolidation of Labor Laws (CLT) in order to encourage the hiring of young people and eliminating constraints on work during weekends and formalities to work on several types of jobs.
Central Bank Autonomy	Grant Central Bank autonomy on the grounds that independence of the monetary authority would help to lower the structural interest rate of the economy

This political accommodation has, combined with a significant fall in interest rates and a stimulus measure allowing a one off exceptional withdrawal from worker's severance fund (FGTS), led to a slow resumption of growth based on consumption, credit and some recovery of the real estate market.

The consensus view is of a GDP growth around 2% to 2.5% in 2020 with continued low inflation, low interest rates and the exchange rate keeping its current level hovering above R\$4 to the US dollar. ⁴

Economic projections 2020

Index	2020E	2021E	2022E	2023E
GDP Growth	2.30%	2.50%	2.50%	2.50%
Inflation	3.40%	3.75%	3.50%	3.50%
Interest Benchmark Rate (Selic)	4.25%	6.00%	6.50%	6.50%
BRL/ USD	4.10	4.05	4.10	4.11

Source: Focus Report – Brazilian Central Bank

After years of recession, how robust is this recovery?

The obvious reason for caution about the resumption of growth in Brazil is the risk of external turbulence and the year has started giving fair warning that besides the predictable volatility due to elections in the US, the Brexit aftermath and trade wars, new surprises and shocks are always possible.

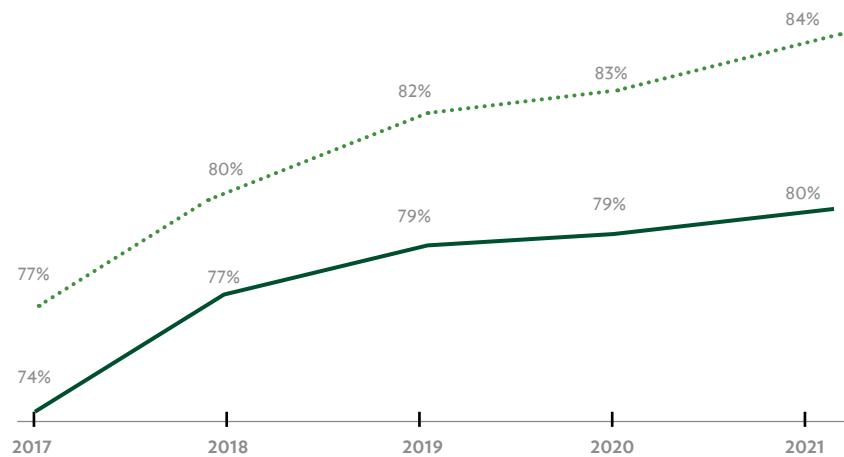
Others are much better positioned than us to discuss scenarios for the global economy but here it might be interesting to discuss two related questions on how susceptible to external turbulence is Brazil. First, what is the nature of the growth and how consistent is it? And second, what is the risk that Brazil will see major political turmoil as has recently happened with a series of civil revolts in other countries?

There are two main views on the nature of the growth. Optimists and government officials see the recent improvement of government accounts as a structural fiscal consolidation. As can be seen on the chart below, the

combination of the spending ceiling (approved in the previous government), the quite significant social security reform and the reduction of interest rates has changed the trajectory of government debt indicating that the public finances are again under control. Success in an administrative reform to make spending cuts more permanent, further privatizations and the reduction or elimination of subsidies to various sectors would make this fiscal consolidation more permanent. Complement the strong crowding-in of private capital substituting BNDES in long term financing that has already taken place with an agenda of micro level reforms to improve the overall business environment, the new law strengthening regulatory agencies (Law n. 13.848/19) and the tax reform that is moving nearer to approval in Congress and you would have in place the conditions for a strong and sustained period of growth.

4. Even though the current global turmoil related to the COVID-19 virus has generated more volatility to the Foreign Exchange, having the BRL devaluated to more than R\$ 4,40 against the US dollar. The GDP growth projections are already being revised by the Government, expected now to be lower.

