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Unveiling the Brazilian truckers' mega strike and perspectives for the industry

Excessive Federal intervention over the last decade prompted expansion of the Brazilian trucking sector, which grew more than its squeezed-margin roots could support. When a recession hit the oversupplied sector in 2014-2016, freight rates plummeted, and truckers paid the price. After May's mega strike, Federal actions tried to alleviate the symptoms effectively appeasing truckers nationwide. Yet, in our view, these measures do little to address the root causes of the problem.

by Fabio Abrahão, Luiz Gosling, and Ana Beatriz Machado

How did we get here?

This report examines May 2018 truckers' strike in Brazil as an industry-wide phenomenon catalyzed by excessive federal intervention in diesel prices and regulation (Truck Drivers' Act / Law 13.103/2015) over the past six years, allied to heavily subsidized credit for truck acquisition in the same period. Such factors have greatly affected the road transportation sector, in which companies and independent truckers struggle to achieve profitability while dealing with large and more powerful clients and suppliers. These government decisions have ultimately undermined the industry's capacity to manage its costs and prices over time.

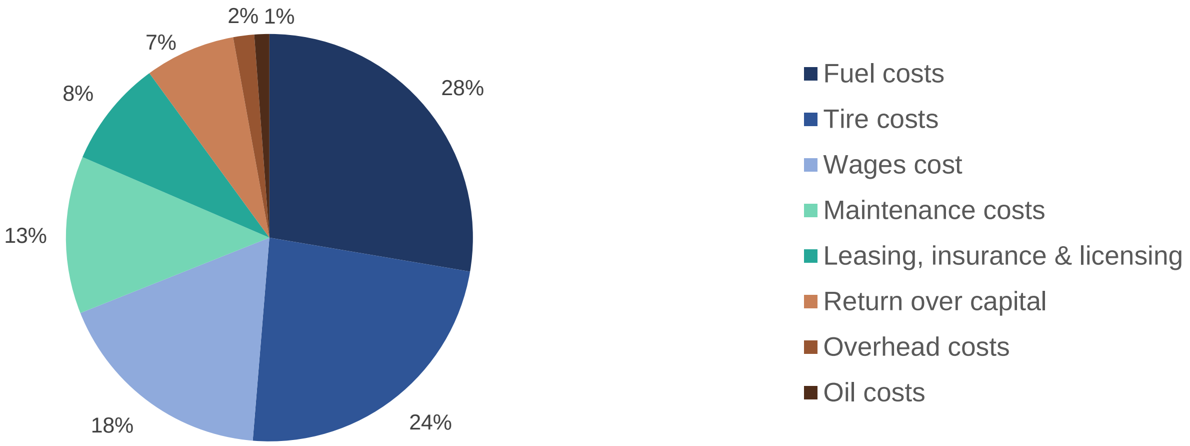
What is more, the country's recent economic recession between 2014 and 2016 caused a severe demand reduction for trucking. In May 2018, the country faced a nation-wide truckers' strike that distressed short-term sales and production across industries. To illustrate the cost pressure faced by truckers, the **Exhibit 1** below shows the average weight of different cost components on a 500 Km operation in Brazil. Note that three major items represent over 70% of total costs: Fuel (supplied by Petrobras through a monopoly), Tires (supplied by a handful of large international companies), and Wages (greatly affected by the Truck Driver's Act of 2015).

Exhibit 1

Fuel, Tire, and Wages hold together over 70% of truckers' operational costs.

Cost components' share on trucking operations[1]

(average % over monthly costs for a 500 Km operation)



Source: Infra Partners analysis. [1] Toll costs not included.

