Investing in Latin American Infrastructure

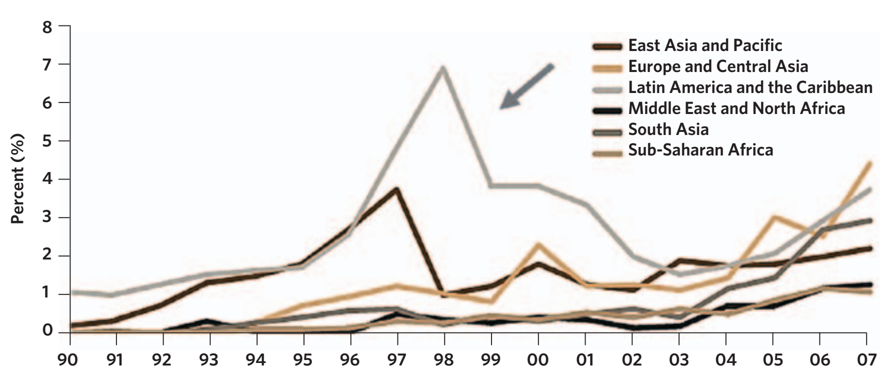
BNY MELLON ASSET MANAGEMENT

BNY MELLON ARX

Remedying decades of neglect could result in US$450 billion of infrastructure investment in Latin America from now until 2015.[1] Improved fortunes allow countries like Brazil in particular to address infrastructure deficiencies that act as a constraint on economic development. These investments, in turn, can boost employment and reduce poverty, both politically desirable outcomes, as Brazil taps its sizeable economic potential. Other countries in the region, such as Mexico and Peru, also have significant infrastructure quality gaps that they are seeking to redress; while Chile, now a member of the OECD, has ambitions to join the ranks of developed countries. For investors, we believe infrastructure is an asset class offering the potential for long-term, stable cash flows, with a generally low risk of capital loss.

We believe prudent macroeconomic policies have created conditions that should enable Latin America to emulate Asia in terms of infrastructure development. Previously, high interest rates and inflation badly affected Latin America, with the payment of social security and government salaries typically crowding out investment in infrastructure. Now interest rates are lower and inflation has been largely tamed, while, in Brazil, significant numbers of people have risen out of poverty into the middle classes. The reduction of real interest rates encourages domestic investment into such areas as infrastructure development. Sub-trend growth globally, particularly in the US and Europe, offers the prospect of interest rates staying low. In Brazil, infrastructure investment is likely to be an important driver of growth. Brazil is also in the fortunate position of having in excess of US$275 billion of international reserves, according to Banco Central do Brasil data as of the end of September.

Exhibit 1 – Total Investment Commitments By Region



Source: World Bank and PPIAF, PPI Project Database. (http://ppi.worldbank.org)
Source: Chart – PIMCO, Morgan Stanley as of April 2010.
Fay M. and M. Morrison, 2005. Infrastructure in Latin America and the Caribbean: Recent developments and key challenges. Report Number 32640-LCR. The World Bank Finance, Private Sector and Infrastructure Unit, Latin America and the Caribbean Region. Washington: The World Bank.

1 Patricio Abal, "Infrastructure Funds in Latin America," *Alternative Latin Investor*, May 2010.

December 2010

In the wake of the global downturn, Latin America has recovered strongly, according to the International Monetary Fund (IMF). The recovery is, in the view of the IMF, being led by Brazil, where real GDP growth has been running close to 10% since the third quarter of 2009. The IMF projects real GDP growth in Brazil of 5% for 2010, while the forecasted figure for the region as whole is 4% for the same time period.[2]

In contrast to Asia, the private sector in Latin America is playing a significant role in the development of infrastructure, while being able to draw on government help with financing.

Lula's Legacy

Outgoing President Luiz Inacio Lula da Silva is widely credited with helping to achieve the Brazilian economy's stability. However, there is also the view that the new-found stability owes more to strong commodity prices than to Lula's personal merits and policies. Others attribute Brazil's recent boom to the groundwork laid by Fernando Henrique Cardoso, Lula's predecessor. Cardoso helped stabilize the country's erratic economy in the early 1990s, charting a course away from the cycles of boom and bust and out-of-control inflation.

