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Nova Bolsa – Quiet Nights of Quiet Stars

Back in 1958, the American Jazz saxophonist Stan Getz and Brazilian composer Antonio Carlos Jobim merged Jazz and Samba music to create a new genre called Bossa Nova assembling the husband-wife pairing João and Astrud Gilberto singing classics such as The Girl From Ipanema (Garota de Ipanema) and Corcovado (Quiet Nights). Notwithstanding recycling and re-compositions by subsequent generations, the Bossa Nova movement only lasted for a little over five years.

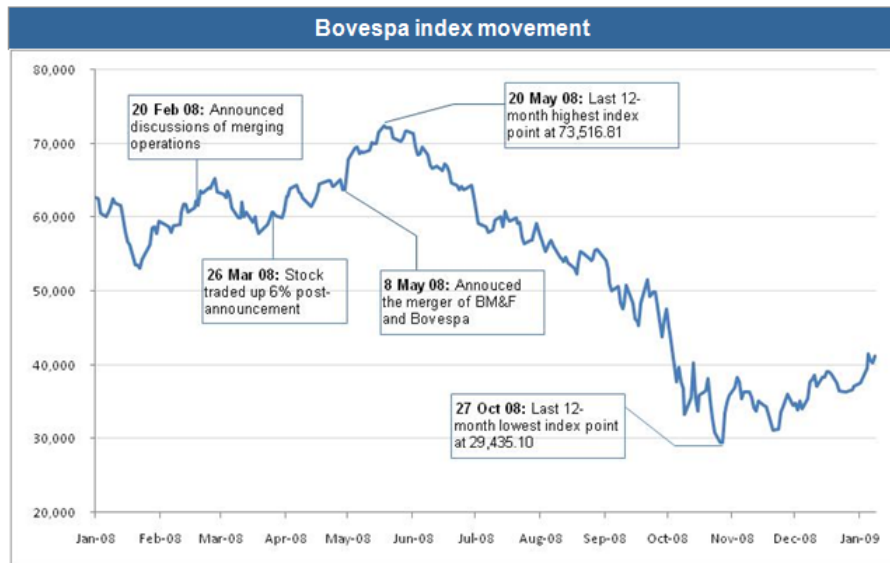


*O Christo Redentor,
Corcovado, Rio de Janeiro*

Fifty years later, Brazil's main stock exchange, Bovespa, and the São Paulo-based Bolsa de Mercadorias e Futuros or BM&F, at the time the world's fourth largest commodity exchange, merged, and the new entity was dubbed Nova Bolsa – it literally translates as the “New Handbag” (Bolsa de Valores in Portuguese means Handbag of stocks, in other words, the Stock Exchange.)

At deal time in the summer of 2008, the combined market capitalization BM&F and Bovespa amounted to US\$21.5 billion and was the world's third largest exchange by market capitalization. The hype over Nova Bolsa, re-christened, BM&F Bovespa lasted but a mere five weeks. Financial crises at almost every corner of the world began to chip away at trading volumes.

That China is known for being the factory to the world and India for being the back-office of the world, Brazil is known for being a major supplier of commodities. Falling stock prices is a symptom as well as a cause of economic recessions which in turn befalls demand and therefore prices of, amongst other things, commodities. The Bovespa Index nose dived 60% since 20 May 2008 with the decreasing in year-over-year trade volumes. The Brazilian Real has devalued 52% against the dollar since 4 August 2008 as foreign investors flee and stay away from such volatile market. These are indeed “Quiet Nights”.



**Bovespa Index represents a theoretical portfolio with the stocks that accounted for 80% of the volume traded in the last 12 months and that were traded at least on 80% of the trading days*

Since the announcement of the merger (8th May 2008) the combined entity, BM&F Bovespa's market capitalization receded to US\$5.63 billion – that is, by common count US\$16.7 billion of shareholders' value destroyed even after they received US\$178 million in dividends in between.

The song Corcovado has an English name "Quiet Nights" but it does not translate into such words at all. Corcovado is a 2,300-ft high mountain in Rio de Janeiro. At its peak is probably Brazil's most famous landmark, Christ The Redeemer (O Christo Redentor), a statue of Jesus Christ that stands 120-ft tall with open arms privy to a spectacular view of the beaches of Ipanema and Copacabana with his left arm pointing North and his right arm South – a useful compass as many Brazilians wake up in the afternoon after heavy nights of drinking Caipirienha (sugar cane alcohol) and can't be certain whether the position of the Sun is an indication of East or West. Redentor is a reminder that a less than stellar performance can be redeemed.