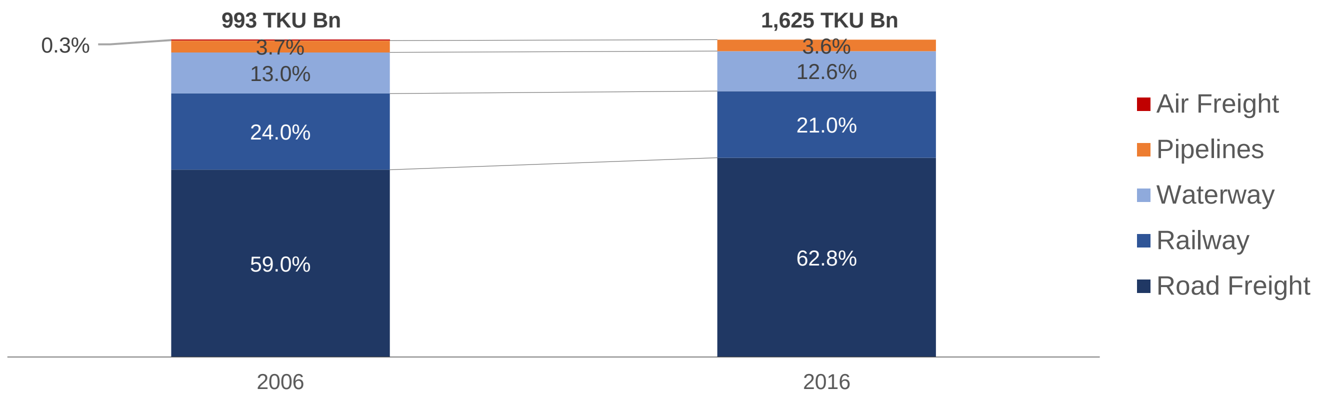
Federal intervention in diesel prices is closely tied to former federal governments' strategy of controlling inflationary pressure by curbing the increase of fuel costs due to international price variation. It is important to mention that trucking is the less cost-efficient mode of transportation (excluding air cargo) yet it responds for roughly 63% of the country's cargo transportation matrix (**Exhibit 2**). During former president Rousseff's terms, international Brent price variation was artificially smoothed and passed through to the market by Petrobras with a reasonable delay. Such measures would provide protection for Brazilian companies against international price volatility, which would then help reduce inflation in the country. In March 2014, several executives from Petrobras were caught red handed in corruption scandals, accused of accepting bribes from construction firms in return for awarding them contracts at inflated prices. The R$ 42 Bn in damages (estimated by the Brazilian Federal Police) left the business in need for a turnaround.

Exhibit 2

Road trucking, the less cost-efficient mode of transport (except for air cargo), handles nearly two thirds of all Brazilian cargo.

Brazilian transportation mode matrix evolution

(share of usage as in % on total TKU, TKU billion)



Source: National Ground Transportation Agency (ANTT), National Water Transportation Agency (ANTAQ), Infra Partners analysis.

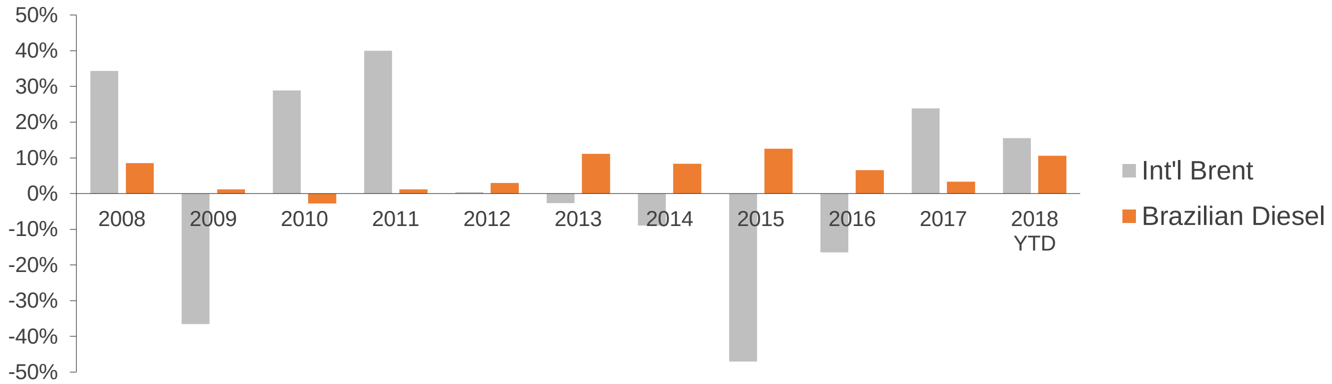
In 2016, a key proposal of the new Petrobras administration's platform was freedom to adjust fuel prices to follow international prices variations. Pedro Parente, the company's CEO at the time (who resigned on June 1st, 2018 after the mega strike's end), sought to align prices more closely with international markets (**Exhibit 3**) through nearly daily price adjustments. This, theoretically, should not have become a problem for the trucking sector by itself since it is not heavily regulated, and costs could be simply passed through. However, pressure from clients, a fragile sector position against the much more structured suppliers' side, allied to fleet surplus and sluggish economic recovery in the past few years prevented cost pass through from happening.