Projection of gross public debt as % of GDP

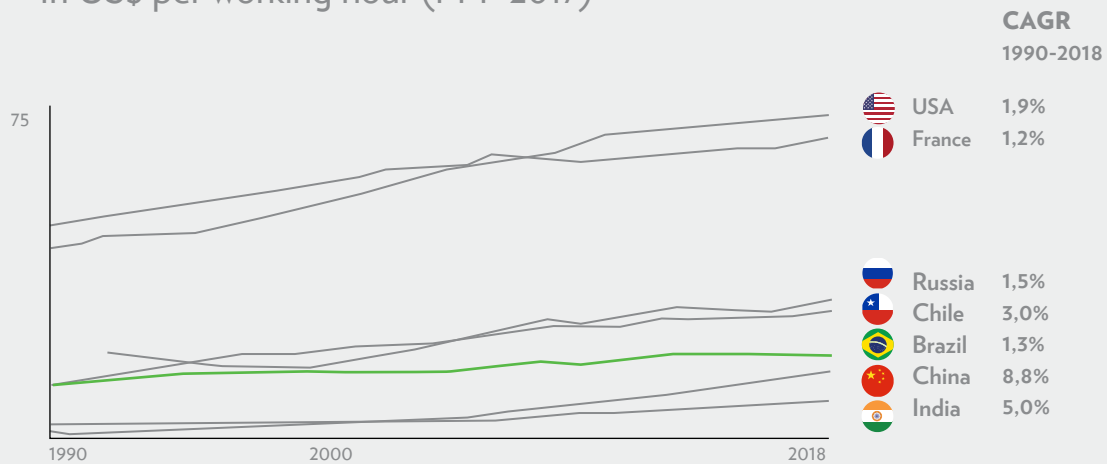


Source: Independent Fiscal Institution (IFI)

- IFI 2017 Projection
- IFI 2020 Projection

Skeptics and pessimists have several reasons for their views. The improvement in government accounts was achieved to a large extent through one off revenues from oil drilling rights and concessions. The much needed administrative and tax reform as well as further privatizations all depend on approval by Congress or, in the case of state level companies, their own legislatures; and all legislative work is subject to sluggishness, delays and, finally, standstill as we approach the municipal elections in October. Speaking of States, many of them still have their finances in shambles and have also to do their own administrative reforms and privatizations. Although the micro reforms have a positive impact on growth, to which the relatively devalued exchange rate as a stimulus for exports should also be added, their growth inducing effects take a long J-curve of a few years to take hold. The new environment of low interest rates has pushed the stock market to new record highs and expanded credit to the private sector but productivity growth, the fundamental basis of sustainable long-term development is still stagnant at best and its main structural source, education, is an area in which the consensus view is that the current federal government is an unmitigated disaster. To top all up there are the frequent relapses of interventionism and populism by President Bolsonaro, such as the decision to “forbid taxing the sun” that overruled months of technical debate, led by the electricity regulator (ANEEL), about how to roll back subsidies on transmission and distribution costs for solar energy.

Evolution of labor productivity In US\$ per working hour (PPP 2017)



Source: McKinsey & Company (2019) "Brazil Digital Report", based on Conference Board Total Economy Database (2018)

Our opinion on how to reconcile these two views is that the optimists are right in pointing to new steps in a long term trend of institutional improvement moving the country progressively to a more stable and market oriented economic environment but, on the other hand, the skeptics are also right that there is still some way to go until Brazil sees strong improvements in productivity and consistent growth and this decades long trend happens within the normal setbacks and turbulence of a democratic environment in which the risk of short term fixes and populism are always present and, unfortunately, occasionally temptations win.

If the dynamics in the political arena are so important to the outlook on growth and political polarization seems to be the new norm, the second question we posed above on the risk of major civil revolt, analogous to what has happened, for example, in Chile, is critical.

