Making sense of Brazil’s Lava Jato scandal

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Executive Summary

• Brazil’s Lava Jato scandal is more than just a mere corruption scandal involving alleged kickbacks at oil giant Petrobras. It has snowballed into at least three other crises that amount to a giant stress test for Brazil: a corporate crisis for many of the country’s biggest companies, whose business has dried up; an economic crisis as the scandal’s impact on investment drags Brazil deeper into stagflation; and a political crisis for President Dilma Rousseff only four months into her new term, as the alleged involvement of many politicians from the ruling coalition raises questions over the country’s governability.

• The economy is likely to get worse before it gets better as the government imposes tough austerity measures and investment in oil & gas and infrastructure feels the impact of the scandal.

• While polls show support for the opening of an impeachment procedure against Ms. Rousseff, that probability remains low, as she has not been personally implicated in the scandal.

• The greater risk is that Ms. Rousseff becomes a lame-duck President, beholden to Congress, and the country muddles through for the next few years, once again disappointing those who believed the proverbial land of the future was finally living up to its potential. Brazil’s presidential system still gives Ms. Rousseff some breathing space, but to save her presidency, she needs to change her style and show the deft political touch and leadership that she has so far failed to display.

• While the consumption boom that drove the Brazilian economy’s growth has come to an end, the low value of the Real, which has depreciated by close to 30% vs the US Dollar and attractive valuations could offer opportunities for foreign investors.

Brazil is the land of telenovelas, and with the Lava Jato scandal, it has created a real-life soap opera whose plot defies the imagination of even the most creative script-writers.

What began as a local investigation into money-laundering at gas stations and laundries (hence the name Operação Lava Jato, or Operation Car Wash) in the southern state of Parana has mushroomed into what the weekly magazine Veja has called “one of the biggest corruption schemes ever revealed in Brazil – and, for its duration, volume of money and reach into the highest political echelons in the country, maybe one of the biggest in the world.”

As the investigation enters its second year, the scandal has already snared in its nets Brazil’s biggest company, state-controlled oil giant Petrobras, many of the country’s biggest private construction companies, a handful of multinationals, more than 50 politicians, the treasurer of the ruling Workers’ Party and has triggered a nascent movement seeking the impeachment of President Dilma Rousseff (still a remote possibility at this stage) less than four months into her second term. And this could be just the start: “The greatest share of accusations is still in front of us,” says Deltan Dallagnol, the public prosecutor who is coordinating the Lava Jato task force. “We’re discovering crimes every week,” he said recently as he unveiled new revelations.

In fact, Lava Jato goes far beyond a mere corruption scandal. It exposes not just the outsized importance of Petrobras for the Brazilian economy, but also the dynamics of Brazil’s political system. Its ramifications and implications are such that it has snowballed into at least three other crises: a corporate crisis for many of the country’s biggest companies, whose business has dried up; an economic crisis as the scandal’s impact on investment drags Brazil deeper into stagflation; and a political crisis for President Rousseff, as the alleged involvement of many politicians from the ruling coalition (including the speakers of the House and the Senate) raises questions over the country’s governability. In short, the interlocked crises are a massive stress test for Brazil that pose a huge credibility issue for Ms. Rousseff and her government – and underscore the domino effect a corruption scandal can have even on a major economy like Brazil’s.

The facts: Lava Jato in a nutshell

How did Brazil reach this point? First, the facts. While investigating a money laundering case in Southern Brazil (itself the result of a previous landmark political corruption scandal
which sent to jail Jose Dirceu, a former government minister and chief of staff to ex-President Luiz Inacio Lula da Silva), the Federal Police came across an intriguing connection: a money dealer involved in the laundering scheme, Alberto Youssef, had purchased a Range Rover Evoque for Paulo Roberto Costa, the Director of Supplies of Petrobras from 2004 to 2012. On March 17, 2014, the Federal Police launched a wave of arrests, including that of Mr. Youssef, followed shortly thereafter by that of Mr. Costa. Building on the seemingly tenuous Range Rover connection, investigators uncovered what appears to be a highly organized “club” that included top Petrobras executives, construction companies, Petrobras suppliers, independent agents and politicians. In what one of the suspects has called “institutionalized corruption,” the cartel of Brazilian companies conspired over several years to deliberately overcharge Petrobras by between 1% and 3% on a number of contracts with third-parties. (Mr. Costa has since changed his testimony and said that Petrobras was not overcharged, it’s the suppliers who cut into their profit margins).