Exhibit 3

Brazilian diesel price adjustments didn't always follow international Brent's[1] in the past.

Brazilian diesel price and international Brent price annual change

(% change over year)



Source: National Agency of Petroleum, Natural Gas and Biofuels (ANP), BP Statistical Review of World Energy 2017, Infra Partners analysis.
[1]US Dollar in current values.

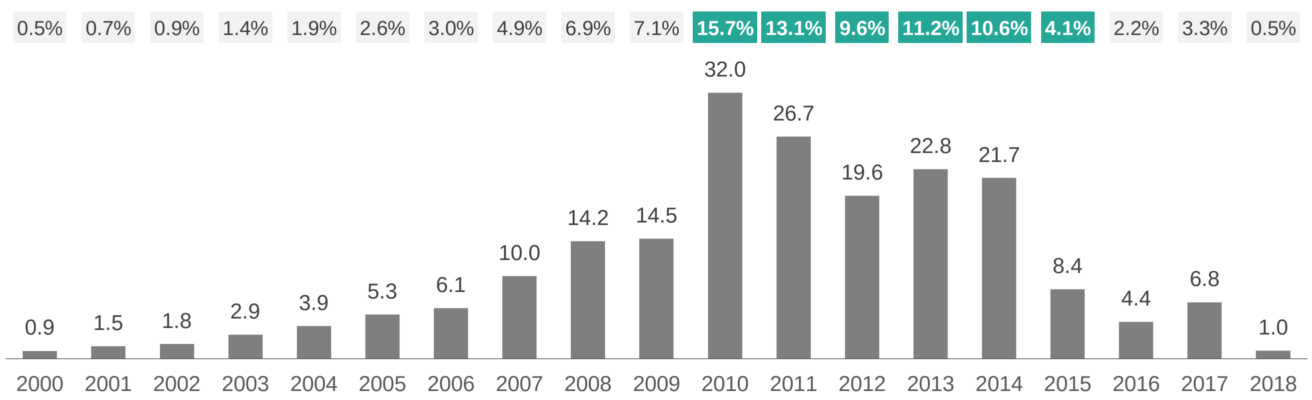
The subsidized credit for equipment acquisition also became an issue, as increased and federal-backed funding became widely available in the past decade, in particular for trucks, via FINAME-PSI (Financing for Machinery and Equipment), a credit line offered by BNDES (National Development Bank) for capital goods. From 2008 to 2014, an ongoing expansion of the credit line took place. Of the total R$ 204.4 Bn approved by BNDES for the Road Transportation Sector from 2000 to March/2018, roughly R$ 131.2 Bn were approved between 2010 and 2015, 64.2% of the total (**Exhibit 4**). This effort to boost equipment sales led to a strong increase in truck acquisition and left the sector oversupplied after 2014 (**Exhibit 5**), when an economic recession caused a severe reduction in demand for road freight. Ultimately, as in any lightly regulated sector, freight rates plunged across the country due to the oversupply, which greatly affected transportation companies. This is exactly what unfolded throughout 2012-2018, when carriers held nearly 13% accumulated cost inflation from their clients (**Exhibit 6**), not being able to pass through all the cost adjustments that happened in the period. At some point, as the domestic economy recovers its growth, that gap should be shortened with price adjustments, but until then, a group of transportation companies and independent truckers are delivering subpar results in a sector that had average margins ranging from 5% to 15% back in 2012 (variations related to cargo type and specific agreement/ markets serviced).

