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Submerging Markets: Brazil's IPO Rush Hits Rough Patch

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SAO PAULO, Brazil -- Brazil's stock market is one of the best performing in the world; its main index is up 22% over the past 12 months. But for investors who took part in an unprecedented rush of IPOs last year -- when 64 companies went public, more than on London's busy stock exchange -- the returns have been decidedly more mixed.

Two-thirds of those IPOs are now trading below their offering prices. Some investors are blaming the banks that brought the deals to market, saying they cashed in on the frenzy for emerging markets by rushing to take unprepared companies public. Along the way, say investors, banks engaged in questionable practices, including lending some companies large sums before taking them public and then collecting extra fees on opening day.

"It's a case of immense bank greed and a lot of naivete on the part of investors with a lot of money on their hands," says Paulo Bilyk, co-head of Rio Bravo Investments, in Sao Paulo, which invests in the local market. "It's our version of the subprime mess."

Even in the most mature markets, IPOs can be risky bets -- after all, companies raising money from the public for the first time tend to be small and inexperienced. Traditionally, investors have been doubly wary of IPOs in volatile, less-regulated emerging markets. But in recent years, investors grew more tolerant of risk, and started diving into emerging-market IPOs. These countries accounted for 44% of the money raised in IPOs globally last year, according to research firm Dealogic.

Now, some investors are regretting their boldness. More than 60% of India's 2007 listings are worth less than they were on their opening day. In China, one of the few emerging economies still cranking out new issues, regulators are concerned that individual investors are getting a raw deal by only having limited access to shares before prices start to surge. The country recently started watching IPOs more closely, including moving to strengthen supervision over banks. Companies that get a huge infusion of cash now have to wait a year before going public.

With credit tightening and investors looking for safer bets, IPO activity world-wide has slowed dramatically. Across the globe, 163 companies have canceled or postponed plans for IPOs worth more than \$28 billion this year, according to Dealogic.

The difficulties facing Brazil's IPO market show how a loose regulatory environment might have helped feed the frenzy. In 2007, about one in nine companies that went public in Brazil did so after receiving large loans from the underwriters that handled their IPOs. These loans were used to quickly prepare for an offering, in some cases by buying new assets. In exchange for lending money, underwriters collected extra fees after the IPO, either in the form of cash or stock options.

Such loans have the potential to create a huge conflict of interest. The job of an underwriter is to act as an intermediary, advising a company on the opening share price and lining up investors to buy those shares. It then pockets a small fee for each share it sells. But when a bank has a bigger-than-normal stake in the outcome of an offering -- such as a large loan it wants to recover or the promise of shares -- experts say the bank might set prices too high or rush an IPO of an unprepared company.

Banks in Brazil "took companies without credentials, and gave them credentials," says Octavio Castello Branco, who helps run the Sao Paulo private-equity fund Patria Investimentos.

Take the case of Agreco Ltd., an agricultural commodities company whose stock has slumped 78% since its October IPO. Credit Suisse, which is the leading underwriter of IPOs in Brazil, took Agreco public in a deal worth 666 million Brazilian reais (\$411 million at today's exchange rate). The bank lined up investors

and fixed the offering price at 10.40 reais per share.

Eight months before the IPO, Credit Suisse lent the heavily indebted trading company \$120 million to build two soy-crushing plants and a biodiesel facility. These were the principal assets later touted to investors.

In return for the loan, Agrenco agreed to pay Credit Suisse a cash bonus of \$11.5 million and 6.9% of the company's shares should it have a successful IPO. On opening day, those Agrenco shares ended up being worth 110 million reais. (Credit Suisse has not yet sold its shares, which would be worth about 27 million reais today.) In addition, Agrenco paid Credit Suisse 30 million reais in underwriting fees. Between repayment of the original loan, bonuses, and fees, Agrenco's bill came to nearly 60% of the money it raised in the offering.

"It was definitely pretty expensive," says Agrenco's director of investor relations, Marco Antonio de Modesti.

Investors, meanwhile, were left holding shares in a company that hasn't delivered. Agrenco managers reported 2007 earnings of about 43 million reais, or about 50% of what was promised. Agrenco says it couldn't raise its own prices enough to make up for rising grain costs.

Credit Suisse says it isn't responsible for Agrenco's performance. The bank says if Agrenco had waited to get a cheaper government loan, it wouldn't have been able to grow as quickly. Credit Suisse says further that it has sponsored some of Brazil's best performing IPOs, including farm company SLC Agricola, up 121% since its IPO in June 2007.

Antonio Quintella, the 42-year-old managing director of Credit Suisse in Brazil, said in an email message that in deals where the bank lent money to companies it later took public, "clients wanted advice, financing and access to capital markets, all areas where we are strong, so we had an opportunity to meet their needs on several fronts."

In the U.S., a variety of rules limit a bank's ability to underwrite the IPO of a company to which it's made large loans. For example, if a company uses more than 10% of the cash it raised in an IPO to repay an underwriter loan, an independent bank has to be brought in to determine if the opening price was set fairly. Investment banks in the U.S. also can't collect fees of more than 9% of an offering's total value. That includes underwriting fees, stock awards and any other special fees connected to a recent loan.

Such independent oversight of deal pricing is not required in Brazil, nor do banks face fee limits. Regulators say the only requirement is that prospectuses offer full disclosure of any loans and special payments.