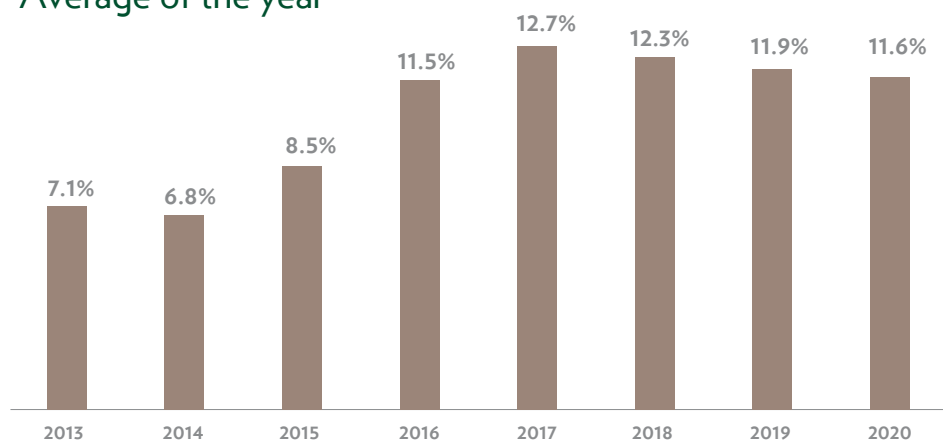
We believe this is unlikely for four main reasons. First, the growing participation of the evangelical right in politics can be traced to the 1990's and has slowly and patiently followed a strategy to build up their influence within the political system. They are concentrated mainly in three political parties (PRC, PR and PRB) but the Evangelical Parliamentary Front has members also in many other political parties and counts for a little more than a quarter of Congress, in line with those that declare themselves evangelical in the overall population. Despite the rhetoric eschewing traditional politicians, the evangelical right has become fully integrated in the political system and Bolsonaro's election and reliance on their support confirms the success of their strategy.

Second, the main leaders of the protest movements of 2013 have also chosen to pursue careers within the political system successfully transitioning and being incorporated into the political system.⁵

Third, there is no new development on the left of the political spectrum so, although there is polarization, the main leaders on the left have long been part of the political establishment and unions, one of their pillars, have been weakened by the last round of labor law reform that drastically reduced their revenues by making union dues voluntary instead of automatically deducted from pay checks.

Forth, although unemployment has unfortunately stayed above 10% for the last 4 years it has not apparently translated into social tension at a level that would lead to widespread revolt. Many people have used survival strategies for several years with informal employment and alternative forms of income generation (Uber drivers, app-based delivery services, street vendors, selling home made goods etc.) diffusing social tension. As long as the recovery continues the creation of new jobs and the formalization of informal jobs reduces unemployment and will slowly create some capacity to cushion the next downturn.

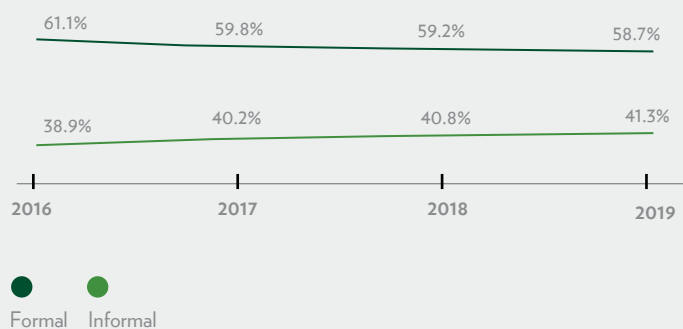
Unemployment rate Average of the year



Source: Pnad Contínua

5. The main examples are Mr. Kim Katagiri (Federal Congressman elected in 2018), Mrs. Janaina Paschoal (State Representative, elected in 2018), Mr. Fernando Holiday (City Councilor elected in 2016), Mr. Rogerio Chequer (candidate to Governor of São Paulo State in the 2018 elections), Mrs. Janaina Lima (City Councilor elected in 2016), Mrs. Samia Bonfim (City Councilor elected in 2016 and then Federal Congresswoman in 2018).

Evolution of formal and informal employment in Brazil



Source: IBGE

On balance our view is that Brazil will continue to have some growth subject to a fair amount of political turbulence but contained within the bounds of a democracy. This leads to the conclusion that external turbulence, when it comes, will surely harm the growth that might be in place but is unlikely to undo the structural institutional progress that has occurred.

We remain optimistic about being able to find good opportunities to deploy capital in Brazil but it is also clear to us that these investments will continue to reflect the ups and downs that the political environment inevitably produces. Given this, we also continue to believe that a more suitable, less risky and volatile approach for private equity is, instead of a more standard growth based strategy, to remain focused on more opportunistic deals involving real assets.

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