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New Financing Instruments for Long-term Investments of SMEs

The Case of Peru

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Foreword

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Bonn, February 2003

Contents

Appendixes

Boxes

Figures

Tables

Abbreviations

AFP	Administradora de Fondos de Pensiones
ASBANC	Asociación de Bancos del Perú
ATPA	Andean Trade Preference Agreement
BCRP	Banco Central de Reserva del Perú
BVK	Bundesverband deutscher Kapitalbeteiligungsgesellschaften (German Venture Capital Association)
CAF	Caja Andina de Fomento
CFI	Corporación Financiera de Inversiones
CIC	Capital Investment Company
COFIDE	Corporación Financiera de Desarrollo
CONASEV	Comisión Nacional Supervisora de Empresas y Valores
DC	Development cooperation
DEG	Deutsche Investitions- und Entwicklungsgesellschaft mbH
FAPE	Fondo de Asistencia a la Pequeña Empresa
FC	Financial Cooperation
FMO	Financeerings Maatschapij voor Ontwickelinglanden
GDP	Gross Domestic Product
GTZ	Gesellschaft für Technische Zusammenarbeit
IADB	Interamerican Development Bank
IAS	International Accounting Standards
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
INEI	Instituto Nacional de Estadística e Informática
IPO	Initial Public Offering
KfW	Kreditanstalt für Wiederaufbau
ME	Microenterprise
MEF	Ministerio de Economía y Finanzas
MFI	Microfinance Institution
MIF	Multilateral Investment Fund
MITINCI	Ministerio de Industria, Turismo, Integración y Negociaciones Comerciales Internacionales
MLE	Medium to Large-sized Enterprise
ONP	Oficina de Normalización Previsional

PROMPEX	Comisión para la Promoción de Exportaciones
SBA	US Small Business Administration
SBS	Superintendencia de Banca y Seguros
SE	Small Enterprise
SEAF	Small Enterprise Assistance Fund
SME	Small and Medium-sized Enterprise
SSME	Small-scale and Microenterprise
USD	United States Dollar

Executive summary

The significant role played by small and medium-sized enterprises (SMEs) for growth and employment is undisputed in industrialized and developing countries alike and has been documented by numerous studies. If the development potential of this business segment is to be harnessed, it is essential that SMEs have access to adequate financing. In capital markets SMEs are faced with a number of company-sized related features of financing, e.g. serious information deficits. This situation entails a number of financing-related disadvantages that may mean higher costs for capital, or indeed wholly exclude SMEs from access to investment capital.

In developing countries provision of long-term financial resources is a source of major problems. While access to the short-term capital needed to finance current assets has been improved decisively by the development of specialized finance institutions in recent years, SMEs continue to be hampered by a chronic lack of financial resources tailored to their specific investment needs. This often means that potentially profitable projects are not realized, the consequence being stagnation of company development.

The use of alternative financing instruments with quasi-equity or equity-substituting features has proven helpful in situations where access to bank loans is problematic. Positive experiences made in industrialized countries indicate that venture capital and leasing are instruments that hold considerable promise for overcoming the bottleneck in access to long-term capital, and this approach is being actively promoted by bi- and multilateral development institutions.

Based on the example of Peru, the present study looks into the questions a) whether the above-named instruments are suited to financing the investments of SMEs in developing countries and b) what conditions have to be met to ensure that venture capital and leasing are used in a manner suited to the specific needs of the target group. Between February and April 2002 the authors of the present study conducted a comprehensive survey aimed at answering these questions. The interview partners included potential investors of venture capital active in the Peruvian investment market and leasing operators that offer services to larger companies. Furthermore, 38 SMEs from two industries were interviewed with a view to assessing the financing constraints faced by Peruvian companies and to determining their views on possible alternative means of financing. The survey also included complementary interviews with private-sector experts and representatives of public-sector institutions.

Key features and advantages of venture capital and leasing as alternative means of financing

Financing papers with different term structures and according different legal rights to investors offer some differentiated possibilities of risk-sharing and incentive design. In typical credit-based financing, collateral securities are demanded as a means of effectively protecting the lender against default. The reasons for this security requirement must be sought in the information asymmetry between borrower and lender. The more weighty the information asymmetry and/or the larger the security gap involved, the more risky a project will appear to the lender.

Long-term investments involve more pronounced objective planning and earnings risks, and they are also more susceptible to the consequences of unevenly distributed information than short-term investments. And if such investments are highly company-specific or investments in human capital or intangible assets made by young and innovative firms, these risks and problems tend to be more frequent and pronounced. Acquisition of information aimed at eliminating existing information deficits becomes increasingly costly; and this in turn makes it more difficult and expensive to work out the contractual arrangements or securities required for credit-based financing.

