

## BYE-BYE BRAZIL?

BY JAMIE MASON

In 2008, when the U.S. was mired in the Great Recession, it seemed almost every troubled company that filed for bankruptcy blamed a “perfect storm” of events for its demise, as lots of things went wrong for them at the same time. Now, unfortunately, that’s what’s happening to many Brazilian companies.

There has been a flurry of restructuring activity in Brazil in recent months, as a confluence of problems—currency devaluation, a corruption scandal involving state-run oil producer Petroleo Brasileiro SA, a recession, and a decline in commodity prices—have afflicted companies operating there.

Restructuring professionals feel there is only more pain to come.

“We have seen restructurings taking place in the last 12 to 18 months in Brazil and I expect to see more, as commodity prices seem like they are going to stay depressed for the foreseeable future and it’s hard to see how these Brazilian companies are going to work their way out of it, other than through a restructuring,” said Patrick J. Nash Jr., a partner at Kirkland & Ellis LLP.

Nor is the damage limited to only one industry, such as energy.

“We have seen trouble in a number of different sectors, which is different than past periods, and that is what makes this potential crisis in Brazil more significant,” noted Richard Cooper, a partner at Cleary Gottlieb Steen & Hamilton LLP.

The most troubled industries in Brazil include sugar, ethanol, construction, real estate, and oil and gas, particularly those involved in drilling, shipping and related services, Cooper said. But he acknowledged that the suffering is going to spread even broader and that distressed debt exchanges and judicial restructurings will become more prevalent.

One source, who asked not to be named, said that the only companies that may be spared are the ones that rely on exports, such as paper and pulp, which are sectors that

are doing very well. One reason is that the costs of export companies are denominated in Brazilian reais while their revenues are in U.S. dollars, the source noted.

Timothy Graulich, a partner in Davis Polk & Wardwell LLP’s insolvency and restructuring group, noted that in a different environment, Brazilian companies could have ridden out a big scandal and some industry-specific issues. “But when you roll them all together and there are a piling up of causes, it’s very difficult to see a quick and easy solution here,” he asserted.

According to data from World Bank, Brazil’s GDP growth has declined significantly over the past few years. It fell to 0.1% in 2014, down from 2.7% in 2013.

One source, who asked not to be named, said that the country is going to have to increase taxes and cut welfare programs next year to deal with the fiscal crisis it is facing or it could be looking at a sovereign debt restructuring. This person added, however, that it’s impossible to predict what the Brazilian government will do.

Meanwhile, in an Oct. 15 report, Fitch Ratings Inc. noted that Brazil is facing a rising government debt burden, challenges to fiscal consolidation and a worsening economic backdrop. Fitch projects that the general government deficit will deteriorate to close to 9% of GDP in 2015.

Then there’s Brazil’s currency devaluation. The reais has declined roughly 40% this year against the U.S. dollar.

This devaluation is causing plenty of problems for Brazilian companies that have dollar-denominated bond debt “because these companies are making interest payments on the U.S. dollar and making money on the Brazilian reais,” Nash explained. “This is making it increasingly difficult for these companies to service and stay current on their U.S. dollar-denominated debt.”

Graulich said that currency in Brazil has been moving in an unfavorable way throughout the year and the deterioration

was accelerated in September, when the country itself was downgraded. He said that the Brazilian reais is now worth a quarter; earlier this year, it was worth closer to 33 cents.

“The companies that have to pay foreign creditors are the ones doing the most restructuring, while some of the smaller companies with locally denominated debt haven’t been nearly as distressed,” he said.

According to Graulich, it’s tough, because of the currency devaluation, for troubled companies to refinance their way out.

“It’s very difficult to get refinancing in the U.S. and Brazilian banks aren’t in a position to help these companies,” he said.

Schahin II Finance Co. (SPV) Ltd., a special-purpose limited liability company and a unit of Brazilian diversified company Schahin SA, didn’t make a Sept. 25 principal and interest payment due on its dollar-denominated senior secured notes. The company has \$750 million in 5.875% senior secured notes due Sept. 25, 2022, with \$651.5 million outstanding on the notes.