International investors largely ignored the recent presidential election, essentially regarding it as a non-event. We believe such views were typically based on the assumption that neither main contender would stray from Lula's and Cardoso's orthodox macroeconomic policies, despite their different backgrounds and political orientations. Constitutionally barred from seeking a third consecutive term, Lula did not stand in the election, which unexpectedly went to a second round. In the first round, Lula's endorsed candidate Dilma Rousseff failed to deliver a knock-out blow to her main rival, Jose Serra, the centrist opposition governor of Sao Paulo state. However, Rousseff decisively won the presidential run-off election to become Brazil's first female president.

Two-Pronged Approach

In contrast to Asia, the private sector in Latin America is playing a significant role in the development of infrastructure, while being able to draw on government help with financing. In Brazil, funding for infrastructure is provided by the government financial institution, Caixa Economica Federal, a promoter of urban development, as well as by the Brazilian Development Bank (BNDES), the main financing agent for development in Brazil.

2 http://blogs.worldbank.org/prospects/prospects-daily-imf-upgrades-world-growth-forecast-to-42-for-2010-led-by-strong-recovery-in-the-deve

Brazilian infrastructure development is likely to be two-pronged, with both private sector and government involvement.

Governments in Asia have typically taken the lead on infrastructure projects — notably, China's government-backed companies have been at the vanguard of its infrastructure revolution. Whereas in some countries land rights are often particularly contentious, in China government clearances for roads or power plants have been easier to obtain because of its state-led character.

Brazilian infrastructure development is likely to be two-pronged, with both private sector and government involvement. That the current state of Brazil's infrastructure could potentially impede economic development is a commonly held view. Extensive capacity shortfalls are evident in the country's ports, railways, airports, roads and distribution centers — in particular, Brazil's transport infrastructure suffers from the lack of a national rail network. The most significant investment opportunities are likely to be in areas such as toll roads, railways and port infrastructure, with an emphasis also on the electricity sector. The supplying of electricity is a sensitive topic, as its rationing contributed to the decline of a previous government.

Over the period from 2010-2013, infrastructure investment is likely to represent 2.2% of GDP per year (Exhibit 2).

Exhibit 2 – Brazil: Infrastructure Investment Plans (2010 - 2013)

Sectors	R$ billion	% of total	% of GDP per year
Electricity	92	33.6	0.7%
Telecommunication	67	24.5	0.5%
Sanitation	39	14.2	0.3%
Railways	29	10.6	0.2%
Highways	33	12.0	0.3%
Ports	14	5.1	0.1%
Infrastructure	**274**	**100**	**2.2%**

Source: World Bank and PPIAF, PPI Project Database. (http://ppi.worldbank.org) Date: 03/25/2010.

Traditionally, Brazil's overall fixed investment to GDP has been below the figures for China (40%) and India (30%).[3] BNY Mellon ARX anticipates that overall fixed investment to GDP in Brazil is likely to increase to 22% in 2011 from the current levels of 18-20%. Fixed investment spending covers both nonresidential investment on plants and equipment as well as residential investment in single-family and multi-family homes.

3 CEIC data as of October 2010.

Among the key infrastructure projects is the Rio-Sao Paulo high-speed rail link intended to allow travel between the two cities in under two hours. This high-profile assignment is an element of phase two of the Growth Acceleration Programme (PAC 2) announced in March 2010. (The aim is to have the bullet train running by 2016 when Brazil hosts the Olympic Games.)

In Brazil, the investable universe of infrastructure-related companies is likely to number more than 100 stocks and be growing all the time.

PAC 2 will provide reais 1.59 trillion (US$940 billion) in infrastructure and public projects as the second phase of the economic stimulus programme targeting areas of high social sensitivity, such as housing and health. Of that total, reais 958 billion (US$526 billion) will be invested between 2011 and 2014.[4] The Programa de Aceleracao do Crescimento (PAC) was originally launched in 2007.

As Brazil prepares to host both the 2014 World Cup and 2016 Olympics, there is already high visibility for infrastructure projects. Both events provide welcome publicity for the infrastructure push and the politicians behind it.

