Is a Reversal of Fortune Imminent in Latin America?

If Mexico has maxed, could Brazil be beckoning?

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Last October 19, the Brazilian government imposed taxes on foreign purchases of the country's stocks and bonds. The government levied the taxes to slow down the colossal run on the Brazilian real, which had appreciated by more than 26% during the 10 months prior. At that time, we recommended looking at Mexico, rather than Brazil, for Latin American investment prospects. While that call has worked out well, the real question is, what's the best move going forward?

Before the imposition of the foreign investment tax, Brazil was massively outperforming Mexico, and for good reason. After all, Mexico was in the midst of a severe economic contraction, industrial production and consumer confidence were at multiyear lows, unemployment was at multiyear highs, and the currency was getting decimated. That was pretty much the opposite of what was happening at the time in Brazil, where despite the global downturn, the economy was holding steady on the back of strong commodity pricing, lower interest rates, and winning the 2016 Summer Olympic bid. But that's was just it. All the good news had been baked into to Brazil (and all the bad news was embedded into the story in Mexico), so in terms of relative upside, Mexico made a lot more sense.

Brazil vs. Mexico: Past 18 Months

	01 Jan 2009 to 19 Oct 2009 (%)	19 Oct 2009 to 02 Jun 2010 (%)
Bovespa (Brazil)	67	-7.23
Bolsa (Mexico)	33	1.77

Source: Bloomberg

Now that the gap has been closed, it might be time to start looking into Brazil once again, especially when it comes to your Latin American telecom exposure.

When the taxes were first levied last fall, the Brazilian real predictably depreciated against the dollar, but has now begun to stabilize. Thanks in part to a strong automobile industry, the country's industrial output was up more in April (+19.74% year over year) than it has during the past six years. Unemployment has declined to 7.3%, and consumer confidence is on its way up. Private bank lending is now at record highs and, thanks to higher wages and greater disposable income, default rates are dropping. Most importantly, equities in Brazil are now cheaper than those in Mexico, despite the fact that Brazil is growing more rapidly.

The economic viability of the consumer is key for telecom carriers, who are trying to extract maximum value from a region that is over 90% penetrated. Despite the high penetration rate, the Brazilian wireless sector offers an intriguing risk/reward dynamic.

VIVO Holding Company VIV

While we weren't overly enamored with what we saw from Vivo in the first quarter (average revenue per user was down more than 9%, and EBITDA per user fell by more than 12%), there are still plenty of reasons for optimism. Vivo took 70% of share of the country's net postpaid additions last quarter, even though it shaved 32% off of its subscriber acquisition costs (SAC). The firm's market share has risen for seven consecutive months through March, and it still leads the sector in both postpaid and overall market share. Vivo also offers the highest-quality service in the industry. Lastly, the stock is down by more than 10% year-to-date, and is now trading below its historical valuation levels.

The other thing to keep in mind with Vivo is the fact that Telefonica TEF is in hot pursuit to buy out the remaining 50% of Vivo it doesn't already own from Portugal Telecom PT. Telefonica would like to fully acquire a wireless unit in Brazil so it could merge it with its fixed line assets and generate considerable cost synergies. The offer that Telefonica made last month valued Vivo at a premium of more than 140% to what it was trading at (actually, to be specific, the offer is for 50% of Brasilcel, a holding company that directly controls Vivo). Telefonica increased the offer on June 1, by another 14%, after Portugal Telecom dismissed the original proposal. It has even been rumored that America Movil's AMX chief, Carlos Slim, could be interested in buying into Vivo (indirectly through PT), if only to block Telefonica's purchase. With all of these potential suitors, there are plenty of potential triggers for Vivo's share price.

TIM Holding Company TSU

Of course, if Telefonica was unable to take full control of Vivo, it could view TIM Brazil as a fallback plan. After all, it already owns a controlling stake in TIM Brazil's parent company, Telecom Italia TI, so it's not too far-fetched to envision a scenario where Telefonica buys up the rest. That said, it would likely mean the end of Telefonica's ownership of Vivo, given the anti-trust regulations in Brazil.

Just like Vivo, TIM's recent key performance indicators are a mixed bag. Very good subscriber growth is offset by continued ARPU declines. However, after a 9.5% year-to-date decline, the shares are cheap relative to their historical valuations. Last quarter, the firm expanded its margins by more than 4 percentage points, and the SAC/ARPU ratio is improving. This could be the reason why Telefonica, and the other Brazilian telcos, have recently been sniffing around TIM as a potential takeout target.

Oi TNE

We wouldn't be shocked to see Oi take an active interest in a deal with TIM either. Now that its merger with Brazil Telecom BTM is in the books, the firm is generating considerable cost synergies that helped expand its first quarter EBITDA margin by more than 4 percentage points, to nearly 34%. The fact that Oi was able to become more profitable without being able to grow revenues (0.3%) is especially encouraging. Unlike its peers, Oi was actually able to grow its wireless ARPU last quarter, thanks in part to the stronger than expected growth in its postpaid base.

Although its fixed-access lines in service declined by 3.4% last quarter, broadband picked up the slack, by expanding its base by more than 8.3%. Add it up, and the firm's revenue generating units expanded by 8% year-over-year. More importantly, EBITDA-per-RGU grew nearly 7%. Not only is the firm's customer base expanding, but Oi is also extracting more earnings from each subscriber. Best of all, management believes that these elevated EBITDA margin levels are not only sustainable, but beatable by year-end. The cost-cutting benefits from the Brazil Telecom merger seem to be paying off in all of the firm's expense metrics, especially in personnel, materials, and cheaper cost of goods sold. Following an 18.75 % year-to-date retreat, the shares are definitely undervalued.

This is not to say that the other more-Mexican based telcos, namely America Movil and NII Holdings NIHD aren't attractive long term investments. It's just that they don't have the same relative upside given their current share prices. America Movil (up 2.55% year-to-date) is a phenomenal company that is only getting better, now that it has fully acquired its fixed line sister-company Telmex TII. The firm could generate close to $1 billion in operational synergies through the merger, which enhanced its already dominant network footprint even further. That said, with the Telmex news already in the price, and spectrum auctions ongoing in Mexico, we don't see any visible share price catalysts on the horizon

On the same day the CFC (Mexico's Federal Competition Regulator) green-lit America Movil's acquisition of Telmex, it also approved media giant Televisa's TV purchase of a 30% stake in NII Holdings. The deal not only alleviated 3G network funding concerns for NII, but it opened the door for numerous integrated-media bundling opportunities. The market loved the deal, and the stock jumped by 10 % following the announcement, and is up by more than 9% year-to-date. Now comes the messy part: NII must wait for the 3G auctions in these countries to be completed, acquire the licenses at a reasonable price point, and then execute the deployment without too many hiccups. In an environment where competition is already increasing, and ARPUs are declining, this could be easier said than done. America Movil and NII Holdings may have outperformed their Brazilian-based peers year-to-date, but don't be surprised to see a reversal of fortune.