# Potential Trends Brought by COVID-19

By Antonio Felix de Araujo Cintra and João Busin, Partners at TozziniFreire Advogados

We write this article at a point where it is close to impossible to make any predictions about the real extent of the COVID-19 crisis and its actual impacts on the global economy. A few questions start to consistently pop up in the webinars, live events, and crisis committees' discussion forums that became part of our daily routine: how will businesses in general look post-crisis? Are there any sectors that will simply disappear? What are the sectors that will fare better? How will the alternatives industry react and adjust to challenges imposed by the "new normal"? Are there any strategies that will gain more traction in this context?

Although answering most of these questions is still a "best guess" effort, players across the whole alternatives spectrum would be better off having these guesses in mind. It seems that there is no right answer, but they help alternatives investors and managers to assess and reassess how they may adjust their strategy in ways that might have been even unthinkable before.

The common sense is that many businesses (especially those that are already under severe financial constraints with low or no activity at all, such as airlines, tourism, and leisure facilities) will need a lot more than government stimulus programs and borrowing from the traditional financial system in order to persevere through the crisis. Government support may partly contribute to streamline the liquidity shortfall in the very short term. Traditional debt has become expensive over the years with more stringent financial institutions that have grown less amenable to risk as a lesson learned out of 2008's credit crunch.

It is time for a profound operational reshape. In an emerging economy like Brazil where companies are constantly in this process, COVID-19 brought an overall sense of urgency, possibly accelerating a few trends.

> "In an emerging economy like Brazil where companies are constantly in this process, COVID-19 brought an overall sense of urgency, possibly accelerating a few trends."

We anticipated one of these trends in a feature we wrote for last year's summer edition of EMPEA's Legal & Regulatory Bulletin: *Private Credit Strategies and the Brazilian Restructuring Law*. Because of COVID-19 many Brazilian companies and groups will potentially undergo the effects of a variety of special situations, most of them motivated by low liquidity. Larger economic groups may need to dispose of non-core assets because of scarcity and higher costs of traditional sources of debt, companies may turn to private lending, and some other companies may file for judicial reorganization under the Brazilian Bankruptcy and Insolvency Act.

This is the perfect landscape for greater focus on distressed and special situations investments, offering numerous opportunities for the whole spectrum, such as acquisitions of non-performing loans (NPLs), debtor-in-possession (DIP) financing, acquisition of separate business units (*unidades produtivas isolada – UPI*) in the context of judicial reorganization, acquisition of legal claims, private lending, amongst others.

Another intuitive trend is private investments in public equities (PIPEs). Many Brazilian companies that operate in sectors heavily impacted by the current crisis are listed in stock exchange or over-the-counter markets in Brazil and/or abroad. Some examples are airlines, online travel companies, gym chains, and retail. The beauty of PIPEs is that they do not demand peculiar abilities or substantially detouring from a more traditional private equity strategy in comparison to the distressed and special situations' environment. Besides, completion of a PIPE is relatively fast because there is more information available about the target business, streamlining discussions around due diligence and valuation.

Although there are still just a few players with a proven track-record and the necessary skillset to operate in these asset classes in Brazil, it would not come as a surprise if we see firms that traditionally focus on growth, development, and buyout strategies starting to look for opportunities in these segments. Not because their underlying strategies will fade, but rather as a means of balancing portfolio risks. One of the key takeaways of this crisis is that diversification is key to players in the alternatives space, both in terms of sector and strategy.

Private Equity Bay (Pebay) recently released an article comprising an assessment of the risk profile of 10 of Brazil's largest private equity managers in the context of COVID-19, based on publicly available information regarding companies belonging to their portfolios. The analysis took into account financial and operational metrics, as well as potential performance under different stress scenarios (the so-called "stress test"). Eight out of the ten managers offer their investors moderate risks. The common element to all these eight managers is that they offer sector diversification from moderate to high. One of the managers presenting a high risk was a consequence of being focused in a sector largely exposed to the crisis. The remaining one presented a low risk, as it is exposed to only one asset that belongs to a crisis-resilient sector.