The excess funds were used in part to finance the political campaigns of politicians linked to the ruling coalition (sometimes in the form of legitimate contributions to political parties) and in part for bribes to Petrobras officials. As one of the jailed businessmen, Engevix’s Gerson de Mello Almada, put it in his testimony: “We drove down a highway called Petrobras on which we had to pay tolls.”

Using a Brazilian plea-bargaining scheme called delação premiada, investigators have used testimony by Messrs. Youssef, Costa and others to arrest 11 senior executives from four construction companies (Engevix, OAS, UTC and Queiroz Galvão), three top Petrobras executives and implicate more than 50 politicians from seven parties, all but one from the coalition that supports Ms. Rousseff. Those implicated include Renan Calheiros, President of the Senate, Eduardo Cunha, President of the Chamber of Deputies, Joao Vaccari Neto, treasurer of the ruling Workers’ Party (PT) and Senator Fernando Collor de Mello, a former President of Brazil who resigned in disgrace in 1992 in a corruption scandal just before an impeachment vote. To date, investigators have identified illegal transactions totalling 2.1 billion Reais, which, says daily O Globo, “already makes it the country’s biggest-ever corruption scandal.”

By some estimates, up to 10 billion Reais may have been embezzled in the case. The investigations are ongoing and there could be more to come. Investigators believe similar schemes may have been in place in other state-controlled companies, and other construction companies including Andrade Gutierrez and Odebrecht, may be involved in yet more tainted contracts. The names of several foreign companies or their agents have also emerged. And in recent testimony, former Petrobras official Pedro Barusco told the recently-installed Parliamentary Investigation Committee that is conducting an enquiry into the case that a bribe of $300,000 was paid by Dutch company SBM Offshore to finance Ms. Rousseff’s 2010 presidential campaign. Ms. Rousseff has not been directly implicated in the scandal, but many of the facts under investigation occurred under her watch, at a time when she was chairman of the Board of Petrobras while serving as Minister of Mines and Energy and, subsequently, chief of staff to President Luiz Inacio Lula da Silva.

Three key challenges

This leaves Brazil facing a triple challenge:

1) Break the corporate paralysis:

The corruption scandal has left Brazil’s corporate world in limbo, with a number of companies lacking cash to invest or banned from bidding for Petrobras contracts because of their alleged involvement in the scandal. The obvious biggest victim of the scandal is Petrobras itself. Once the world’s fourth biggest stock-market capitalization following its 2010 share offering, Petrobras has lost two-thirds of its market value. With gross debts of $135 billion, the company is the world’s most-indebted oil major, and Moody’s recently downgraded Petrobras’s credit to junk status, warning that it faces “serious near-term liquidity pressure.” Such is the uncertainty surrounding the cost of the corruption scandal that the company has been unable to publish audited accounts since November, when it was slated to issue its third-quarter numbers (though press reports say Petrobras is hoping to finally unveil its accounts next week.) Petrobras has come up with two vastly-differing estimates: the first takes into account the 3% cut on suspicious contracts that Mr. Costa has mentioned; this would have cost Petrobras an estimated 4 billion Reais. The second estimate attempts to put a mark-to-market value on Petrobras’s assets, discounting the inflated value of contracts and construction projects, mainly for refineries; by this count, Petrobras should take a write-down of a staggering 89 billion Reais. In the absence of a credible number, Petrobras’s auditor, PwC, has refused to approve the accounts. This, in turn, impedes Petrobras from accessing credit markets to finance its
huge investment program (though it recently signed a $3.5 billion financing deal with the China Development Bank). Folha de Sao Paulo wrote recently that CFO Ivan Monteiro has "the worst job in the world." Mr. Monteiro joined the company on the coat-tails of CEO Aldemir Bendine, who was appointed by Ms. Rousseff after her protégé, Maria Das Graças Foster resigned as CEO, along with five top executives. Mr. Bendine, who previously ran Banco do Brasil, is now seeking to slash costs, shed $13.7 billion worth of assets and downsize Petrobras’s $206 billion investment plan.