Take Bovespa: the average daily trading volume rose 60% per annum between 2004 and 2007. Bovespa makes money throughout the whole vertical chain from clearing, custody, data services, securities lending (for short positions). Located in the heart of Sao Paulo, Bovespa is the largest stock exchange in Latin America. Bovespa was established in 1890 and consolidated other smaller exchanges to become the sole securities exchange in Brazil.

Bovespa's merger counterpart, The Brazilian Mercantile and Futures Exchange (BM&F), was founded in 1986. By leveraging Brazilian's rich traditional agricultural history, BM&F quickly became one of the world's

leading futures exchanges. BM&F went through a string of mergers. In May 1991, it merged with Sao Paulo Commodities Exchange (BMSP); in June of 1997, it merged with the Brazilian Futures Exchange of Rio de Janeiro (BBF). The consolidation strengthened the domestic commodity market via scale and financial products such as derivatives blossomed. Prior to the merger, BM&F was the fourth largest derivative exchange in terms of numbers of contracts, with market value at deal time of US\$10.3 billion.

Bovespa was the first to demutualize and launched its IPO in October 2007, raising US\$3.7 billion. BM&F quickly followed with an IPO of its own in November of the same year and raised US\$3.4 billion.

The Merger

Capital flows and investments have become more global over the years and so is the need for the re-positioning of exchanges. Witness the frenzied M&A activities of the major exchanges such as the NYSE, NASDAQ, CME-CBOT, LSE, Deutsche Börse, OMX, Borsa Italiana, and Dubai Bourse amongst them with motives of sizing up market shares, cross-selling products, offering dual-listings, and circumventing highly regulated markets (the USA's Sarbanes-Oxley).

In the merger, the shareholders of BM&F and Bovespa received 50% of equity of the combined exchange. In addition, BM&F also paid R\$1.24 billion (US\$710.2 million) in cash to the shareholders of Bovespa to balance out the deal.

On synergies, the merged entity can cut costs in areas such as: personnel, IT, and marketing. BVMF has so far eliminated 13% of the fulltime work force, and cut outsourced headcounts by 31%. On the IT side, the company plans to shut down 2 old datacenters and leaving only 2 of the more modern datacenters. The mainframe used at Bovespa has been turned off and replaced by a cheaper (maintenance) technology. As well, it is reviewing, and cancelling several IT contracts.

On marketing, BM&F Bovespa hopes to offer a wider range of products, in areas such as equity derivatives and options, and increase liquidity in mid- and small-cap cash-traded shares. Not only would the combined exchange create an attractive product offering for investors, but also it would satisfy the increasing demand for low-cost electronic trading of securities. Furthermore, the exchange expects to save up to 25 percent in combined operational expenses by the year 2010. Other benefits of the combination of the exchanges include empowering investors, reducing complexity, and lowering transaction costs.

Strategic Collaboration

Prior to the merger, the world's largest commodities exchange, The Chicago Mercantile Exchange (CME) already owned a 10% stake in BM&F when it swapped out 2.18% of CME shares at the time worth US\$691 million. After the merger, CME's ownership was diluted to 5% in BM&F Bovespa.

This cross-shareholding and the instituted partnership between BM&F Bovespa and CME enable the two exchanges to cross-sell products and leverage on one another's infrastructures and in the process giving BM&F a far larger geographical footprint than done alone. BM&F has 750 trading terminals while CME has 110,000 terminals worldwide called Globex. This tie-up allows CME customers an unprecedented access to trade BM&F Bovespa products through the Globex terminals. Additionally, BM&F Bovespa and CME have an operational partnership to optimize distribution networks and clearinghouses, and to combine efforts in developing new product offerings.

The Redemption

Financial markets have a history of overshooting their targets. At pre-merger level, the combined Enterprise Value of BM&F Bovespa would be trading on 19.5 times combined EBITDA 2008. Today this same dollar of cash flows (EBITDA) trades for just 4.05 times.

Looking ahead, however, the macroeconomic fundamentals of Brazil and its comparative advantages of being an agricultural-based country with endowed natural resources serve as a strong foundation for the Exchange's growth. Furthermore, the routing agreement with CME will allow BM&F Bovespa to compete effectively against the leading exchanges in terms of technology. Notwithstanding being the only non-Spanish-speaking country in Latin America, Brazil is positioned to serve as the main hub for commodities and derivative trades to other Latin American countries.