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ILAP DEFAULT: NAVIGATING AN IDIOSYNCRATIC QUASI-SOVEREIGN CREDIT EVENT TO AN ALPHA-ACCRETIVE OUTCOME

By Sergey Sobolev November 2024

Executive Summary

Inversiones Latin América Power (ILAP), a privately-owned Chilean electricity generator, defaulted on its bonds in July 2023 and concluded its restructuring by October 2024. Despite private ownership, the company meets our definition of a "quasi-sovereign" credit due to its indirect ties to the state through contracts and regulations.

Such idiosyncratic credit events (defaults independent of the sovereign), while rare, are significant in the context of our strategy and warrant a check-in with our meta thesis.[1] The last similar case we examined, International Bank of Azerbaijan, was in 2017.[2] Once again, the outcome is favorable: with an 83-cent recovery, our ILAP position delivered a positive total return and outperformed our other Chilean portfolio holdings over the same period (Exhibit 1).

EXHIBIT 1: GMO ECD STRATEGY UNWEIGHTED TICKER-LEVEL RETURNS

Ticker	*Annualized Total Return*	*Annualized Total Credit Return*
ILAPCL	**+4.2%**	**+6.7%**
ENAPCL	+2.7%	+5.2%
ENELGX	+4.0%	+6.5%
CHILE (Sovereign)	-2.4%	-0.1%

As of 10/1/2024 | Source: GMO.

Total returns calculated for the period from 6/9/2021 to 10/1/2024, the same period we held ILAP bonds in the GMO Emerging Country Debt Strategy. Credit spread returns are approximated by subtracting the total return of the Bloomberg U.S. Treasury: 7-10 Year TR Index (Bloomberg ID: LT09TRUU).

We were able to influence the outcome in our favor through a combination of:

1. **Focusing on quality assets:** Being selective about the types of borrowers and structures we underwrite has given us extra downside protection in distressed situations.
2. **Process discipline:** Our deep understanding of the asset's intrinsic value enabled us to accurately estimate recovery and capitalize on distressed market prices.
3. **Recovery value enhancement:** Our restructuring expertise allowed us to enhance the recovery value through active creditor committee participation.

And what have we learned from this particular credit event?

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[1] The Mystery of SOE Debt: A Unique and Growing Opportunity (Sobolev and Ulukan 2020).

[2] The International Bank of Azerbaijan (Ulukan 2017).

We cite two very important lessons:

1. **Conflicting debt and equity interests:** Incentives between creditors and private shareholders can become misaligned, even for quasi-sovereign entities.
2. **Aggressive energy transition poses systemic risks:** Countries with high shares of renewable power generation without adequate backup capacity face grid stability issues.

