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New Brazilian Asset Classes in International Capital Markets - Infrastructure Debentures and REITs

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In recent months, two new asset classes from Brazil have made their way into international capital markets - infrastructure debentures and real estate funds with structures similar to those of U.S. REITs. Infrastructure debentures are Brazilian local bonds with infrastructure investments as their main use of proceeds; concessionaries of public services, including tollroad, power, sanitation, airport and port companies are the most likely issuers of these instruments. Recent examples include the issuances of secured debentures by tollroad concessionaires CART and ECOVIAS in an aggregate amount of over R\$1.5 billion. The Brazilian version of a REIT is the *Fundo de Investimento Imobiliario* (FII), a real estate fund established as one of the main formats for local capital markets fundraising in the real estate/property management industry, and which is now beginning to find traction in the international capital markets. Examples include the US\$1 billion inaugural BTG Pactual Corporate Office Fund offering in 2012 and the ongoing Fazenda Boa Vista private

placement by real estate developer JHSF.

Both of the new asset classes are real-denominated, settled and traded locally in Brazil, and both are long-term investments with public policy-driven tax incentives. They have been offered principally in the form of private placements and Rule 144A and Regulation S offerings. In this article, we will analyze the background, market trends, challenges and prospects for these new asset classes.

Background

The international offering of both infrastructure debentures and FIIs have a number of key economic aspects in common, mainly tax incentives and the need for capital intensive long-term investments.

FIIs that are publicly distributed to at least 50 investors and that are traded in regulated market systems are exempt from withholding income tax in Brazil, provided that no investor holds more than 10% of the FII.

Infrastructure debentures are also exempt from Brazilian withholding income tax. To qualify for the exemption, the debentures must have a minimum average term of four years and must have a use of proceeds related to the financing or refinancing of infrastructure projects.

Additionally, foreign exchange transactions related to the inflow and outflow of resources into and from Brazil related to investments in FIIs or infrastructure debentures

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are currently exempt from the tax on foreign exchange transactions (IOF)¹. Until very recently, the IOF tax on these investments to international investors was 6%, which made these asset classes unattractive.

As a result of these tax incentives, the tax treatment of FIIs and infrastructure debentures is now the same as that for direct equity investment in Brazil.

In addition, both these asset classes are driven by the extraordinary need for funding in the highly capital-intensive infrastructure and real estate markets. According to the Brazilian development bank BNDES, nearly R\$500 billion² in infrastructure investments and more than R\$750 billion³ in investments in residential real estate are planned by 2016. As local banks and the BNDES are unlikely to be able to meet this immense funding demand, the Brazilian government has increasingly felt the need to encourage investment and incentivize local and international investors to invest in these areas.

Market Practice

Recent practice in offering infrastructure debentures and FIIs has varied between lower profile private placement transactions and fully marketed Rule 144A/Regulation S offerings, depending on the expected level and type of demand from international investors. All of these offerings are registered with the Brazilian securities regulator, the (*Commissao de Valores Mobiliarios* or CVM), and are usually public offerings in Brazil with a private international tranche, similar to the long-standing practice for offerings to investors outside of Brazil under Rule 144A and Regulation S.

While the infrastructure debentures are clearly marketed to fixed income investors, FIIs have a somewhat hybrid demand base – they are fixed income products from a cash flow and Brazilian regulatory perspective, but have also been marketed as equity capital market products competing with BOVESPA-listed public real estate management companies like BR Properties, CCP and others.

The settlement of the transaction always occurs in *reais* in Brazil, requiring investors to be registered as foreign investors with the Brazilian authorities (the so-called 2,689 investors under Resolution 2689/2000). Although the FIIs and the infrastructure debentures are always registered with CVM and as a technical matter often sold in public offerings, they are not as widely distributed as equity offerings, but are targeted at a limited number of selected investors.

Transactions of FIIs and infrastructure debentures in a Rule 144A/Regulation S format are marketed as any other transaction in this format, with a U.S. roadshow, a complete offering memorandum, U.S. underwriting/agency agreements and the typical due diligence protections to the underwriters/placement agents usually found in Rule 144A and Regulation S equity and international bond offerings.

Private placements are marketed to a much smaller number of U.S. investors with much less publicity and without the use of the broader Rule 144A sales and marketing channels. The level of disclosure and information provided to investors can vary, from a bare bones disclosure document that is little

more than a translation of the key terms of the underlying agreements, terms and tax implications, to more comprehensive private placement memoranda that are in substance similar to the customary Rule 144A and Regulation S offering memoranda. Investor representation letters are usually required for the execution of the transaction and investors conduct their own diligence in these transactions. Regarding the international private placement of infrastructure debentures, two observations are of particular interest:

While the infrastructure debentures are clearly marketed to fixed income investors, FIIs have a somewhat hybrid demand base – they are fixed income products from a cash flow and Brazilian regulatory perspective, but have also been marketed as equity capital market products.