"We don't have the power to stop a loan. It is not up to us to say it's good or bad," says Felipe Claret, a superintendent at Brazil's stock-market regulator, the Comissao de Valores Mobiliarios, or CVM.

Brazil's IPO wave, which began in 2004, was a breakthrough for a country where high interest rates long stifled investment. Sao Paulo's Bovespa stock exchange spurred IPOs by launching the Novo Mercado, a new board open only to companies that meet rigorous corporate-governance standards.

During the past five years, a total of 111 Brazilian companies went public, raising the total number of public companies in that country by a third. The IPO boom peaked last year, when offerings raised a total of 56 billion reais, most of it from foreign investors. Local magazines dubbed Brazil's enthusiastic young executives "generation IPO."

Few major IPO markets rose as quickly as Brazil's -- and perhaps none have fallen so sharply since. So far this year, only four companies have gone public, down from last year's record 64. This year's list includes Brazil's largest ever IPO, also led by Credit Suisse, of oil start-up OGX Petroleo e Gas Participacoes SA. Those shares are up 14% since trading began last Friday.

Stock prices of last year's IPOs are down about 7%, on average, even as the overall Bovespa index, a basket of leading Brazilian stocks, has continued to rise.

Global market turmoil played a big role in the poor performance of IPOs, hitting stock prices of these relatively small, untested companies particularly hard. Indeed, when the stocks of newly public companies were soaring, there were few complaints. Will Landers, manager of the \$8.5 billion BlackRock Latin America fund, which has 70% of its money in Brazil, says he doesn't entirely blame banks for losses. "I don't want to give them a pass," he says, "but it's not correct to blame the banks. No one forced anyone to buy anything."

But other investors say banks, riding a frothy market, simply arranged too many deals too quickly. For instance, partly because of the success of offerings by home builders like Gafisa, which went public in February 2006, banks piled in, taking 19 more home builders public. By contrast, the U.S. has 10 public home builders and Mexico has six.

"A lot of those companies should never have gone public," says Thomas McDonald, an associate of billionaire Sam Zell, whose investment fund backed Gafisa. "I think the overzealous bankers convinced founders their dreams would come true, and at valuations they never imagined."

Ilan Goldfajn, head of the investment fund Ciano Investments in Rio de Janeiro, was among the investors who bet heavily on new domestic stocks, in retail and other sectors. Partly as a result of wide declines in those shares, his fund sharply underperformed the index last year. "So now I am whining," he says.

The pace of deals in 2007, sometimes several a week, left little time to read the fine print. Prospectuses, which are hundreds of pages long, are translated for U.S. investors from Portuguese into English. Greg Lesko, a manager at hedge fund Deltec Asset Management in New York, recalls how the stack of unread prospectuses grew on his office floor. "There is no way we could go through all the information," says Mr. Lesko.

In a story about Credit Suisse's loans to clients that appeared last year in a local Brazilian business newspaper, Jose Olympio Pereira, Credit Suisse's head of investment banking, was quoted as saying, "whoever invests in IPOs has to know how to read the prospectus and understand it."

In Brazil, companies that received large pre-IPO loans have greatly underperformed other new issues. Credit Suisse, for example, gave loans and collected bonus payments in five of 26 deals it participated in last year. Those five stocks, including construction companies InPar SA and Triunfo Participacoes e Investimentos, beef-supplier Minerva SA, Banco Pine and Agrenco have declined by about 52% on average since they began trading.

Credit Suisse says those stock losses are related to a general market downturn that has affected all newly public companies.

UBS, which competes fiercely with Credit Suisse in Brazil, also gave loans to the owners of companies that it later took public, including two small banks. Cruzeiro do Sul, a small bank whose offering UBS handled last year, showed net equity of 287 million reals before it went public. More than half of that -- 150 million -- had come from UBS just three months earlier, according to the offering's prospectus. Cruzeiro's stock price is down about 52% since its offering in June.

UBS declined to respond to questions about specific offerings. In an emailed statement, the bank said, "UBS offers a broad range of products and advisory services to our clients. Our primary objective is to determine solutions best suited to clients' needs."

Fausto Guimaraes, investor-relations director of Banco Cruzeiro do Sul, says the loan money from UBS "had the effect of preparing the bank for the IPO, and increasing its size." Mr. Guimaraes says that the IPO went well, and that so far the bank's results are "all in line with the pre-IPO projections." He blamed the company's stock-price decline on a general market downturn caused by the U.S. subprime-mortgage crisis.

In the case of construction company Triunfo, Credit Suisse lent the company 200 million reals weeks before its July 2007 IPO. Carlos Lima, Triunfo's CFO, says the money went to purchase a toll road and part of a port operation, and that Credit Suisse helped Triunfo negotiate these deals.

Credit Suisse's loan came with a hefty price tag: low-priced options for 23% of the company's shares. On IPO day, Credit Suisse cashed in those options for a profit of about 110 million reals, more than four times the 26 million real underwriting fee. Together, the bank took in a quarter of the value of the entire offering, not counting the loan repayment.

Triunfo's stock has fallen 40% since its IPO. Mr. Lima blamed the decline on market conditions and says the loan for Credit Suisse was worthwhile. "They were doing a lot more than loaning to the company, they became an investor and a partner," he says. "I wouldn't be here if it weren't for Credit Suisse."

James T. Areddy and Romit Guha contributed to this article.

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