Private Credit Strategies and the Brazilian Restructuring Law

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Brazil is currently resurfacing from what could be viewed as one of the Country's most prolonged political and macroeconomic crisis, with some large local companies facing severe credit restrictions. In this context, the Chinese saying, "there is an opportunity in every crisis" has never been as appropriate in Brazil as it has been over the past couple of years.

With the recession came the development of an actual distressed debt, direct lending, and special situations industry, adding a new strategy to the local alternatives ecosystem.

According to data released by EMPEA in Brazil's Data Insight, GPs raised a record USD2.1 billion for distressed debt, direct lending, and special situations funds — more than quadruple the amount raised over the preceding 12 years combined[1]. These numbers are not restricted to players with a reputation on private credit / special situations' strategies – such as the likes of Jive Asset Management and Canvas Capital. They are rather largely represented by private credit / special situations' funds raised by GPs traditionally recognized for their Private Equity, Infrastructure and/or Real Estate strategies, such as HSI, Patria Investimentos, and Siguler Guff. These traditional houses generally conceive their private credit / special situations' operation as an anticyclical strategy that has the purpose of supporting their core Private Equity, Venture Capital, Real Estate, and Infrastructure strategies.

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1. https://www.empea.org/app/uploads/2019/04/brazil_data_insight_Q4_2018_member.pdf

With a solid track record in Brazil, sponsors that have decided to enter this industry can leverage from their ability to renegotiate debt and restructure the main following types of targets:

i. Companies / business under financial distress, with high indebtedness and/or credit issues. For instance, many Brazilian companies involved in the core of the 'car wash' investigation (Operação Lava Jato) faced severe difficulties to repay contracted debt as a consequence of (a) early maturity triggered by the fact that these companies faced criminal charges; and (b) authorities imposing measures to freeze the assets held by these companies, including funds deposited in their bank accounts;

ii. Companies / business under temporary financial distress, which is relatively common for capex intensive growth businesses;

iii. Companies / business operating in segments that are not covered / backed by capital and financial markets. Several innovation companies in Brazil struggled to get access to credit, simply because banks and other financial players didn't properly understand the business;

iv. Companies facing corporate governance issues (conflicts / disputes amongst shareholders, forced sale of assets, forced liquidation etc.). Brazil's economy is still very fragmented, with several family-owned business across the country;

v. Non-core assets on sale or to be discontinued by a larger economic group. Similarly to the global 2007 credit crunch, many Brazilian companies (including those involved in the 'car wash' investigation) started to shrink their balance sheets, with the purpose of focusing in their core activities in order to regain traction; and

vi. Underperforming portfolio assets belonging to private equity & venture capital funds achieving their vintage. This is particularly common in Brazil especially because how the funds are structured. Several local – and even some international - sponsors raise their funds (or Brazil-focused funds) in the form of FIPs – Fundos de Investimentos em Participações, which are closed-ended funds, meaning that the carried interest is only paid to investors in the end / liquidation of the fund. Therefore, in some cases these sponsors "flash-sell" these underperforming assets in order to be able to pay the carry.

The higher risks associated with these strategies obviously demand that sponsors seek higher returns. These returns accrue by purchasing these assets at a deep discount, by streamlining critical operational issues and financial obligations, upon employment of stringent liability management, and by creation of vigorous and effective governance structures among others.

One thing that all these measures have in common is a requirement of true activism by the fund. Therefore, in most cases these funds would prefer acquiring control or at least ensure that they have control over management and key strategic drivers of the respective targets, with a package normally comprised by the right to appoint "C-suite" level management, board members, and veto rights.

The Brazilian Bankruptcy and Insolvency Act, approved by Law No. 11,101/2005 (Brazilian Insolvency Act) has become an important ally to private credit / special situations funds, more specifically because of the possibility of sale of assets under a judicial reorganization process.