Against this background, **venture capital** represents an interesting alternative means of financing. By making his capital available, the investor bears a share of the investment risk, though he is at the same time entitled to a share of any possible increases in profits. The investor's rights of control and codetermination serve to compensate him for the lack of collateral provided for his investment. For the company involved, the equity character of this means of financing implies enlarged liquidity margins, since it involves no redemption payments and profit-related investor returns accrue only in the case that the company operates successfully. Furthermore, young companies in particular can benefit from the management support often provided for in connection with a venture-capital investment. Another key feature of venture capital is its limited investment horizon of five to ten years. Since the mid-1980s venture-capital funds have been launched in developing countries with the support of the IFC and other institutions engaged in financial cooperation, the main objective being to overcome some of the financing constraints faced by SMEs.

With **leasing contracts**, the fact that the leased asset remains the property of the lessor minimizes risk and facilitates financing efforts. The leased asset is an investment good and may at the same time constitute collateral for the provider. What this means is that when a company lacks the necessary collateral, leasing may be the only viable financing instrument available to it. The fact that in most cases no asset-unrelated security is required for leasing enhances the financing options open to a company. And in this case whatever collateral may exist is available for use in other transactions. Two further advantages of leasing are the lower immediate liquidity drain and the normally flexible and expeditious contract procedures which the instrument involves. One factor of particular interest for development policy is that leasing ensures that financial resources provided are in fact used for investment purposes. At present the IFC is the leading actor involved in promoting leasing for SMEs in developing countries.

The financing framework in Peru

Three factors that play a crucial role for the financing situation of SMEs are monetary policy, the institutional structure of the financial sector, and the volume and efficiency of the national financial system. Since the early 1990s the paramount goal of Peruvian monetary policy has been monetary stability, and this has led to continuously declining inflation rates, which reached a low of 2 % in 2001. However, the high minimum reserve requirements set for deposits in nuevo sol and USD entail, not least, a tangible strain for commercial banks, limiting the credit supply and hampering the mobilization of saving. Furthermore, high interest rates constitute an obstacle to outside financing of companies. An additional monetary factor relevant to the financing situation of companies is the progressive dollarization of the Peruvian financial sector. At the end of 2001 no less than 71.5 % of all deposits and 80.1 % of all credits were denominated in USD, a fact that mirrors insufficient confidence of economic agents in the domestic currency. In other words, a deterioration of the nuevo sol's external value entails risks for the stability of the banking sector as well as for companies indebted in foreign currency.

In Latin America financial intermediation is generally dominated by banks, an observation which applies for the overall structure of Peru's financial system as well. In 2001 Peruvian commercial banks handled some 90 % of all national lending operations and administered 85 % of all financial assets. And yet the volume of the banking sector, i.e. its size and activity measured as the ratio of M3 to GDP, is relatively small, the current ratio being 31 %. High relative operating costs also indicate a low level of efficiency on the part of Peru's commercial banks. Peru's financial markets are likewise marked by low volume and low levels of efficiency.

All told, Peru's financial sector cannot be said to fully fulfill its intermediary function, and this lack of financing capacity has highly adverse impacts on SMEs, a fact reflected in the findings of the present company survey.

Peruvian SMEs in the textile and agricultural industries: investment activity and financing behavior

Aside from a large number of formal and informal small-scale and microenterprises (SSMEs) active in Peru, one feature typical of the Peruvian business structure is its low proportion of dynamic, competitive SMEs. According to estimates, only some 2 % of the enterprises registered in Peru are SMEs. Our empirical study looked into the investment and financing behavior of companies in the textile and clothing industry and the agricultural industry. Both industries generally are seen as having great potential for development and growth. In particular, the present study interviewed a number of relatively successful and comparatively dynamic companies from these two industries, though without aiming to come up with any representative statements on the overall industries.

The survey confirmed that the SMEs in the sample are flexible and have growth potential. However, they see themselves faced with a number of problems that prevent them from exploiting their specific competitive advantages and developing into a central pillar of the Peruvian economy. Our companies see the lack of (long-term) financing as the most serious obstacle to their development.

On the one hand, the dynamics and productivity of the SMEs interviewed is reflected especially in their high level of expansion-oriented investment activity. Over the past three years these companies have invested an average of USD 457.000 p.a., with only 11 % not reporting any investment activity at all during this period. On the other hand, their remarkable level of innovativeness is an indicator of the creativity of these companies. The companies in our sample also indicated their intention to continue to invest and expand in the future. However, for a number of different reasons these companies are faced with difficulties in financing their investments:

The companies interviewed **lack sufficient access to bank credits**. The demand for medium- to long-term credit is often not met for lack of collateral security, and this means that important investments are often simply not made. The majority of our companies indicated that they have lost customers or good market chances for lack of credits or sufficient credit lines. Their restricted access to outside sources of financing and the need this implies to fall back on company profits as their main source of financing is reflected in their high equity ratios, which range between 43 % and 60 %.

