

**Mexico's *Concurso Mercantil*
from an International
Bondholder's Perspective**

Should There Be a "Vitro Premium?"

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**EMTA Conference: The Vitro Effect: Troubling
Developments in Mexican Insolvency Law
December 7, 2011**

Overview of Presentation

- **Global Perspective on Bankruptcy Procedures**
- *Concurso Mercantil* in Perspective
- **Practical Considerations as an International Creditor**
- **The Case of Vitro and Ramifications for Bondholders**

Global Perspective on Bankruptcy Procedures: Overview

- Globally, corporate bankruptcy procedures were traditionally focused on liquidation of collateral and thus, while perfunctorily creditor oriented, provided only a draconian remedy from a creditor's or debtor's perspective.
- The US Chapter 11 style reorganization approach was developed from a practical standpoint after the revision of the US bankruptcy code in 1978.
- Many countries in the last 10-15 have revised their corporate bankruptcy regulations, which in most cases were not prepared to deal with post-war corporate practice or globalized commerce, and have also attempted to adopt rules that address the objective of preserving the company and its business through some form of reorganization proceeding.
- Although Mexican law has provided for both a reorganization (*suspensión de pagos*) and liquidation (*quiebra*) procedure since 1948, the old rules were largely ineffective and unsatisfactory for most of the stakeholders except for controlling shareholders.

Global Perspective on Bankruptcy Procedures: Bias

- In any situation of corporate distress, there are many different stakeholders affected: shareholders, management, labor, the underlying business itself (i.e. the “estate”), creditors of various classes, the government. Bankruptcy and reorganization procedures in a specific jurisdiction each reflect a bias that favors one or more of the stakeholders.
- Old-style Latin American procedures historically tended to give massive protections to labor claims and to the fiscal claims of the government. This precluded effective reorganizations (and often had the perverse impact of ensuring these claimants never saw much of a recovery) as such claims typically overwhelmed the financial capacity of the corporation. Management and shareholders would often continue to run their business as usual, to their own benefit, with little effort to resolve their financial situation. Private creditors could expect little recovery.
- A US Chapter 11 proceeding focuses on preserving the value of the company itself. Control of the company is taken away from management and given to an independent receiver and to the judge, contracts and labor arrangements can be modified, junior creditors and shareholders can be partially or entirely wiped out. A crucial element of the procedures is that capital structure priority is maintained.

Concurso Mercantil in Perspective: Historical Development

- *Concurso mercantil* was developed in response to the Mexican crisis of 1994-95, when virtually the entire banking system became insolvent. The limitations of the previous regime contributed greatly to the distress in the financial sector.
- As with so many revolutionary regulatory changes, the process was highly political as the various interest groups lobbied for advantage. The final procedures, effective in May 2000, reflect the politics. In the context of understanding the bias of the procedures, they would be characterized as “controlling shareholder friendly,” with the exception that the local banks were able to lobby for absolute protections for secured creditors by incorporating no provision for cram down.
- Although there have been hundreds of cases resolved under *concurso mercantil*, it is still largely untested. There have been only a dozen large restructurings completed under the new rules, and none of these large cases have involved what I would term to be “hostile” resolutions, i.e. determined by established court process and not through negotiations largely out of court, until Vitro.

Concurso Mercantil in Perspective: Suspensión de Pagos/Quiebra

- No unbiased observer would question that the new *concurso mercantil* procedures are a vast improvement over the previous *suspensión de pagos/quiebra* regime.
- The principal issues were time, impunity of management/shareholder actions, and lack of accountability.
- Compañía Luz y Fuerza del Centro (the Mexico City electric utility) entered *suspensión de pagos* in the 1950s, went into *quiebra* (liquidation) in the early 1970s, and yet was in operation largely for the benefit of the union until shut down by the presidential decree in October 2009. The capital structure was so convoluted, and labor claims so overwhelming, that previous governments had not been able to rationalize the business or integrate it with the CFE (the national electricity monopoly).
- Altos Hornos (AHMSA), the Mexican steel producer, was put into *suspensión de pagos* back in late April 1999. While there is always talk of a negotiated settlement to be announced shortly, the presiding judge in the local court in Monclova has not even completed the claims recognition process...nearly twelve years later!