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Subject to certain conditions[2], any debtor may apply for a judicial reorganization if it faces a financial crisis. If the legal requirements are so fulfilled pursuant to a court decision, the reorganization proceeding begins. All lawsuits and foreclosure proceedings filed against the debtor are suspended for 180 days[3].

Upon publication of a formal notice about the process containing some details about it[4], creditors may file a claim to the administrator appointed to handle in order to challenge the amount and/or the creditors' rank (based upon certain criteria set out by Brazilian law) listed by the debtor.

Meanwhile, within 60 days counted from the notice publication debtor must submit a reorganization plan. If debtor fails to present the plan or delays its presentation, debtor is declared bankrupt. If any creditor challenges the plan, the court would convene a Creditors' General Meeting where creditors may:

i. Approve the plan as proposed;

ii. Approve an amended version of the plan, provided that debtor accepts the changes; or

iii. Deny the plan, in which case the company is declared bankrupt.

This process entails a clear incentive for private credit / special situation funds that is the ability of debtor to sell a "separate business unit,"

2. The request must be accompanied by several documents and information, including (i) explanations about the financial difficulties faced by the debtor, (ii) financial statements, (iii) a list of creditors, (iv) a list of employees, (v) a list of the assets belonging to the managers and the controlling shareholder of the debtor, (vi) a list of the lawsuits filed against the debtor etc.
3. There are some credits that are not submitted to the effects of the judicial reorganization, such as: tax credits, creditors with title to assets and foreign exchange contracts.
4. Such as summary of the request made by the debtor, list of creditors, and a term for creditors to challenge the process or request adjustments.

provided that, in addition of being outlined in the plan, the court so authorizes the sale.

If sale of this "separate business unit" occurs by means of a judicial auction, the winning bidder is entitled to acquire it free and clear of any liens and encumbrances, and without any succession regarding to any indebtedness, including tax and labor liabilities. The most obvious benefits brought by this exemptions are:

i. Avoidance of a lengthy and cumbersome due diligence process to assess the level of risks presented by liabilities;
ii. Avoidance of the burden of having to manage liabilities and indemnification procedures; and
iii. Direct impact on potential returns generated by the asset, in view of the respective cost savings.

It is also possible that the sale is not made by means of a judicial auction, although purchaser would not benefit from the liability exemptions that are granted in as a consequence of an acquisition in the context of a competitive process. The benefit is that purchaser would have more certainty about the feasibility of acquiring the asset. It may well be sensible to follow this path depending on the magnitude of liabilities incumbent upon debtor, in which case purchaser may try to mitigate risks by including strong indemnification provisions in the respective Stock Purchase Agreement (SPA). However, insolvency of seller may affect buyer's indemnification rights, considering that, amongst other things, failure of debtor to deliver anything addressed in the plan within the statutory 2-year term for implementing the plan may result in debtor's bankruptcy.

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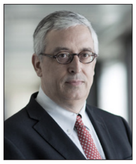
According to data released by Serasa Experian, a credit data company, only in 2018 1.408 entrepreneurs filed for judicial recovery in Brazil[5].

Since the introduction of the concept of judicial recovery in 2005 there have been some successful cases of sales of "separate business units", but still not many involving a significant participation of private credit / special situation funds. As an interesting example, a few years ago the Canada-based global alternative investment manager Brookfield attempted to structure a Debtor-in-Possession Financing for acquiring Invepar, a company that has concessions to operate some transportation assets, including Guarulhos Airport. However, the transaction did not go through because local pension funds vetoed the plan.

As this alternative industry has just started to take shape in Brazil, it is a matter of time to see a more solid and recurring deal flow with this profile. Players who raised capital or that are in the process of raising capital for this class will certainly be well positioned in the competition for the best assets.

About the Authors



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5. https://www.serasaexperian.com.br/sala-de-imprensa/recuperacoes-judiciais-caem-08-em-2018-ainda-influenciadas-pela-lenta-recuperacao-da-economia-revela-serasa

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