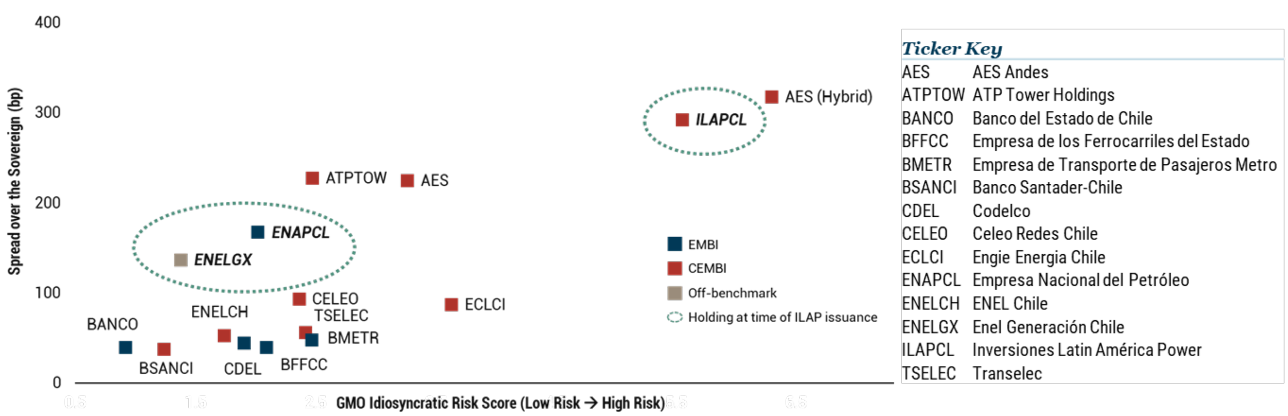
Our Original Investment Thesis

ILAP, initially rated Ba1/BB/BB+ by Moody's/S&P/Fitch, is a Chilean renewable energy company, owned by regional private equity firms BTG, Patria, and Geomar, that operates wind farms with a total capacity of 239MW. ILAP held dollar-denominated power purchase agreements (PPAs) with Chilean-regulated distribution companies (DISCOs) and certain state-owned enterprises (SOEs), featuring fixed prices and volume commitments over a 10.6-year average term. In June 2021, ILAP issued a $403.9 million 5.125% amortizing senior secured bond with a weighted average life of 9.3 years.

The bonds, offered in the primary market at a roughly 300 basis point spread over the sovereign, screened cheap relative to our assessment of idiosyncratic risk, making them attractive compared to alternatives in our opportunity set. This justified a moderate active weight in our portfolios, alongside the more traditional Chilean quasi-sovereigns, such as Empresa Nacional del Petróleo (ENAPCL), a 100% government-owned downstream oil and gas company.

Exhibit 2 illustrates how we approach quasi-sovereign risk within any given country, focusing on two key factors: the entity's proximity to the sovereign (i.e., its likelihood of extraordinary support) and its standalone credit quality (i.e., the likelihood that support will be needed). The latter becomes especially significant for privately owned entities such as ILAP, which has indirect government ties through PPAs with regulated entities and a highly leveraged balance sheet. We ultimately felt comfortable underwriting this risk because of the strong contractual protections under New York law and a robust collateral package, including pledges over valuable PPAs, equity, and hard assets.

EXHIBIT 2: CHILE'S USD QUASI-SOVEREIGN OPPORTUNITY SET AT ILAP'S ISSUANCE



As of 6/15/2021 | Source: GMO, Bloomberg.

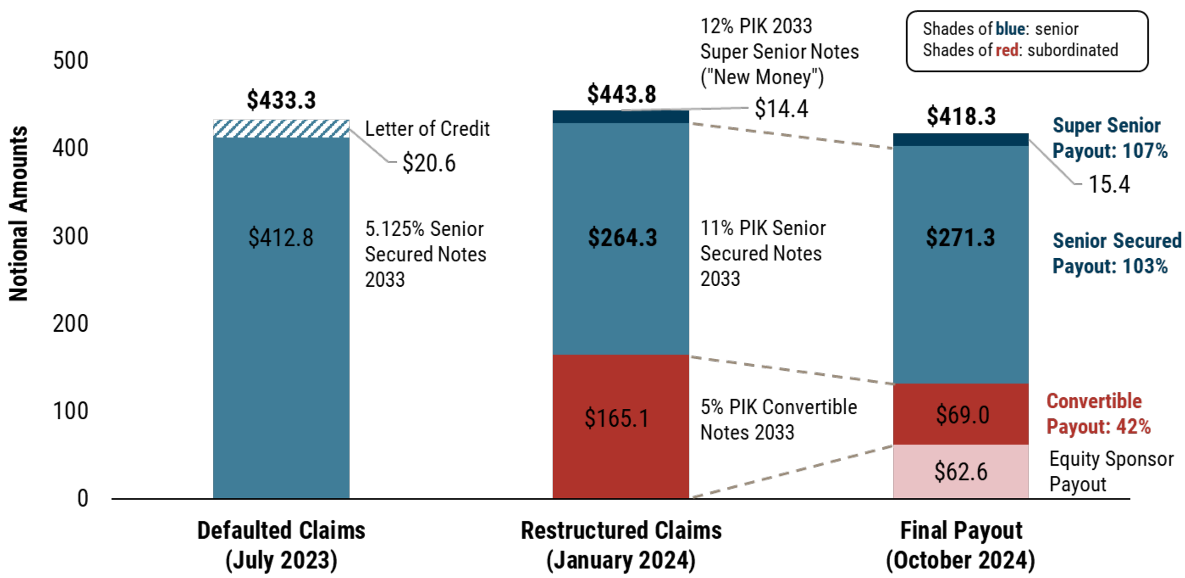
Y axis: Interpolated credit spread over the sovereign curve of a chosen single instrument outstanding at the time of ILAP's issuance, using weighted average remaining life as of 06/15/2021. **X axis:** The GMO Idiosyncratic Risk Score is a proprietary measure of the relative riskiness of the quasi-sovereign credits vs. their sovereign and incorporates the likelihood of the sovereign's extraordinary support and its standalone credit quality.