Another Schahin unit, Lancer Finance Co. Ltd., had insufficient funds to meet its recent interest payment, causing it to default as well. Lancer has \$270 million in 5.85% senior secured notes due Dec. 12, 2016, with roughly \$41.78 million outstanding on the notes.

Officials at Schahin couldn’t be reached for comment.

Meanwhile, São Paulo-based operator of shopping centers, General Shopping Brasil SA, is also struggling because more than half of its debt is in U.S. dollars while its revenue is generated in reais.

In September, General Shopping Brasil elected to pay an interest payment due on its \$150 million in 12% perpetual subordinated notes-in-kind, rather than in cash, in order to preserve its liquidity. The company also has \$250 million in 10% senior unsecured perpetual notes.

A spokeswoman for General Shopping Brasil declined to comment.

But devaluation isn’t the only thing casting a pall over Brazilian companies. Controversy involving Petróleo Brasileiro, better known as Petrobras, has also become a dreary overhang and, Nash said, “caused many Brazilian banks to tighten up credit.”

There’s been a deleterious effect on the Brazilian debt markets, too. According to Dr. Anshuman Jaswal, a senior analyst at research and advisory firm Celent, in the first half of 2014, there were around \$33 billion in corporate bond

issuances in Brazil. Since then, issuance plummeted to \$5.8 billion in the second half of 2014, and was just \$6.15 billion in the first half of this year.

Petrobras generally accounts for 25% of the issuance in Brazil’s credit markets, but hadn’t visited it since the probe of the scandal started in 2014. It did return on June 1 to raise \$2.5 billion in 6.85% 100-year bonds, due June 5, 2115, but the damage was done. Construction companies, in particular, haven’t been able to raise money, with OAS SA being the most prominent example.

Petrobras and its executives have been under investigation for a corruption scandal on allegations that executives accepted bribes in return for awarding contracts to construction firms at inflated prices. The probe, labeled Lava Jato Operation (Operational Car Wash), has been conducted by the Brazilian Federal Police since last year and has led to charges of money laundering and organized crime.

A spokeswoman for Petrobras declined to comment.

One of the service providers, OAS, on March 31 filed an application for a judicial recovery proceeding after being put on a list by Petrobras that barred it from competing for new contracts, which comprised 3% of its revenue. The company in January had missed a \$16 million interest payment on its \$400 million in 8% senior unsecured notes due July 2, 2021.

On April 1, OAS received the blessing of Judge Daniel Garnio Costa of the 1st Section of Bankruptcy and Judicial Recoveries of the Court of Justice of the State of São Paulo to enter bankruptcy. The company also filed for Chapter 15 in the U.S. Bankruptcy Court for the Southern District of New York in Manhattan on April 15.

Andrew Janszky, a partner and head of Milbank, Tweed, Hadley & McCloy LLP’s Latin America practice group, explained that because of the Petrobras scandal, some construction companies are barred from bidding on public construction contracts and are running out of money.

He also said that due to the decline in oil prices, Petrobras has started to renegotiate its drilling contracts for rigs, so oil and gas services companies, in addition to construction companies, are being hurt by their association with the oil giant.

An Oct. 8 report from Moody’s Investors Service Inc. said that the Brazilian national oil company cut its capital spending budget almost 30%, to \$19 billion, from \$27 billion in October.

Petrobras terminated its offshore drilling charter agreement with Schahin II Finance and Lancer Finance on May 22. And Botafogo-based Odebrecht Oleo & Gas Ltd.’ affiliates

Odebrecht Offshore Drilling Finance Ltd. and Odebrecht Drilling Norbe VIII/IX Ltd. were downgraded by Fitch Ratings Inc. on Oct. 12, after Petrobras terminated charter and services agreements with the company, reducing its cash flows.

