

# International Corporate Rescue



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## Keynote on Brazil: Reaping from Country and Corporate Recovery

Eduardo Lemos, Managing Partner, Perform Management & Consulting, São Paulo, Brazil<sup>1</sup>

The cost premium of investing in Brazil is reducing to a more attractive risk-return balance in the eye of a wider range of foreign investors. Practical aspects supporting this reality should be observed by capital investors or industry players who have not yet grasped the opportunity of investing in the South American giant.

### Country recovery: improved institutions are attracting foreigners

Brazil's economy is growing steadily and consistently. A per annum GDP average growth of nearly 6% is expected for the next five years. This is merited by an impressive improvement in Brazilian social-political institutions and macroeconomic fundamentals. Four examples deserve to be mentioned.

Firstly, the economics-driven Central Bank and the politics-oriented National Treasury Secretariat (STN) have streamlined between them non-overlapping objectives and implemented world class debt management policies and predictable controls for inflation, interest and exchange rates. As a result of this, by 2014 projected public debt will be 27.8% of GDP and public nominal deficit will be zeroed, both down from 60.4% (2002) and 5.2% (2003) respectively. The Brazilian currency, the Real, has been continuously appreciating: 136% since president Lula's first term election and 13.5% since January 2010. The country's basic interest rate (SELIC) started 2010 at 10.75% and inflation rate kept below 6%: both down from 27% and 17% respectively when Lula entered office in 2003.

Secondly, the central government's social policies are upgrading consumer spending by the 100 million active consumers market (total population is 192 million). Unemployment and poverty levels are at their lowest: 6.1% and 16 million people respectively, down from 12.3% (2004) and 28.1 million (2003). Credit-GDP ratio, now 49.5%, has been systematically rising from 25% in 2003 and is expected to reach 70% in 2014. The Growth Accelerating Pact set forth

by former Minister of Energy, then Chief of Staff, now newly installed president, Ms Dilma Rousseff, is increasing public and public-private investment in general infrastructure. Brazil's investment rate, which was only 14.7% in 2003, is currently 18.9% and the government is pushing it to 22.4% by 2014.

Thirdly, the consolidation of capital and industrial regulations through Brazil's SEC-equivalent (CVM), antitrust and market-sector authorities are enhancing ever-growing corporate governance and transparency. 70% of Brazilian IPO funding comes from abroad and foreign portfolio investment grew by 150% in 2010.

Fourthly, non-listed and small and medium-sized companies (SME) now too follow IFRS-compliant accounting standards and issue electronic, IRS integrated, invoices. Registration and fiscal bureaucracy have been simplified for these companies that in fact represent the best investment opportunities in Brazil. Corporate governance and professional management cultures are being extended to them, or this is the goal, by the NACD-twinning Brazilian Institute of Corporate Governance (IBGC) which is about to release a much expected SME corporate governance guide to stimulate their perpetuation and funding.

### Corporate recovery in Brazil: understanding the environment

Focusing now more specifically on investment and the turnaround of businesses in distress, it is necessary to consider some key practical aspects of the Brazilian growing turnaround practice and the five-year-old, US Chapter 11-style, Corporate Bankruptcy and Restructuring Law (CBRL).

The use of in-court corporate recovery in Brazil is still weak. For example, filings in the US are around twenty-fold greater whereas there are only about twenty percent more registered firms in the US than in Brazil. Furthermore, Brazilian filings are disproportionately more for bankruptcy than for reorganisation procedures (this is even more in the case of SMEs) and entire company

#### Notes

<sup>1</sup> Eduardo Lemos is President of the Brazilian affiliate of the Turnaround Management Association.

sales as going concerns are non-existent. So there are many latent turnaround opportunities to exploit.

Although statistics are still unreliable for the young CBRL, on-the-ground experience and debates developing in the Brazilian affiliate of the Turnaround Management Association and in the Brazilian Institute of Corporate Recovery Studies hint at some important aspects for foreign investors to exploit, and beware of. They are briefly portrayed in the sequence: the turnaround plan, pre-packaged organisation, DIP finance and succession liability.

## The turnaround plan

Business recovery plans in Brazil are, in general, a mandatory formal resort for troubled companies mainly to settle debt re-profiling in court. Only very few of these plans effectively challenge the entrepreneurial essence of the underlying business and value chain by questioning product-market positioning and critical process improvements deeply enough. Hence Brazilian turnaround plans, let alone their execution, rarely address and resolve the business fundamentals related to profitability, cash flow and sustainability.

Brazilian trustees and judges are limited to adhering to CBRL procedures, which hardly ever confront the plan, a responsibility reserved for creditors according to the legal code. But so far creditors have focused on their individual payment schedule, seldom tackling the plan from business or industry perspectives. Credit committee representatives, figures created by the CBRL, are also reluctant to assume such responsibility. Conditions and vetoes they authorise could strike back at them in the form of personal liabilities inflicted upon them by angry counterpart stakeholders suing them in ancillary court procedures.