In parallel, strategy diversification may help unlock value generation even in choppy times.

Yet, there will continue to be a lot of room for pure private equity, infrastructure, real estate, and venture capital in Brazil, especially in the aftermath. The unprecedented low benchmark interest in Brazil and the favorable foreign exchange rates will make Brazilian assets comparatively attractive for foreign investors. In addition, statutory admission of electronic transactions means for signing documents, making certain filings and also holding shareholders' meetings, all forced by social distancing imposed by COVID-19, come as a welcome relief to the red tape that has historically been one of the chief danger zones in Brazil's business environment. However, while screening for opportunities amid the crisis, players should focus on:

a) Choosing sectors that may recover in a reasonable timeframe for executing an exit at the expected level of return. Investing in sectors that are crisis resilient may well be tricky, as some of them may have their real value inflated as a consequence of increased competition amid the crisis, not necessarily presenting a growth curve that is consistent with the expected returns;
b) Crafting pricing structures that address uncertainties about how certain companies will perform in the long run (earn-out arrangements have become an interesting tool in this context, despite all complexities they may bring along);
c) Negotiating risk allocation and carve-outs in respect of material adverse effect and conduct of business provisions vis-à-vis *force majeure* and other principles of local civil law; and,
d) Planning on fulfilment of conditions precedent. Having a reasonable longstop date may help lift some of the pressure brought by access limitations. Although many governmental authorities have been working from home as well, responsiveness tends not to be the same as in the pre-crisis scenario.

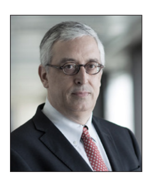
Just as an example, amid the crisis, Vivante, an outsourcing services company belonging to Axxon Group's portfolio, a well-reputed Brazilian private equity firm, closed a deal to sell its stake in Hospital Novo Metropolitano, a Brazilian hospital in the State of Minas Gerais, to OPY Health, the health care platform of a fund of IG4, another Brazilian private equity champion. Closing was on April 15, 2020, nearly a month after the government of the state of São Paulo, Brazil, officially determined to put the whole state on quarantine as a protective measure against the wide spread of COVID-19 (although the hospital is located in Minas Gerais, most of the parties involved in the deal are based in São Paulo). The closing meeting was fully remote, carried out through video conferences. Parties signed the transaction documents at the end of 2019 and closing was dependent on the fulfilment of certain conditions precedent, including regulatory approvals.

In addition, against all odds, the Brazilian parking lot company Estapar, controlled by the Brazilian investment bank BTG Pactual, and with funds from private equity firms Equity International and Crescera Capital amongst the company's shareholders, launched an initial public offering (IPO) on April 22, 2020. The underwriters were banks BTG Pactual itself, Bradesco BBI, Banco do Brasil, and Santander. The company placed 28,600,000 shares on primary offer, whilst the shareholders placed 1,234,430 on secondary offer. It was the first ever fully remote IPO with B3 on the Brazilian stock exchange.

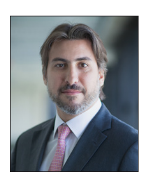
Obviously, these are all nothing but possible trends that may, however, serve as good insight for those who are somehow exposed to Brazilian alternatives' industry or those who see the current situation as an opportunity. The only thing we know for sure is that there will be deal activity in Brazil. There is still dry powder for Brazil-focused and/or broader Latin America strategies. Managers need to make the allocations.

The moment demands caution, flexibility, and some level of creativity, but, despite the difficulties brought by uncertainty, the legacy of this crisis will consist of invaluable lessons that hopefully will create a stronger and more realistic/resilient business environment.

## About the Authors



**Antonio Felix de Araujo Cintra** is Partner of the Capital Markets and Banking & Finance Practice Groups at TozziniFreire Advogados.



**João Busin** is Partner and Head of Private Equity & Venture Capital practice at TozziniFreire Advogados.