Practical Considerations as an International Creditor: The Good

From an international investor's perspective, there are several positive elements of the *concurso mercantil* process

- Time periods constraints pressure the debtor to come to the table
- Adjudication is at a federal level (instead of local) court
- The IFECOM appointed *conciliador*, if sophisticated and savvy, can be a positive facilitator of a resolution

Practical Considerations as an International Creditor: The Bad

Unfortunately, there are several bad aspects from the perspective of an international investor

- Statutory time periods are malleable (e.g. Fertinal)
- Judges even at the federal level are not necessarily that sophisticated with respect to their understanding of global finance
- IFECOM *conciliadores* may not have the international experience necessary to grapple with the complexity of cross-border restructurings

Practical Considerations as an International Creditor: The Ugly - 1

There is no transparency in the proceedings

- Proceedings are not made available in the public record
- Financial statements are not public either
- Greater risk, or at least “fear of risk,” of unmonitorable chicanery
- Makes it difficult to predict what should occur “next time”
- Hard to monitor as an international bondholder not intimately involved in the restructuring discussions

Practical Considerations as an International Creditor: The Ugly - 2

Lack of an “absolute priority rule”

- Modern capital markets have introduced debt instruments with a fine and nuanced delineation of capital structure priority
- *Concurso mercantil* merely differentiates between “secured” vs. “unsecured” claims
- *Concurso mercantil* permits junior classes of stakeholders to receive consideration even if senior classes are impaired
- Cram down of unsecured creditors with only 51% approval facilitates gamesmanship by junior class members, particularly controlling shareholders

Practical Considerations as an International Creditor: The Ugly - 3

Difficulty of dealing with secured creditors as there is no cram down procedure

- Lack of authority to force secured creditors to participate in a restructuring greatly complicates the process
- However, given the lack of an absolute priority rule, it is entirely understandable why secured creditors would balk at having any sort of cram down provision
- This is less of an issue with individual secured bank credits but becomes devastating with secured capital markets instruments, eg Satmex 2006

Practical Considerations as an International Creditor: The Ugly - 4

There is no concept of “substantive consolidation” of an economic group

- An operating company restructuring is handled separately from a holding company restructuring despite the fact that it is really one business
- The logical albeit absurd result of this is that intercompany payables and receivables are considered on par with legitimate third party liabilities and assets; even more absurd is the fact that the intercompany payables have an equal vote with the real unsecured debt of the company, with the vote controlled by shareholders/management
- While there will clearly be a practical attempt to coordinate the multilevel restructuring discussions, it is not assured that the optimal resolution can be reached as the procedures are legally separate

Practical Considerations as an International Creditor: The Ugly – 5

Control of the ongoing management of the company in a *concurso mercantil* proceeding remains with the shareholders/management

- This is clearly a “fox guarding the chicken house” problem, and gives shareholders extraordinary leverage over creditors in the negotiating process
- Shareholders continue to run the company for their own benefit and control the use of cash, information and financial disclosure, timing, and strategic and operating decisions
- Shareholders use the corporate assets and cash flow to fund their often adversarial actions against creditors in the process; creditors are required to finance their own activities in trying to gain a reasonable recovery
- Shareholders/management vote can intercompany payables on a *pari passu* basis with legitimate unsecured creditors