Exhibit 4

BNDES FINAME for Road Transportation Sector approved significant amounts between 2010 and 2015

BNDES FINAME approved funding for Road Transportation Sector

(R$ billion, % over total approved funds)



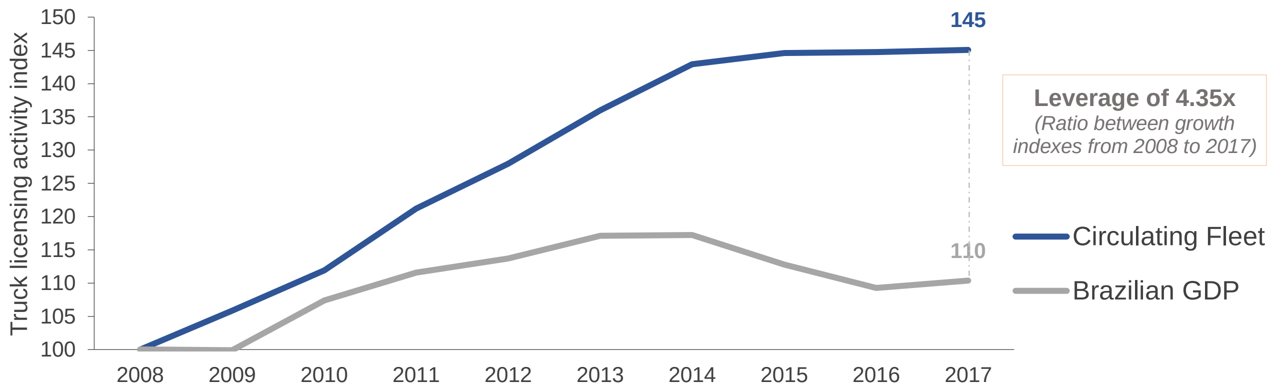
Source: National Bank of Development (BNDES), Infra Partners analysis.

Exhibit 5

Truck fleet growth showed significant leverage when compared to the economic performance in Brazil

Brazilian GDP and Operational Truck Fleet accumulated growth index

(accumulated index, 2008 = 100)