The fact that small companies are required to pay an **interest rate** of 15.6 % for loans denominated in USD constitutes an additional obstacle to the realization of investment projects and places export-oriented companies at a disadvantage in competition with foreign competitors. Nor are current **loan repayment periods** in line with company needs. In most cases, the credit agreements concluded by companies interviewed have a repayment period of under one year (65 %). This short term nature of credit has influenced our companies in two ways: on the one hand, companies are unable to make certain investments. On the other hand, to be able to realize investments despite this situation, our companies have fallen back on financing mechanisms such as short-term working capital loans, which in turn can seriously jeopardize a company's liquidity.

On the whole, the findings of our survey reflect the inadequate supply of financing instruments available in the Peruvian banking system, above all as far as long-term financing is concerned. In view of the fact that most of the companies in our sample anticipate future growth, a better supply of SMEs with financial resources tailored to their needs would contribute to a more efficient allocation of capital and encourage economic growth in the long term. Against this background it appears reasonable to promote alternative financing mechanisms and the markets bound up with them, in particular since this could be expected to increase competition and efficiency in the national financial system.

Venture capital as an alternative source of financing in Peru: chances and constraints

In view of the advantages of venture capital outlined above, and against the background of the inadequate availability of long-term financing resources for Peruvian companies, both public and private actors in Peru are engaged in efforts aimed at launching venture capital as a an alternative means of company financing. The Peruvian venture-capital market is still in its infancy. Whether or not this instrument of financing will prove successful, depends, first and foremost, on external conditions. While the existing economic and legal conditions do not constitute an impediment to a dynamic development of the market, institutional factors such as an underdeveloped capital market, a low number of potential investors, a lack of experienced fund managers, and a lack of exit options constitute serious obstacles.

The supply of venture capital tends to grow most rapidly in a prospering economy. Experiences made in other countries have shown that the prospects of a venture-capital investment are particularly positive when the investment is made in a phase of recession or stagnation and can then profit from gains made during a period of economic upturn. Following a phase of economic recession, **positive economic growth** is anticipated for Peru in 2002, and this could mean prospects of good returns for potential venture-capital funds.

The **legal framework** in Peru is also seen as adequate by market actors. Compared with other countries in the region, protection of minority shareholders and company buybacks of shares are seen as unproblematic in Peru. But one obstacle must be sought in the country's current **tax legislation**. Under it investment funds are defined as natural persons and are subject to income tax, a situation which leads to double taxation in that investors are also required to tax their earnings from funds as income.

A smoothly functioning and active **capital market** provides a transparent view of the investment behavior of institutional and private investors and plays an important role in the successful termination of investments. In Peru, however, a weak primary market and the low level of liquidity in the secondary market indicate that the capital market is still underdeveloped. This means highly restricted options when it comes to terminating an investment made in a venture-capital fund.

In Peru the **potential investors** for venture capital include the private pension funds (*Administradoras de Fondos de Pensiones*/ AFPs), insurance companies, public institutions, commercial banks, and national and international development cooperation organizations. While all of the actors interviewed complained especially about the lack of long-term investment opportunities in the Peruvian capital market, only about half of our potential investors, including in particular the AFPs, would be prepared to invest in a venture-capital fund. This reticence to invest, due mainly to risk aversion, further restricts the number of potential investors in the Peruvian market, which is low in any case.

As far as **fund management** is concerned, we can identify some bottlenecks in Peru, most of which are bound up mainly with lack of experience in the market. Specifically, the number of institutions interested in launching a fund is not only low, these potential investors are also criticized for their lack of both a track record and institutional backing.

Peruvian SMEs, mostly family-run, are noted for their **lack of openness** and their **low** level of **transparency**. Yet the only way to heighten investor confidence would be for companies to accept control mechanisms put in place by fund managers. Coming up with a **critical mass of companies** offering good investment opportunities is not seen as a major obstacle in Peru, since there are enough companies with interesting potentials in the country.

A further impediment to the development of the venture-capital market is the **lack of sufficient exit options** in Peru. At present the only exit options available are trade sales – i.e. sales of shares to other companies – and, most important, company buybacks. But it is currently practically impossible to terminate an investment by means of a secondary purchase, i.e. sale of the shares to another financial investor, or via an initial public offering.

Venture capital as a financing instrument for SMEs?

Apart from the general conditions required to establish a venture-capital market, introduction of the instrument as an alternative means of financing SMEs hinges on its acceptance in the relevant business segment as well as on the willingness of investors to invest in funds geared specifically to SMEs. In Peru both small and medium-sized companies have a positive attitude toward accepting an investment partner, but the risk-averse stance of potential investors appears to indicate that Peru's first venture-capital funds will tend to look more to medium-sized companies than to small firms.