- In the U.S., the offering of infrastructure debentures as private placements is one of the very few examples of private placements of non-U.S. debt securities into the U.S. Traditionally, U.S. investors are accustomed to a Rule 144A-style marketing format for non-U.S. debt securities. Thus, non-U.S. companies that do not choose the (more expensive) Rule 144A offering route limit their sales to non-U.S. investors under Regulation S. The traditional domestic U.S. private placement market, with insurance companies as the main investors, has not been open to placements by non-U.S. and non-investment grade issuers, with very few exceptions.
- Unlike prior market practice, it appears that certain sophisticated U.S. investors have felt comfortable investing based on an indenture and security package under Brazilian law instead of a typical high yield covenant package governed by New York law.

Overall, the international and U.S. demand for private placements of infrastructure debentures and FIIs has so far been limited, with only small tranches being sold to non-Brazilian investors. However, considering that this is a new product in a new format, the importance of the international tranche of these offerings may increase in the near to mid-term.

Finally, the marketing of Rule 144A and private placement transactions in the United States may be affected by recent SEC rulemaking that lifts certain restrictions on communication in and publicity of these transactions, but it is too early to tell if and to what extent this will have an impact on the development of the international placement of Brazilian FIIs and infrastructure debentures.

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Challenges

The new asset classes face a number of challenges, including low secondary market liquidity, currency risk, low cost alternative local and BNDES funding and the lack of a DTC settlement mechanism for these products.

The debt market in Brazil is largely dominated by pension funds and other major institutional investors which have for many years followed a clear buy and hold investment strategy. As a consequence, liquidity for local debt and FII securities in the secondary market in Brazil is extremely low when compared to the total amount of outstanding debt. Although this environment has been changing in the recent past with the participation of local asset management and family office investment firms, wealthy individuals and fixed income investment funds, the relative liquidity that is provided by these investors is still quite small. In the near term, international investors are more likely to find liquidity with other international investors rather than with local investors.

The FIIs and the infrastructure debentures are denominated, settled and traded in Brazilian *reais*, which causes foreign investors to be exposed to exchange rate risk. This feature is a major difference from other fixed income instruments issued by Brazilian issuers in the international markets, such as bonds and commercial paper, and may become an obstacle for the development of a large market for the new assets classes. In addition, for infrastructure debentures the transactions have to date been limited to transactions of already operating projects, and investors have not taken an development or construction risk related to greenfield projects.

Another element that could affect the development of FIIs and infrastructure debentures is alternative long term, low cost funding provided by Brazilian government-owned financial institutions, principally the BNDES and Caixa Economica Federal (CEF). These institutions traditionally finance infrastructure and real estate investment at low interest rates. The FIIs and the infrastructure debentures were created at a time when it became clear that the governmental institutions would not be able to supply all the necessary funding for existing projects. But to the extent that in the future BNDES and CEF increase their funding capacity, the further development of FIIs and infrastructure debentures may be impaired.

Finally, the lack of a DTC settlement mechanism through Global Depositary Notes (GDN) or trust structures for the new asset classes may pose a challenge. Brazilian regulation to date does not allow fixed income securities like the infrastructure debentures to be the underlying security for a GDN. Although there are requests to the CVM pending to change this limitation, it is unclear if such change would indeed lead to an increased use of these structures. Experience in Mexico, which allows for fixed income securities to be the underlying security for a GDN, has shown that this structure

has been used only in a handful of select circumstances and by large issuers like PEMEX. Trust structures are sometimes used for the DTC settlement and trading in U.S. dollars of transactions that are primarily settled locally. However, these structures are complex and rather expensive, so unless there is a real increase in international demand or liquidity created by them, companies seem likely to opt for a local settlement only (especially given that most investors interested in FIIs and infrastructure debentures are 2,689 eligible and used to directly investing in Brazil).

The current market uncertainty with regard to investments in Brazil in general, however, has in recent weeks reduced the demand for the new asset classes and is likely to continue to do so in the short term.

Prospect

Despite these challenges described above, the offerings of infrastructure debentures and FIIs appear to have come to stay. The first executed transactions were quite successful, raising the interest of many relevant players in these new funding opportunities. Some companies may do these transactions to get known in the international markets to pave the way for larger international financings; other companies, especially in the FII area, have and may continue to use these new formats to raise significant amounts of long-term funding internationally.

The current market uncertainty with regard to investments in Brazil in general, however, has in recent weeks reduced the demand for the new asset classes and is likely to continue to do so in the short term. For infrastructure debentures, the total issue volume remained well below the expectations of the BNDES, which predicted a total issue volume of R\$10 billion⁴ for 2013. As a result, the BNDES is considering making infrastructure debentures more attractive through a number of measures, including possibly a put option for investors for investments in projects that encounter development problems.

While the new asset classes are in the short term not likely to attract international investor demand as deep as in the traditional Rule 144A and Regulation S equity and bond markets, they do seem to have established their niche, and we do expect international investors to over time become increasingly familiar and comfortable with them. □

¹ *Imposto Sobre Operações Financeiras* or IOF

² Approx. US\$225 billion.

³ Approx. US\$337 billion.

⁴ Approx. US\$4.5 billion.