Credit Event Recap

In 2022, ILAP found itself in a perfect storm. Wind generation fell for an extended period, below the consultant's most conservative projections. As a result, ILAP struggled to meet its contractual supply commitments and was forced to buy electricity from the spot market at exorbitant prices, driven up by a severe drought that hampered hydroelectric power generation – a crucial source of Chile's electricity – and by increased dependence on pricier fossil fuels further strained by the Russia-Ukraine war. Transmission issues in the grid strained free cash flow even further, which ultimately depleted ILAP's liquidity sources. After exploring less invasive liquidity options, such as monetizing receivables and shareholder financing, the sponsors unexpectedly brought in Lazard as a restructuring advisor.

ILAP defaulted in July 2023 and emerged in December exchanging defaulted claims for new instruments. The restructuring was orderly and took just six months, comparing favorably to most EM workouts. Designed with a focus on an eventual sale rather than ILAP servicing the new debt, the structure incentivized the sponsors to find a buyer for the asset no later than 2025. The proceeds from the sale repaid the new capital stack in order, albeit with sponsors receiving preferential treatment (i.e., an "equity tip"). In 2024, Colbún, a major Chilean utility, acquired ILAP for $418 million – around 10x normalized EBITDA – underscoring our conviction in the asset value and the temporary nature of ILAP's challenges.

EXHIBIT 3: EVOLUTION OF ILAP'S CAPITAL STRUCTURE ($M)



As of 10/1/2024 | Source: GMO, ILAP.

Defaulted claims include accrued past due interest. New claim stack is bigger than the defaulted claims due to the "new money" component.

The outcome was an all-in recovery of 83 cents on the dollar.[3] Arguably, at this level it did not need to become a credit event at all. But the equity sponsors deemed a 17-cent haircut a price worth paying, even at the risk of potentially increasing their cost of capital for future leveraged deals that rely heavily on competitively priced debt capital raised in the bond markets to extract the desired economics.

So, what have we learned from all this?

[3][83% recovery] = [original bondholder claim] x [PDI factor] x [exchange ratios] x [payout ratios]. Bondholders were allocated 60% of senior secured notes and 40% of convertible notes.

What We Got Right

1. **Focusing on Quality Assets**
Our focus on quasi-sovereign credit leads us to finance "real assets" – that is, strategic infrastructure with non-cyclical cash flows. On top of that, we prioritize robust structures that enhance creditor recourse and safeguard asset value in distressed situations. There is ample empirical evidence that our focus on quality assets can have the ability to deliver additional downside protection amid distress (Exhibit 4).

EXHIBIT 4: HISTORICAL RECOVERY EXPERIENCE AND LEVEL OF RECOURSE

GMO ASSET FOCUS

Sector	*Senior Secured*	*Senior Unsecured*	*Subordinated*
Infrastructure, Utilities	68%	60%	38%
Cyclical Corporates	55%	38%	33%

As of 7/31/24 | Source: Moody's, Infrastructure Default and Recovery Rates, 1983-2023, July 2024.

This global infrastructure default study includes DM and EM infrastructure defaults.

In ILAP's case specifically, we got comfortable with the credit risk because of the security package – creditors were granted "step-in" rights through pledges over contracts, equity, and physical assets. Of course, no institutional money manager aspires to become an operator of wind turbines in a foreign country overnight, but in this case, those rights provided significant negotiating leverage to recover value from assertive equity sponsors.