Making it difficult for Brazilian companies to compensate for devaluation and a tight lending climate is the decline in commodity prices. Brazil's commodities include iron ore, oil, sugar, ethanol, steel and copper, as well as agricultural goods, according to Janszky.

He said that while commodity prices have gone down, so has demand, so companies are selling less and at a lower price. As a result, São Paulo-based sugar and ethanol producer Grupo Virgolino de Oliveira has been working on a debt restructuring after missing various interest payment on debt this year. The company hasn't been able to raise the financing that it needs and could be facing a Brazilian bankruptcy proceeding. The company is being advised by Moelis & Co. LLC and Kirkland & Ellis.

Sugar, ethanol and energy producer Tonon Bioenergia SA completed its out-of-court restructuring in July after swapping its \$300 million in 9.25% senior unsecured notes due Jan. 24, 2020 for new step-up senior unsecured notes due Jan. 24, 2020. The company also finalized \$70 million in new secured financing from its existing unsecured noteholders, including funds managed by Gramercy Funds Management LLC.

Even non-commodity parts of the Brazilian economy has felt the heat. São Paulo-based real estate developer PDG Realty SA hired Rothschild as its financial adviser for its debt restructuring, including the renegotiation of contracts to strengthen its working capital and capital structure, it said on Aug. 17. PDG is one of the largest homebuilders in Brazil, with projects in 14 states in virtually all price segments. It had R\$6.98 billion (\$1.78 billion) in gross debt as of June 30.

Meanwhile, Rossi Residencial SA, a São Paulo real estate development and construction company, announced on Aug. 5 that it has hired RK Partners Financial Advisory and Asset Management Ltda. and MaxCap Real Estate Investment Advisors Ltda. to advise it on its restructuring and strategic objectives. Rossi said in financial documents that it had started talks with its banks to adjust its debt profile. It had R\$2.1 billion in total debt as of June 30.

"As a part of its reorganization process, Rossi Residencial has elected, on the last month, new executives for the administrative board presidency and vice-presidency, as well as new CEOs," according to an email from company spokeswoman Luciana Lins. "Since August, RK Partners Assessoria Financeira e Gestão de Recursos and MaxCap Real Estate Investment Advisors have been working in a

partnership with the company in reviewing its strategic objectives and in restructuring its operations. The company remains focused in protecting cash and reducing leverage."

Meanwhile, homebuilder Viver Incorporadora e Construtora SA missed a payment on its senior secured debentures in April, after restructuring its debt outside of court in November 2014. A spokeswoman at PDG Realty and officials at Viver couldn't be reached for comment.

"The problems with Brazilian real estate developers are systemic as demand has dropped off in the housing market because of the economy," said Lawrence Young, a managing director at AlixPartners LLP.

Perhaps the silver lining in Brazil is that few companies have had to resort to bankruptcy filings and have been able to refinance outside of court. Other than OAS, for example, Aralco SA, a Brazilian ethanol and sugar producer filed for Chapter 15 in the U.S. Bankruptcy Court for the Southern District of New York in Manhattan on Feb. 25, in order to have its confirmed plan in a Brazilian bankruptcy case become effective in the U.S. Aralco commenced its Brazilian case on Feb. 28, 2014, in the 2nd Civil Court of Araçatuba, and the court entered a commencement order on May 9.

Schahin also had several units file for recuperação judicial in Brazil in the São Paulo Bankruptcy and Judicial Reorganization Court on April 17.

"There is a real appetite to avoid bankruptcy in Brazil as there is a limited body of law combined with no dedicated judges, so no one wants to go to court," said Young.

Unlike in the U.S., where there are courts dedicated to bankruptcy and specific laws dealing with it, Brazil has a system that uses local judges who may not have the knowledge needed to deal with significant business concepts. The judges also have a mandate to keep people working, even if the business is losing money and recoveries for senior lenders are reduced.

Young said that, in Brazil, the absolute priority rule recognized in the U.S. doesn't exist. As a result, at the corporate level, equity holders end up controlling the restructuring and hold other, more senior creditor groups hostage during the process.