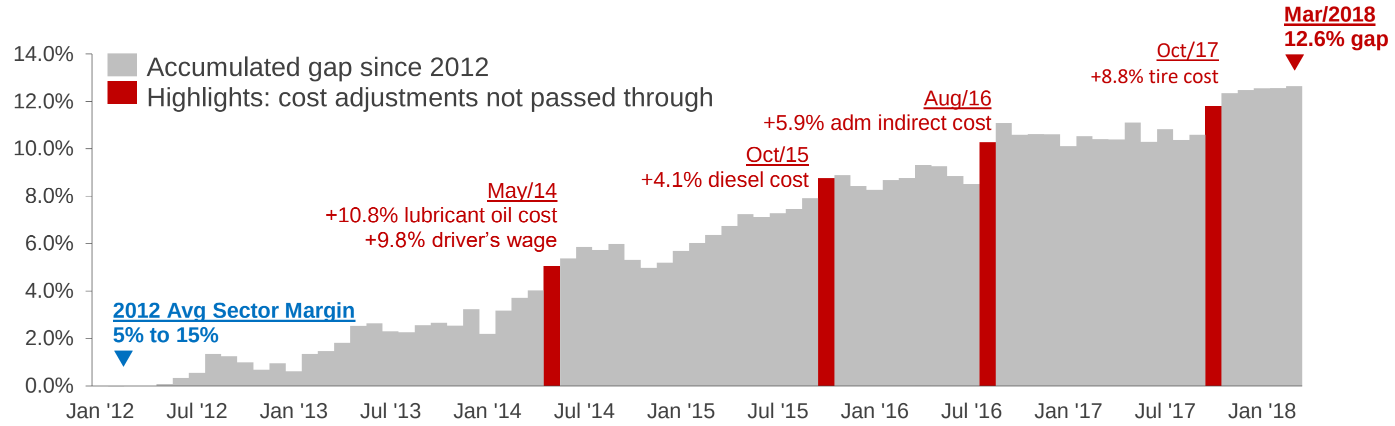
Source: Brazilian Institute of Geography and Statistics (IBGE), National Association of Automotive Vehicle Components Industry (SINDIPEÇAS), Brazilian Autoparts Industry Association (ABIPEÇAS), National Association of Vehicle Manufacturers (ANFAVEA). [1] Average truck in Brazil is over 10 years old, according to the National Transport Alliance (CNT), thus vehicles licensed in 2008 are likely to still be in the system.

Exhibit 6

Evolution of the cost-price gap shows truckers' difficulty to pass costs through

Accumulated gap between trucking cost inflation and freight rates adjustments

(% accumulated, Jan/2012 = 0%)



Source: Brazilian Institute of Geography and Statistics (IBGE), National Agency of Petroleum, Natural Gas and Biofuels (ANP), Fundação Getúlio Vargas (FGV), National Transport Alliance (CNT), National Association of Vehicle Manufacturers (ANFAVEA), Union of Professional Drivers and Workers of Mato Grosso (SINDMAT), Union of Drivers of the Greater Osasco Region (SIMTRATECOR), Union of Independent Truckers of São Paulo State (SINDICAM-SP), Union of Road Vehicle Drivers and General Cargo and Passengers Transport Professionals of Rio de Janeiro (SCVRTTCGP), Minas Gerais State Cargo Transportation Union (SETCEMG), National Cargo Transportation and Logistics Association (NTC&L), Infra Partners analysis.

On the positive side, the cost-price gap is growing at a slower pace since mid-2017 and, in our analysis, indicates a turning point for the next few years. Since the truckers' strike began, over a week ago, various measures were discussed by either federal or local governments to both address strikers' requirements and solve structural problems in the sector, like the ones described above. Specifically, the Federal Government issued a provisional decree on May 27th, 2018 that managed to meet the requirements of the strike's leadership (**Exhibit 7**). Be it through tax cuts on diesel prices, by lowering toll costs, or ensuring future demand (see item 4 on Exhibit 7), the sector will likely struggle to pass through all the accumulated costs. For shippers, it is likely that freight rates will increase, and the current supply/demand imbalance will likely dictate a quest for increased productivity. While the short and mid-term effect of the government's measures should push various sectors towards a drive for greater logistics efficiency, in the long run they do not address any structural causes of the current imbalance. While some increase in profitability is surely a step forward for truckers, slow demand recovery in the overall economy is still an issue. Additionally, consequences and impacts of the measures on the country's economic health are still unclear, and we worry about two things: how much positive impact those measures will carry and how much enforcement power any administration will have.

Exhibit 7

The five federal measures ended the truckers' strike, but they will not fix the sector in the long run

1	Diesel price reduction around R$ 0.46/Litre, which accounts for the total taxation relative to PIS/Cofins and Cide. (Provisional act 838/2018)
2	Freeze in current diesel prices (after R$ 0.46/Litre cut) for the next 60 days starting at May 28th, 2018. Price adjustments for consumers will occur monthly.
3	Toll exemption for suspended axles on empty trucks in federal, state and municipal highways. (Provisional act 833/2018)
4	A minimum volume guarantee with 30% of the freight needs of the National Supply Company (Conab) being transported by freelancer truckers. (Provisional act 831/2018)
5	Creation of the minimum freight fee schedule, as provided for in Bill 121, currently pending before the Federal Senate. (Provisional act 832/2018)

Source: Diário Oficial da União (DOU), Infra Partners analysis.