## Pre-packaged organisation

The Brazilian turnaround culture has yet to mature. In general, companies showing crisis symptoms admit the need for recovery only when it is too late, and when they are already heading to court, and only if they are big enough to shoulder the expense associated with the procedure obligations and professional counselling. The 'extra judicial' approach imbedded in the CBRL, which compared to the US pre-packed organisation, provides a leaner procedure for stakeholder negotiation which only needs to be court-stamped. But it is rarely adopted.

It is true that the 'extra judicial' solution needs legislative improvement as the indebted company can only apply it to unsecured creditors, and its procedure is based on weak foundations, left unprotected by reason of a lack of moratorium and has the potential to go straight into bankruptcy.

But even if the Brazilian legislation were a 'pre-pack' enabler, this approach would rarely be followed as the culture for early turnaround and for constructive and transparent creditor communication is underdeveloped in the country, in addition to the fact that banks themselves lack the right attitude, hand-cuffed by the country's financial system and conservative norms – but more on this later.

'Pre-pack' mediation should also be stimulated in Brazil for another reason. CBRL's Achilles' heel is the General Creditors Assembly (AGC). The AGC rigidly institutionalises what should really happen swiftly beforehand on a multiparty negotiation table facilitated by the trustee. Instead, the plan is presented and debated by the creditors in a bureaucratic and overwhelmingly extensive assembly meeting, with an intimidating 'go/no-go' attitude, moderated by the trustee acting as a mere court based oversight. AGCs therefore should be avoided or used simply to initiate the plan, which should be really negotiated upfront with all stakeholders, which can be a daunting task especially when credit is spread among a vast number of stakeholders.

## DIP finance

Although the CBRL in theory protects new-money priority, the practice of debtor in possession financing has yet to affirm itself in Brazil. There, the distress finance primary and secondary market has yet to structure itself too. It is a catch-22 situation, as one depends on the other. With the lack of specialised investors to provide new turnaround money, the option for Brazilian companies in crisis – remembering that these typically recognise the need for restructuring when it is too late (i.e. with all assets already pledged and strategic alternatives highly compromised) – has been to get their new money from their old creditors who hence fight to 'roll-up' their debts and 'self-prime' themselves. This mixes up old and new money priorities and sets up a fierce battlefield among stakeholders concentrating on a work-out, but not focussing on overall business recovery and value generation.

A big issue, related to strict central bank asset protection policies for financial institutions, is that banks must provision for their bad debts with companies in CBRL procedures, all credit of which is classified as high-risk irrespective of DIP priority for new money. According to them, CBRL rules are not trustworthy and with the time and money spent on the procedure they might as well collect what's left and lend elsewhere. It is difficult to argue they are wrong in such a credit-thirsty and highly priced market. Therefore, banks have little incentive for DIP restructuring and tend to come to the table with a bankruptcy mentality.

Another point hindering DIP finance is 'extra-concourse' credits which CBRL exempts from being

subject to the DIP recovery plan, and which therefore are enforceable and can trigger bankruptcy directly. 'Extra-concourse' creditors for CBRL are issuers of letters of credit for export, fiduciary owners of assets, including receivables, and financial lessors. In practice, creditors are migrating to 'extra-concourse' lines of credit. With this, Brazilian companies filing for recovery often find themselves hostages trapped between 'extra-concourse' and asset-backed creditors.

### Succession liability

'Succession', also known as 'solidarity responsibility inheritance' in Brazil, can lead to a deconsideration of investors' limited liability, especially for, but not restricted to, those in position of shareholding control or administration. In Brazil, this issue can be quite tricky. Fiscal and labour claims which run separately from, and often override corporate recovery procedures, can attack shareholders and administrators, irrespective of whether they are there to help rescue the company and were not involved with the issue originating the claim.

### Conclusion

Brazil still has to embrace higher investment grade levels. Nonetheless, its current business environment is becoming receptive even for non-listed targets in which foreign funds and companies can approach leveraging their own money and expertise.

Seasoned investors, in particular those with a global footprint with synergy potentials, are prone to add and reap value by planning, negotiating and executing proper turnarounds with appropriate governance, preferably out of court using their 'pre-pack' experience. They can thus help mature the Brazilian early turnaround culture and make profits in the process.

Active specialised creditors are also welcome in late, in-court, turnaround opportunities in Brazil. But only if there are unpledged assets available to secure their new money and if there are no fiscal or labour claims or contingencies that they would have to inherit.

In any case, foreign investors and strategic partners should both have legal counsel to represent their interests, and locally established managers to integrate local operations to their own corporate culture. And Brazilian turnaround managers are increasing in both number and quality.

## **International Corporate Rescue**

*International Corporate Rescue* addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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