Later this decade, Brazil has the potential to emerge as a leading global oil supplier by extracting from the deposits in its "pre-salt" fields. State oil and gas company Petrobras said it plans to spend US$224 billion between 2010-2014 to accelerate development of Brazil's pre-salt oil deposits, so called because they lie under a thick layer of salt, deep below the seabed. Petrobras recently raised US$70 billion in a heavily oversubscribed public share offering.[5]

In Brazil, the investable universe of infrastructure-related companies is likely to number more than 100 stocks and be growing all the time.[6] Private participation in road projects provides an illustration of how the investable universe might develop. After having no new road projects with private participation in 2002–2006, Brazil implemented one project in 2007 and eight in 2008, according to the World Bank Group. It is notable for investors that Brazilian companies often pay dividends.

4 Brazilian government press release from March 29, 2010, "President Luiz Inacio Lula da Silva Announces US$526 Billion in Public and Private Investments Over 2011-2014," www.brasil.gov.br/press-releases
5 Peter Millard, "Petrobras Raises $70 Billion in World's Largest Share Sale," *Bloomberg,* September 23, 2010.
6 BNY Mellon ARX research.

According to the Plan Nacional de Desarrollo 2007-2012 (National Development Plan 2007-2012), the Mexican economy — barring significant changes — is expected to grow on average by approximately 3.5% per year.

Infrastrastructure Elsewhere in Latin America

Mexico has also acknowledged that its infrastructure lags that of other countries and requires improvement; in 2007, Mexico rolled out the National Infrastructure Programme (NIP). The NIP identified more than 300 infrastructure projects in multiple sectors representing over US$141 billion to be financed using public-private partnerships, with significant Mexican public-sector investment.[7]

Established in February 2008, the Fondo Nacional de Infraestructura (FONADIN) is the Mexican government's agency for infrastructure in the sectors of communications, transport, water, the environment and tourism. FONADIN supports private-sector participation in the planning, design, construction and transfer of Mexico infrastructure projects. It covers four major areas: highways, roads and bridges; water, irrigation, drainage and sanitation; railways, ports, airports, urban and interurban transport; and projects designed to preserve the environment and biodiversity.

According to the Plan Nacional de Desarrollo 2007-2012 (National Development Plan 2007-2012), the Mexican economy — barring significant changes — is expected to grow on average by approximately 3.5% per year. The Plan Nacional de Desarrollo calls for major public- and private-sector investment in infrastructure.

Despite its wealth of resources and demonstrated economic resilience in the global downturn, we believe Peru has a significant infrastructure quality gap. The government's economic stimulus plan, meant to offset the effects of the global financial crisis, targeted spending on public works and infrastructure public-private partnerships. With the plan largely implemented, the private sector is increasingly expected to play a leading role again.

7 http://www.buyusa.gov/mexico/en/infrastructure.html

We believe the involvement of private capital creates a favorable environment for prospective shareholders and should make for attractive investment opportunities in Latin American infrastructure.

In February 2010, a massive earthquake hit central Chile. The country's electric power, telecommunications and transportation infrastructure were among the segments of the Chilean economy hardest hit and will require extensive rebuilding. The Chilean government estimates the cost of repairing and rebuilding the infrastructure damaged during the earthquake will be around US$1.2 billion.[8] Prior to the earthquake, the Ministry of Public Works had unveiled major construction plans — Chile 2020 — to celebrate Chile's bicentenary in 2020. The projects envisaged included the enlargement of Santiago's airport, the creation of reservoirs and irrigation canals, shipping and coastal infrastructure and a coastal road spanning the two-thirds the length of Chile. Here, as elsewhere in the region, the private sector is expected to play a significant role.

We believe the involvement of private capital creates a favorable environment for prospective shareholders and should make for attractive investment opportunities in Latin American infrastructure. In our view, the multiplier effect of such investment will help stimulate growth and make for a compelling case for investing in the region for many years to come.

8 "Chile's Earthquake-Delayed School Year Begins," *Associated Press*, March 8, 2010.

BNY MELLON
ASSET MANAGEMENT

The Alcentra Group
Ankura Capital Pty Limited
Blackfriars Asset Management Limited
BNY Mellon ARX
BNY Mellon Beta Management
BNY Mellon Cash Investment Strategies
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management