The balance sheet had its attractions too. Aside from the bonds and a small letter of credit (both ranking pari passu), the company carried no other debt. This simplicity allowed us to construct a straightforward asset sale waterfall, with creditors holding a senior (albeit diluted) position in the distribution of proceeds.

2. **Process Discipline**
Throughout the restructuring process, we constantly revisited our original investment thesis, which centered on the idea that the contracts with regulated and state-linked entities were the crown jewel and would remain "money good," especially in a country with strong legal institutions like Chile. That thesis held true, and we were able to correctly estimate that ex-ante recovery value range. This conviction allowed us to lean into the overly distressed prices, reducing the average cost of our position and setting the stage for a solid recovery.

EXHIBIT 5: ILAP'S HISTORICAL BOND PRICE EVOLUTION AND RECOVERY

As of 10/1/24 | Source: GMO, Bloomberg.

3. **Recovery Value Enhancement**
   Our team's extensive expertise in navigating credit-intensive situations across corporate and sovereign markets[4] underscores our belief that active engagement in select distressed opportunities is essential for maximizing value recovery. This is particularly true in cases like this one, which presented several critical factors we had to manage effectively:

   - **Creditor committee dynamics:** Creditor committees are typically made up of two major groups: long-term investors who purchased closer to par and opportunistic players who bought at distressed prices. This dynamic creates natural tension and requires representatives from each group to actively defend their interests.
   - **Misaligned incentives:** Misalignment between private equity sponsors and creditors can be value destructive. Here, both sides had significant leverage – creditors could seize the asset, while sponsors could jeopardize the PPA contracts. Avoiding mutually assured destruction required a pragmatic approach and knowledgeable advisors.[5]
   - **Resolution regime:** Less developed local EM resolution regimes can lengthen the time taken to emerge from a restructuring, thus detracting from the IRR of the exercise. Our choice of pre-packaged Chapter 11 in NY courts proved crucial in this respect.[6]

   In the end, our commitment of time and resources yielded concrete results:

   - A swift and orderly restructuring that minimized asset value decay and boosted the IRR
   - Maximum share of new senior claims in the restructured capital stack
   - Enhanced NPV of new instruments through higher coupons
   - Full recognition of past-due interest
   - Preferential access to an attractive "new money" tranche
   - Greater transparency on recovery prospects throughout the process

Lessons Learned

1. **Incentives between creditors and private shareholders can become misaligned, even in quasi-sovereign entities.**
   There's a natural tension between shareholders and creditors. Shareholders focus on maximizing returns, often through dividends which can weaken credit metrics. For closely affiliated quasi-sovereign entities, weaker balance sheets are not a concern since governments almost always support such entities in times of stress.[7] With private shareholders, the dynamic is more nuanced.

   Strategic private owners, often involved in the business itself (e.g., shipbuilders who own the floating production storage and offloading units), tend to make the same calculus as governments. In contrast, purely financial investors, such as PE sponsors, require caution; when their investment horizon shortens, as with ILAP, it can become a zero-sum game where shareholders extract value at the expense of creditors.

   An idiosyncratic case like this makes it difficult to draw systematic conclusions, but given our exposure to privately owned quasi-sovereigns across the ECD strategy, we monitor this dimension of credit risk

[4]See The Many Faces of Sovereign Default (Ross 2023) and Sovereign Distressed Credit: Where We See Opportunity and How We Navigate It (Ross and Vandersteel 2021).
[5]Creditors represented by Rothschild & Co (Restructuring Advisors) and Cleary Gottlieb (Legal Counsel).
[6]Despacito: The Pace of In-Court Restructurings in Latin America (Cleary Gottlieb, Rothschild & Co 2023).
[7] The Mystery of SOE Debt: A Unique and Growing Opportunity (Sobolev and Ulukan 2020).

closely. In our strategy only two entities are directly comparable – Enfragen and AI Candelaria (Exhibit 6) – and in all cases the shareholders fall into one of the following categories, which bodes well for alignment of incentives:

- Reputable PE sponsors with long-term investment horizons
- High-quality strategic shareholders actively involved across the business value chain

EXHIBIT 6: PRIVATELY OWNED QUASI-SOVEREIGN PORTFOLIO HOLDINGS

Company Name	*Country of Risk*	*Majority Shareholder*	*Portfolio Weight (bp)*
AI Candelaria	Colombia	I Squared Capital	51
EnfraGen	Colombia/Chile	Partners Group	12
Enel Generatión	Chile	Enel	66
MV24	Brazil	Mitsui, Modec, Marubeni	75
Yinson Boronia	Brazil	Yinson Berhad, Sumitomo	35
Adani Green Energy	India	Adani Family, Total Energy Renewables	45
Adani Renewable Energy	India	Adani Family	32
PT Paiton Energy	Indonesia	Mitsui, Nebras Power, JERA and BHP	85
AES Panamá Generation	Panama	AES Global Power Holdings	4
Trinidad Telecom	Trinidad & Tobago	Cable & Wireless	38
Zorlu Enerji	Turkey	Zorlu Holding	101

As of 10/29/2024 | Source: GMO.

The above information is based on a representative account in the strategy selected because it has the fewest restrictions and best represents the implementation of the strategy.

Exhibit 6 also shows how we seek to diversify across these privately owned quasi-sovereigns, another element of risk management. Were these holdings to be very clearly quasi-sovereign (like the 100% government-owned Pemex or Petroperú, for example), we would allow more portfolio concentration as the systemic (to the sovereign) implications of a default by one such as these would be much more material to the parent sovereign, and therefore that much less likely to occur.

2. **Aggressive energy transition poses systemic risks.**
At issuance, our main concern was Chile's electricity price controls, as DISCOs could push to renegotiate ILAP's PPAs, set at over $100 per MWh (well above spot prices of $40 to $60 at the time). Ironically, ILAP's default arose from purchasing electricity at spot prices that exceeded their contracted sale price. Chile's renewable-heavy grid (58%)[8] faces strain during shortages – often due to weather events like El Niño – driving unsustainable price spikes. While Chile is a useful case for understanding the systemic risks of the energy transition, we observe this dynamic across our entire EM investment universe.

Renewable energy's intermittency, paired with inadequate storage, puts EM governments in the tough spot of balancing carbon reduction with the need for reliable, affordable energy. Achieving a sustainable transition demands more than just adding renewable capacity; it requires substantial investment in backup fossil fuel generation, storage, and transmission infrastructure. The financial gap is significant, with a $7 trillion shortfall in EM energy transition funding by our estimates. This challenge introduces new credit risks, but also offers a rare opportunity to combine investment returns with impact. For deeper insights on this topic, see Emerging Debt Energy Transition: Attractive Returns in a Growing Investment Universe (Sobolev and Ulukan 2024).

[8] IEA (2023).

Summary

Idiosyncratic defaults by quasi-sovereigns as we broadly define them continue to be exceptionally rare and need not be alpha detracting if managed well. Even in such cases, we maintain discipline throughout the event: diversifying and sizing new-issue-at-par positions prudently in more remote, "privately owned" quasi sovereigns; choosing investments with quality assets and structures; then, if the rare impairment event threatens, taking an activist approach to restructuring committees while making further investments at prices below recovery estimates for the quality assets and structures. The ILAP case was a reminder of the potential misalignment of interests between bondholders and purely financial equity sponsors. And, unrelated to lessons one might learn about investing in any particular asset, ILAP's perfect storm was a tangible case of the risks that accompany a country's accelerated energy transition.

About the Author

Sergey Sobolev is a senior analyst engaged in research for GMO's Emerging Country Debt team. He conducts research on complex financing structures and corporate credits, with a primary responsibility for state-owned enterprises ("quasi sovereigns") in Latin America and China. Prior to joining GMO in 2018, he worked as an investment banker at ING in London structuring public and private debt instruments for EM corporate borrowers. Mr. Sobolev earned his BS in Economics from University College London and his MS in Management from Imperial College London. He is a CFA charterholder.