Given Petrobras’s weight – its investments represent 10% of Brazil’s total, its operating expenses are higher than the government’s annual expenditures on its Bolsa Familia social program and the taxes it pays amount to 5% of Brazil’s total tax take – its woes set off a chain reaction throughout the Brazilian economy. Suppliers such as Sete Brasil, which makes platforms and probes, is close to bankruptcy. Construction company OAS has suspended payments on its 2021 debt in order to preserve liquidity after being banned from bidding for contracts with Petrobras and has sought protection from creditors. News reports have suggested that a number of construction companies are considering seeking protection from creditors as their liquidity dries up. Banks face the risk of defaults and large provisions on outstanding debts and are requiring guarantees from the 25 construction companies that are effectively prohibitive. As a result, many are unable to honor their commitments on other projects such as roads or airports – just at a time when the government is hoping to relaunch infrastructure investments to jump-start the economy.

2) Relaunch the economy:
Even without the Lava Jato scandal, Brazil’s economy is “a mess,” as The Economist put it recently with characteristic British understatement. The economy is in recession, with economists expecting GDP to fall by anywhere between 0.5% and 2% this year. Inflation is running at an annualized clip of about 8%, significantly above the range set by the government of 2.5% to 6.5%. Unemployment, at 6.8%, is rising, and the economy is creating fewer jobs. Consumption, the engine of Brazil's growth in the past decade, is falling, and investment is expected to fall by 0.7% this year. The Real is at its weakest level against the dollar in 12 years, having depreciated by 30% vs the dollar since Ms. Rousseff’s re-election. The government is in a policy bind: to control inflationary pressures (partly the result of the government lifting a pre-election price freeze on gas, electricity and transportation prices), the Central Bank has pushed through a series of interest rate hikes, and the base Selic rate is at 12.75%, one of the highest rates in the world. But these successive hikes risk further strangling the economy.

Ms. Rousseff has repeatedly tried to lay the blame for the country’s stagflation on a challenging international environment. But to many economists, the problems are home-grown, the result of Ms. Rousseff abandoning in her first term the country’s “tripod” policy – inflation targeting, budget surpluses and a floating currency – in favour of a so-called “new economic matrix,” a mix of stimulative measures including tax cuts on a broad number of sectors and subsidized credit. In a stunning policy reversal, Ms. Rousseff appointed Joaquim Levy, a notorious fiscal hawk, as Finance Minister in her second term. With Brazil at risk of losing its investment grade, Mr. Levy has not shied away from tough measures in order to achieve his aim of a primary budget surplus of 1.2% of GDP and stabilize gross debt, including cutting some subsidies and spending programs. Nor has he shied away from polemical statements, calling a measure backed by Ms. Rousseff that allowed companies to reduce social security contributions “a joke that cost 25 billion Reais per year and did not create or even protect jobs.” But the problem is that Mr. Levy “is very isolated,” in the words of former Central Bank governor Arminio Fraga, and the government does not have a full growth agenda beyond pushing a fiscal adjustment, which is viewed as a necessary, but insufficient, pre-condition. And this is where Lava Jato does not help: Mr. Levy’s bet was that the recessionary effect of his fiscal measures would be offset by a confidence shock that would stimulate investment. But with Petrobras and construction companies facing liquidity issues, the country’s investment engines are stuck, and confidence in the government’s ability to boost growth in the short-term is low. Says economist Mario Mesquita of Banco Plural: “The Petrobras topic has become a macro issue this year, because of the risk factors, the company’s decelerating investment plan and its significant macro-economic implications.”

3) Regain political credibility:
Rarely has a government lost momentum so fast: Less than four months after her re-election (admittedly by 51.64% to 48.86% for Aécio Neves, the slimmest margin of any president since Brazil’s return to direct democracy in 1989) Ms. Rousseff is already facing calls for her impeachment (which is improbable as Brazil’s constitution says a standing president can only be impeached for acts committed during the current term in office) and massive street protests against her government. An
estimated 2 million people marched against her government throughout the country in March and another 660,000 marched again last Sunday. Her popularity level has fallen to an all-time low of 23% in February from 42% in December, coinciding with what Estado de Sao Paulo calls “the most intense reversal of economic expectations in the past two decades.” A new poll by Datafolha shows that 60% of Brazilians characterize her management as bad, while 27% say it is “OK” and 13% say it is good. The poll also showed that 63% believe Congress should open an impeachment procedure against Ms. Rousseff – but 64% also said they believed she would not be removed from office.