Concurso Mercantil from an International Investor's Perspective

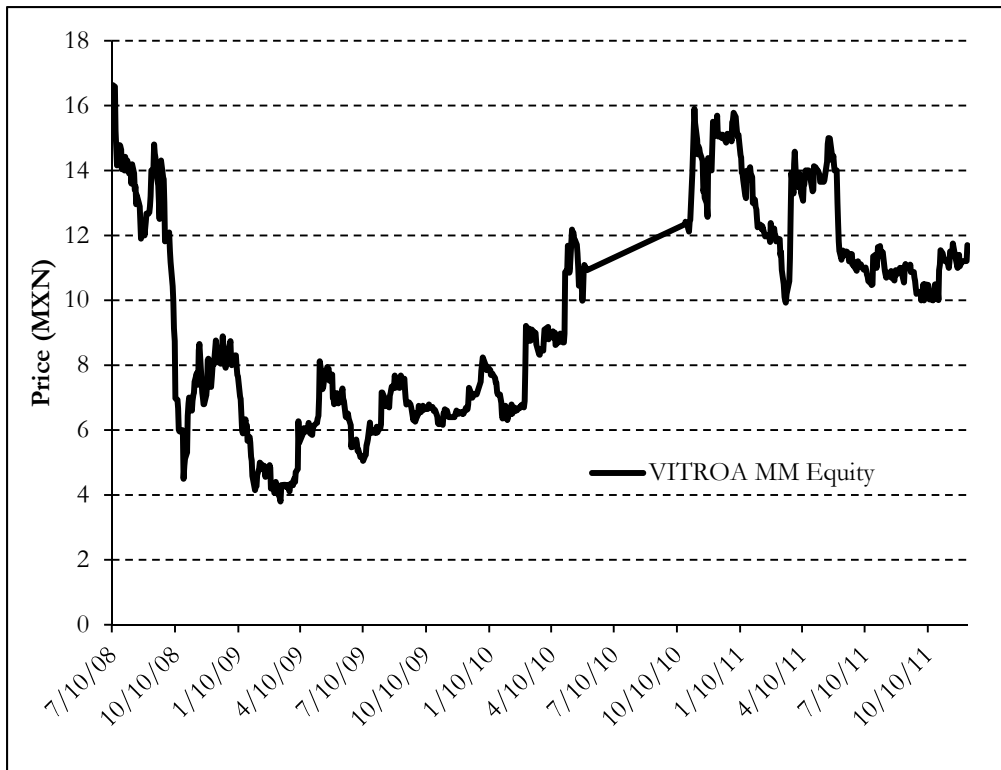
- *Concurso mercantil* is clearly a major improvement over the old Mexican reorganization/bankruptcy statutes, but it still has major flaws from the perspective of an international investor
- Due to its historical development, the regime is still biased towards the interests of controlling shareholders who, in the absence of good faith, can still act with impunity
- If there are to be revisions to the procedures, they should be made with careful consideration of the balance of stakeholder interests; for example, it has been widely discussed that there is a need to provide for cram down of secured creditors; however, in the absence of the introduction of an absolute priority rule, this would bias the process even further toward the parochial interests of shareholders
- In the end, the lack of effective reorganization rules or sophisticated judicial process will likely lead to a sub-optimal economy and poorer efficiency in the allocation of capital; implications will likely be felt in this next credit cycle downturn

The Case of Vitro: An Example of the “Ugly”

- Vitro is the first large Mexican company to try to exploit the loophole and use intercompany payables to approve a restructuring plan over the objections of the US\$1.45 billion of debt of legitimate creditors. Durango had previously threatened this but eventually reached a consensual deal.
- Many elements of the case are of note: the US\$1.9 billion of payables were incurred long after the default, an outside party provided financing in a transaction viewed by many as fraudulent conveyance, and the final plan put forward by the *conciliador* is extremely punitive to creditors who do not consent to the terms.
- On December 6, 2011, Vitro announced its debt restructuring plan received support from holders of 74% of its debt and that the *conciliador* had submitted the plan to the Mexican judge; with US\$1.45 billion of third party debt and US\$1.9 billion of intercompany payables, this suggests that only 40% of legitimate creditors voted in favor of the plan.
- JP Morgan recently valued the plan as giving consenting senior creditors an NPV recovery of 45-50% of original face, and even less for non-consenting creditors.
- Despite these poor expected recoveries, the current equity market capitalization of Vitro as of December 6, 2011 closed at Ps. 4.53 billion (US\$336 million).