Implications and perspectives for the future

- The first two measures announced mean a roughly 10% reduction on fuel costs for 60 days. This means 2.8% margin growth for truckers in a typical 500 Km FTL operation. It sure offsets part of the 13% accumulated gap, but it is not nearly enough to solve the problem;
- The third measure reduces toll costs for suspended axles on empty trucks, which already exists in federal concessions, and is now being extended to state and municipal levels. Considering a typical 500 Km FTL operation between Rio de Janeiro and São Paulo, the decision would provide a small benefit to truckers' bottom-line results by taking an average 0.4% off total costs, since it only affects empty hauls. This might ultimately impact concession agreements for toll roads across the country;
- A fourth measure aims at increasing volume for independent drivers by ensuring 30% of all Conab's grain volume to be handled by individual truckers registered under cooperatives or similar organizations without the usual bidding process. Yet, Conab's operation is strictly focused on supplying mainly grains to federal warehouses in order to control domestic prices (mainly corn and rice). Conab's corn inventory levels at Dec/2017, for example, showed roughly 1.2 MM metric tonnes, a volume not significant enough to structurally affect the current scenario;
- The last measure will try to establish minimum freight rates for the Brazilian network once it passes through Senate, yet it is still mostly grey in terms of quantitative impact. ANTT would regulate the new tariffs, yet we do not see a strong governance process in place capable of ensuring compliance across the country, in particular due to the informal part of the business (independent truckers account for 35% of the Brazilian fleet, according to CNT).

Overall, the five measures delivered a small positive impact on truckers' bottom-line. However, this is not sufficient to address the actual level of financial deterioration faced by truckers. There is no simple answer to the problems described in this report, yet the worst possible approach is subsidizing costs, since it generates incentives for artificial consumption increase (of trucks, fuel, parts, and whatnots) that is not always justified. More than just freezing diesel prices or artificially cutting taxes to end a strike, policymakers and legislators should try to ensure that costs and prices are managed in a balanced manner for service providers and clients alike, maintaining a healthy business environment. Such environment should present a level of maturity and organization compatible with the dimension and importance of the Brazilian market.

There may be lessons for other industries in the way the recent events are reshaping the trucking sector in Brazil. While truckers will likely find relief in the short term as the government grants their requests, their success has highlighted how Brazil's logistics infrastructure depends on trucking, a fact legislators, policymakers, investors, executives and the general public are now more than aware of. That being said, the country faces a severe infrastructure gap. Even if developing alternative modes, such as cabotage and railroads, demands greater investments, their superior efficiency usually justifies investments in the long run. This will not end the demand for trucking, but rather favor a more efficient and modern logistics infrastructure as this format would still demand trucking for last mile and feeder operations.

In this context, our experience suggests that multimodal operations are usually better alternatives for many large-scale industries across the globe, yet do not reduce the country's risky exposure to a fragile trucking sector, which faces a disproportionate exposure to federal intervention.

Infrastructure transformation is essential to the future economic well-being of Brazil and finding sustainable solutions for the long run is paramount to ensuring a matrix that delivers on the challenge of servicing the continental size of the country. If policymakers and other agents are not proactive on this front, we may soon find Brazilian truckers once again stopping the country.

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About the company

Infra Partners is a Brazilian investment boutique dedicated to bridging the gap between investors and projects in the logistics industry. With a track record of over US$ 4 billion in asset value transacted, we advise our clients on their investment strategies, the development and structuring of new ventures, strategic due diligences, and company turnarounds.
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