Her drop in popularity is due in part to the fact that she has disappointed her own electorate by implementing the economic policies that she attacked during her campaign, leading some to speak of “electoral fraud.” Like the 2013 protest movement, it is also partly due to general exasperation with corruption and poor public services – cities such as Sao Paulo face the risk of water rationing as low rainfall aggravates lack of investment in infrastructure and poor planning by the government.

But Ms. Rousseff has also brought some of the problems onto herself by her solitary, top-down style of governing. Having promised “dialogue” after her re-election, she has had a conflictual relationship even with the leaders of the parties who are part of her coalition. In a recent setback for the government, efforts to push through by decree a key part of its austerity package – a partial roll-back in payroll tax breaks – was shot down by Senate President Renan Calheiros, saying it should go through the normal – but slower – parliamentary process. Similarly, the President of the House of Representatives, Eduardo Cunha, has shown signs of rebellion against the government, even though both men are part of the PMDB, the largest party in Congress and a key ally of the government. Sensing a weak government, the PMDB appears to be trying to increase its influence by playing hardball and impose its agenda. Last month, after a public squabble with Mr. Cunha in a Congress session, the PMDB forced the resignation of education minister Cid Gomes. “The PT and the PMD seem opponents, treat themselves like opponents and have a level of dialogue typical of the most ferocious opponents,” wrote Veja. This lack of support has raised fears that he government could have difficulty passing legislation through Congress, further complicating implementation of the austerity package.

Where does all this leave Brazil? It would be easy, given the converging challenges and pressure from the streets, to believe that the government is on its last legs. And indeed, Ms. Rousseff faces two big constraints:

1) The Lava Jato scandal is clearly not going away quickly – if only because the US Department of Justice and the SEC have also opened investigations, as Petrobras trades in New York. New revelations are expected. While the recent disclosure of the list of beneficiaries is likely to shift the focus somewhat away from the corporate world and more towards individuals, a key question will be whether or not companies will manage to reach leniency agreements with authorities, accepting to pay fines in order to be removed from Petrobras’s black list. Ms. Rousseff says that “people should be charged, not companies,” for fear that punishing companies will delay key infrastructure projects and set off a chain reaction leading to further economic slowdown and higher unemployment, but others are pushing for the full force of the law to apply.

2) The economy is likely to get worse before it gets better as the impact of the government’s fiscal adjustment makes its way through the economy. Most economists believe at least part of the adjustment program will be approved, and Ms. Rousseff has started defending it more vigorously as a necessary step, but it’s likely to be watered down somewhat as it goes to Congress.

But to her credit, Ms. Rousseff has said the investigation will continue, whatever its consequences. The fact that the investigation is proceeding unimpeded and Brazilians are taking to the street en masse but peacefully to demand change attests to the robustness of Brazil’s democracy. The prospect of an impeachment procedure at this stage is unlikely. Risk consultants Eurasia Group ascribe a 20% probability to that scenario. In fact, Brazil has a tradition of expressing anger or frustration, and then moving on (as was the case with the protests that rocked Brazil in 2013). The greater risk is that Ms. Rousseff becomes a lame-duck President, beholden to Congress, and the country muddles through for the next few years, once again disappointing those who believed the proverbial land of the future was finally living up to its potential. Ms. Rousseff needs to quickly show she has heard the clamor from the streets. She is seeking to regain the initiative through a new package of anti-corruption measures that would reform campaign financing. She is also seeking to open dialogue with her allies, relaunch infrastructure investments through more favourable concession terms and attempt to improve corporate governance and compliance at Petrobras. Brazil’s presidential system still gives Ms. Rousseff some breathing space, but to save her presidency, she needs to change her style and show the deft political touch and leadership that she has so far failed to display.
Brunswick is the global leader in financial and corporate communications, providing senior counsel to clients around the globe on critical issues that affect reputation, valuation, and business success.

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