The Case of Vitro: An Example of the “Ugly”

Vitro Equity



Timeline of Events	
12/6/2011	Vitro announces debt restructuring plan receives support from holders of 74% of its debt and that conciliador has submitted plan to the Mexican judge; with US\$1.45 billion of third party debt and US\$1.9 billion of intercompany payables, this suggests that only 40% of legitimate creditors voted in favor of the plan.
12/6/2011	US District Judge denies Vitro appeal and allows creditors to sue Vitro's non-bankrupt U.S. subsidiaries
10/31/2011	Conciliador ignores creditor counterproposals and submits a revised plan more punitive for Vitro's creditors
8/12/2011	Vitro bondholders lose in Mexican court on intercompany loans
6/20/2011	Vitro bondholders continue to battle in U.S. courts
4/15/2011	Vitro files for Ch. 15 in NY, later changed to Dallas at request of BHs
4/8/2011	Same Mexican judge reverses decision and accepts Concurso
1/9/2011	Vitro plan rejected by Mexican judge
12/27/2010	Mexican judge accepts Vitro plan
11/29/2010	Vitro says it will vote intercompany payables
11/1/2010	Vitro offers plan for debt swap
10/19/2010	Fintech buys option related to loan
12/1/2009	Vitro engages in questionable intercompany transactions
9/22/2009	Vitro receives counterproposal from Chanin Capital
8/5/2009	Vitro's initial restructuring proposal to creditors
2/2/2009	Vitro defaults on its coupon

The Case of Vitro: Quantifying the “Vitro Premium”

- Notwithstanding the negative financial impact on the specific set of creditors of Vitro and the financial windfall that may be enjoyed by its shareholders, there is a larger public policy question of whether there is any impact on the economy of a country with such a flawed restructuring system or an impact on other companies looking to raise debt. This is a notoriously difficult exercise because of the limited set of data and the difficulty in controlling for numerous exogenous factors that might influence borrowing costs or spreads at any given time.
- Most studies tend to focus on nominal recovery rates on defaulted debt, which is not very instructive in an NPV world.
- Given these complexities, Gramercy has done a simple review of the weighted average spreads on the outstanding corporate bonds of issuers in Argentina, Brazil, and Mexico within the broad sub-investment ratings of double-B and single-B. In particular, it is single-B names that are most likely to be impacted by a poor judicial reorganization system.
- Using data from JP Morgan on November 28, 2011, we reviewed the weighted average spreads on 59 single-B and 75 double-B corporate bonds, aggregating US\$23.4 billion and US\$22.9 billion, respectively.
- Although we do not adjust for sovereign credit risk, we note that, on that date, 5 year CDS spreads were 1,044 bps for Argentina, 181 bps for Brazil, and 173 bps for Mexico.

The Case of Vitro: Quantifying the “Vitro Premium” (cont.)

Rating Level	# of Issuers	# of Issues	Face Value	Wtd Avg Spread (bps)	Wtd Avg YTW (%)	Three Largest Issuers
Argentina						
B	17	26	\$5,727	1,020	11.69	City of Buenos Aires, IMPSA, TGS
BB	4	4	\$900	501	6.58	Pan American Energy, Pecom, YPF
Brazil						
B	11	16	\$8,108	948	11.05	OGX, Marfrig, Centrais Eletricas
BB	29	52	\$16,953	676	8.26	Fibria, Friboi, Brasil Foods
Mexico						
B	8	17	\$9,517	1,175	13.02	Cemex, NII Holdings, Axtel
BB	16	19	\$5,080	712	8.53	Azteca, ICA, Scribe
Total LatAm High Yield Issuance						
B	36	59	\$23,352	1,073	12.13	
BB	49	75	\$22,932	694	8.29	

Source: Gramercy, JPMorgan
Data as of 11.28.11

Mexican Single-B Spread Premium to Argentine Corporates: 155 bps
Mexican Single-B Spread Premium to Brazilian Corporates: 227 bps

