



Acquiring Mid-Sized Private Companies in Brazil

Key Success Factors from our Experience

When acquiring a mid-sized company in Brazil, it is highly recommended to observe some common practices of the country, in order to appropriately evaluate the opportunity, reduce risk and generate more value for the acquirer.

Based on Ártica’s experience of over 400 buy side negotiations since 2014, we have compiled in this article our advice for acquirors with limited M&A experience in Brazil.

1. Be proactive and agile throughout the acquisition process

- Have a hands-on approach in mapping and approaching targets. Waiting until targets come to your door most likely leads you into competitive bids and/or winner’s curse situations.
- Moreover, there are highly interesting companies under the radar which could be identified by a deep and focused market screening.
- Being in the position to present a proposal without hearing an asking price helps anchor the negotiation at a reasonable pricing point.
- Successful consolidation cases have in common a dedicated team and a well-structured process.

2. Apply the required adjustments to the target's financials before indicating a price

- Presenting a non-binding offer based on unadjusted accounting or managerial figures provided by sellers can be tricky. Quite often they don't reflect the reality of the underlying business, and consequently there is a high likelihood that the initial valuation is off mark.
- There are some common and easily identifiable shenanigans that happen in Brazilian companies, such as: paying compensation for employees as dividends; not reporting all revenues and expenses to avoid taxation, which can both overstate or understate the profitability; use of the company to pay for shareholder's personal expenses, and other schemes.
- If the offering price is higher than the fair value, trying to reduce it after due diligence will cause friction with the seller, who could even walk away after the acquirer has already incurred in due diligence costs. If the offering price is lower, the acquirer may not be invited for a due diligence in a situation where it would be willing to pay more if it had the correct information.

3. Be creative to bridge expectations between acquirer and seller

- Vendor's financing is quite common, due to high cost of capital in Brazil. Since the nominal value of a transaction (important to seller) and the NPV of the payment structure (important to bidder) can differ quite widely, the use of deferred payment is a powerful tool to bridge value expectations.
- Tax liabilities are common in smaller deals and, sometimes, quite sizable compared to the total transaction size. In Brazil, acquirer is legally bound to the target company's liability for past tax obligations (which typically have five years statute of limitation), so it's crucial to structure a deal that protects the acquirer while remaining interesting for the seller. To the benefit of buyers, holdback structures (which are tied to deferred payment structures) are sometimes negotiated instead of escrow accounts.
- Earnout structures, wherein the purchase price is contingent on the "future performance" of the target company, are tempting to be used but should be considered carefully. They might seem a great idea at the negotiation table, but could generate wrong incentives and/or serious discord afterwards. Since dispute resolutions in Brazil, either via the judiciary system or arbitration, are costly and time consuming, the use of earnouts can be detrimental and value destroying to the buyer.

4. Prioritize critical points to determine early in the process if there are any deal breakers

- Mid-sized companies in Brazil are rarely audited, and often financial statements do not include relevant liabilities.
- It is advised to ask the right questions to the company before entering a full-fledged due diligence, as the cost of failure is quite high.
- Due to complex and changing legislation in Brazil, it is not uncommon that due diligence uncovers potential contingencies or wrong practices in the company that the owner is not aware of.

- Frequent deal breakers are: company paying wrong (and lower) revenue tax rate, irregular labor practices, lack of proper documentation, environmental contingencies, etc.

5. Lookout for commercial agreements that are not at arm's length. Frequently they are not sustainable after the deal.

- It is not uncommon to find mid-sized companies with incipient financial controls. It is also not uncommon for acquirors to focus too much on financial statements, while overlooking other important strategic factors – such as weak commercial partnerships, evolving regulation and legislation, concentration of revenues in a few clients, to name a few –, and having “unexpected” bad news after the acquisition.
- Special care is required when the target has B2B contracts that cannot be considered at arm's length terms. It can be related to the owners' personal relationships (e.g., real estate contracts) or even to personal connections to the hirer agent.
- Risk of losing these as-is agreements is mitigated by conditioning the transaction payment upon migration to a new contract structure.

6. Consult with seasoned professionals outside the due diligence team to challenge your risk assessment and synergies assumptions

- In Brazil, it is common practice not to discount potential liabilities from the purchasing price. Instead, they addressed in indemnification clauses, and the risk perception of their materialization plays a major role in the negotiation of final contracts.
- Due to Brazil's large, ever-changing, and complex legislation, relevant estimates of materialization may go incorrectly assessed through the due diligence of a generalist team. Even experts may have conflicting views on some potential liabilities.
- This may seem overzealous, but, for some specific and relevant potential liabilities, it is important to consult seasoned professionals and double check assessments.

7. Invest resources exploring the best deal structure

- The legal structure of the acquirer and the payment scheme directly impacts the tax amount for the sellers and future tax bill for the buyer.
- Thus, choosing the most suitable structure can increase the value both for the acquirer and for the seller.
- For example, Brazilian tax legislation allows, in specific scenarios, the amortization of the goodwill paid by the acquirer, which can generate tax savings equivalent up to 25% of the transaction value.

Source: Ártica internal analysis, based on over 400 previous experiences supporting national and international investors in acquiring companies in Brazil.

About Ártica: Independent financial advisory firm in mergers & acquisitions, fundraising and IPOs. Helps investors and entrepreneurs to make decisions and carry out transactions such as: sale of equity interest, acquisition of companies, mergers, joint ventures and raising funds from investment funds, sovereign wealth funds and development institutions. Have extensive experience in international transactions and highly complex operations in the most varied sectors of the economy.

In 2023, Ártica was named by the Leaders League ranking in the “Leader” category of the best M&A companies in Brazil. For more information: www.articainvest.com.br