"Since equity has a lot of leverage, you want to take a consensual approach to restructurings and talk your way up from the equity holders," he said.

Nor is the bankruptcy process completely transparent in Brazil, Young noted, adding that you don't know where the law is going to take you and so it's hard to determine what the downside of an investment is.

“When a company goes into bankruptcy in Brazil, it’s not easy to get debtor-in-possession financing. The DIPs in the U.S. are loans against the liquidation value of the company, but when companies go into bankruptcy in Brazil they don’t have a good liquidation value,” Graulich said.

In the U.S., if the credit markets won’t let you refinance, you can go into bankruptcy and get DIP financing. Not in Brazil.

“It’s the exact opposite and you are no more likely to get financing and may in fact be less likely to get financing,” Graulich said, “DIP financing is the exception, not the rule.”

In Brazil, the debtors have the exclusive right to propose the restructuring plan and creditors vote on it. Often, the debtor’s plan proposes a haircut for the debt and then permits the controlling shareholder to retain valuable equity rights. There is also not an opportunity in Brazil for a creditor to propose a plan. If creditors vote against the plan and it’s voted down, there is a high likelihood of liquidation, a dynamic that frequently pressures creditors to accept equity-friendly plans, Graulich said.

Not surprising, given all those shortcomings of the bankruptcy system for creditors, Graulich said the preferred path in Brazil is to do an out-of-court financial restructuring, particularly if you have management and ownership that is concerned about preserving value.

Moreover, what keeps investors so interested in Brazil despite the distress is that the upside there is still so large.

“I think there is a big opportunity for investors in Brazil at the moment,” said Kirkland’s Nash. “There are a lot of Brazilian companies that are overleveraged and being squeezed by the credit markets.”

These companies are having to delever by selling off assets and spinning off non-core businesses, so there is opportunity for investors in Brazil—to buy footloose assets, invest equity or gobble up debt—if they are willing to do the work to understand the local context and environment.

Young said that there is a considerable amount of money on the sidelines in Brazil, including hedge funds, because “in distressed situations, people are unsure of the recoveries in a given case. The risk of downside is compounded by the lack of visibility given the economy. As a result, no one knows

where the bottom is in Brazil. Everyone is still waiting for the knife to fall.”

He noted that American hedge funds that do invest in Brazil like to have a local participating partner.

Milbank, Tweed’s Janszky said that everyone is convinced that there is incredibly good value in Brazil and your money will buy twice as much as it did a year ago, but not a lot of buying is taking place.

“There is a lot of uncertainty and investors hate uncertainty,” he said.

A source who asked not to be named said that hedge funds including Gramercy, King Street Capital Management LP, Centerbridge Partners LP and Brookfield Asset Management Inc. are investing in Brazil. Officials at Gramercy and Centerbridge couldn’t be reached for comment, while King Street Capital and Brookfield declined to comment, but in an Aug. 7 shareholders’ letter, Brookfield’s CEO Bruce Flatt said, “Brazil is undergoing extreme pressure, and this has been exacerbated by scandals that have affected many of the global champions in the country. Despite this, and a recession, the country has a strong democracy with an emerging middle class, and we continue to believe in the long-term emergence of Brazil. As a result, we are investing large sums of capital there.”

In fact, Brookfield provided OAS with R\$800 million in postpetition financing to fund its Brazilian bankruptcy case.

Young believes more restructuring activity will occur in Brazil in the last part of this year and in 2016 as people get more comfortable with the economy and businesses start to stabilize.

The restructurings in Brazil “are going to create work for U.S. restructuring advisers since there are often a lot of U.S. creditors involved,” Nash said.

Already, he said, a multitude of American restructuring lawyers and bankers are working with creditors and investors from the U.S. in partnership with Brazilian professionals.

“We are at the 20-yard line [in this distress cycle in Brazil],” said Cleary Gottlieb’s Cooper. “There is a long road ahead. It’s going to be a very busy market.”

AS FEATURED ON

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