The Case of Vitro: Protections Bondholders Should Insist Upon

- ***Concurso Mercantil* rules may be changed in the future, but there are obstacles to that occurring any time soon**
 - Civil law vs. common law means there is no improvement through building upon precedents
 - Political pressures from vested shareholder interests
 - “Culture of non-payment” in Mexico fostered by debtors and political groups and parties
 - Unwillingness of IFECOM to acknowledge that incidents of fraudulent conveyance and blatant conflicts of interest damage credibility
- **With the game rigged against creditors – shareholders effectively are at the top of the capital priority structure – then bondholders still interested in buying bonds at new issue should insist upon a number of elements with their DCM desks to protect returns:**
 - Segregation of intercompany claims into a voting trust controlled by legitimate creditors
 - Disclosure of consolidating financial statements so that there is an understanding of the magnitude of intercompany payables at the issuing entity level
 - Perfected security interest in real assets as collateral
 - Payment of the “Vitro premium” in the form of a higher coupon to protect aggregate returns on a Mexican corporate bond portfolio
- **Bondholders need to do their analysis with a more cynical eye, focusing on “process risk” elements such as the character of the controlling shareholders, the composition of the bondholder group, and potential negotiating leverage if a restructuring is necessary**

Background on Gramercy Funds Management LLC

- **Specialty:** Gramercy is an investment manager with US\$2.7 billion in assets that specializes in event-driven investments in global emerging markets. The firm invests in both sovereign and corporate debt, private equity, and non-performing mortgage and commercial loan portfolios, and it also offers quantitatively-driven global equity and macro funds.
- **Investment Philosophy:** An event-driven selection process for overvalued and undervalued securities offers consistently superior risk-adjusted returns versus most other investment approaches.
- **Investment Strategy:** Divide the investment process into three distinct phases: first, establish a strategic entry price that permits sufficient flexibility given the contemplated event horizon; second, actively participate in the restructuring process to catalyze and shape the desired positive outcome; and third, monetize the investment in the way that maximizes the net present value of returns in the recovery phase of the distress and recovery investment cycle.
- **Structure:** Gramercy Funds Management LLC is an SEC Registered Investment Advisor based in Greenwich, CT.

Background on Robert L. Rauch

Robert L. Rauch is a Partner and Director of Research of Gramercy, an investment firm specializing in global emerging markets with US\$ 2.6 billion of funds under management. Mr. Rauch has over 31 years of investment and finance experience and oversees the research, corporate investment, and corporate restructuring activities of Gramercy. He serves as Portfolio Manager for Gramercy Distressed Opportunity Fund and for funds invested in non-performing mortgage loan portfolios in Mexico. Additionally, he is the Co-Portfolio Manager for Gramercy Emerging Markets Fund, Gramercy High Yield Corporate Debt Fund and Gramercy Corporate Emerging Markets Debt Fund. Mr. Rauch has been, or is currently involved, as a leading creditor or advisor in the restructuring of numerous companies across emerging markets including Accel, Alestra, Arpeni, Asia Pulp and Paper, BTA Bank, Dina, Durango, Essar Steel, Industrias Unidas, Iusacell, Mechala, Medefin, Metrogas, San Luis, Satmex, SIDEK, Synkro, Transtel and Tristan Oil.

Prior to joining Gramercy at the end of 2000, Mr. Rauch worked as a consultant to hedge funds managed by Van Eck Global and Farallon Capital Management, specializing in the analysis of emerging markets special situations. From 1994 to 1999, Mr. Rauch was President of The Weston Group, where he was responsible for overseeing the firm's securities research and corporate debt advisory business in Latin America. In the early 1990s, Mr. Rauch worked as a Vice President with Lehman Brothers and CS First Boston in their emerging markets fixed income trading groups. In the second half of the 1980s, he was a Vice President and Trader with First Interstate Bank's Loan Syndications Group, structuring and syndicating loan facilities to highly-leveraged American and Asian corporations. He began his career in 1980 with Swiss Bank Corporation in several credit and corporate finance roles.

Mr. Rauch received a MM in Finance and International Business from Northwestern University – Kellogg Graduate School of Management and his BA in Political Economy from Williams College. Additionally, he is a member of the American Bankruptcy Institute.