Most Peruvian SMEs are relatively unfamiliar with the concept of venture capital. Only 23 % of the companies interviewed indicated that they were familiar with the instrument. The companies unfamiliar with venture capital were given a brief rundown on the way the instrument works and then presented with some of the key features of this alternative means of financing. As the study's findings indicate, these companies would welcome management support and consultations on the conduct of business, be it in the areas of accounting, marketing, or the establishment of new business contacts. They even see this as the most important feature of venture capital. Most of the entrepreneurs interviewed regard the equity function of such investments as beneficial, noting that an equity base strengthened by a venture-capital investment would not only make their companies "more sound" but would also imply an active investor interest in their companies. An additional point of interest for our companies was the improved access to credit and longer terms of credit associated with a venture-capital investment. Even though both the investor's right to information and, in particular, his right of codetermination in company management were seen in a somewhat critical light, the companies interviewed were still more open to the idea of accepting a new partner than we had anticipated. The annual returns of 20-30 % expected by investors were regarded by most of our companies as too high. Still, some companies, especially small firms, would be prepared to accept a participating interest as an alternative means of financing.

However, potential investors are somewhat reluctant to invest in small companies and regard such investments as highly risky, especially in view of these companies' lack of transparency and their informal character. Only four potential investors, including DC institutions, signaled their willingness to invest in a fund tailored to this business segment. But nearly all of the potential investors interviewed stated their willingness in principle to invest in a fund for medium-sized companies.

Leasing as an alternative means of financing in Peru

Unlike venture capital, leasing is widespread in Peru. This can be demonstrated, first, with reference to the volume of leasing-financed investments, second, in relation to other financing instruments, and, third, by comparison to the use of leasing in other Latin American countries. This instrument also shows a high degree of maturity as regards the goods and sectors financed in Peru with the aid of leasing. Leasing has, however, been slow to catch on as a financing instrument for SMEs. Whether leasing will develop dynamically for this segment as well, depends on the external framework conditions, the attitudes of leasing companies, and the flexibility and concrete terms of leasing agreements.

Framework conditions for the Peruvian leasing market

Apart from the weakness of the Peruvian economy in recent years, which has contributed to a decline in leasing investment, the **institutional framework** has an important role to play in the development of leasing in Peru. For instance, independent leasing operators, which cannot fall back on the resources of a parent bank, have seen themselves faced with refinancing problems. And it is precisely this group of leasing operators that have proven to be SME-friendly, serving this customer segment more actively than bank-affiliated leasing operators. On the other hand, the widespread dollarization of the Peruvian leasing market inhibits the demand for leasing of companies that do not earn foreign exchange. A further institutional factor inhibiting an SME orientation on the part of Peruvian leasing operators is the underdeveloped state of the used-goods markets in Peru. In cases of customer insolvency, leasing operators are faced with the risk of being unable to recover the market value of certain leased assets. This lack of sufficient avenues of compensation for possible losses gives rise to a more cautious risk assessment on the part of leasing operators, a factor that has negative impacts on SMEs, which are perceived as risk-intensive.

As far as the **legal framework** is concerned, leasing operators have no problems in asserting their property rights to leased assets. However, the tax implications of a recent amendment to Peru's leasing law (December 2000) has clear-cut negative impacts on leasing investments.

Leasing: customer structure and outreach

Despite the obstacles outlined above, leasing is a profitable business field in Peru. Thanks to the high profits margins it offers, leasing business with the SME segment is generally regarded as lucrative. Due to a lack of statistical data on customer structures broken down for company size, however, it is as good as impossible to make any exact statements on the percentage share of SME contracts in the portfolios of leasing operators. Looking at the information provided by the leasing operators interviewed, we find that leasing business with medium-sized companies is already relatively well established in Peru, while the instrument reaches far fewer small companies.

Despite the often-announced intention of leasing companies to gear their business more to the SME segment, there is still a lack of both concrete plans to develop this customer potential and efforts geared to lowering administrative costs as a means of offering leasing contracts that are at the same time small in volume and profitable. The reasons cited by leasing operators for this more or less cautious attitude include the often informal nature of SMEs, their weak financial management, and the high default risk implied by this situation.

Our company sample shows that medium-sized companies are served by all leasing operators, while small companies have access only to independent operators and a few bank-affiliated providers. Accordingly, thus far hardly any of the very small companies in our sample have made use of leasing. Moreover, there are marked disparities between company locations. While the large majority of companies in Lima have already gained experience with leasing, only a small minority of companies in Arequipa and Cusco had made use of the instrument.

The advantages of leasing in theory and in Peruvian reality

As far as concrete leasing arrangements are concerned, the present study shows that the leasing contracts offered in Peru either wholly lack certain elements often attributed to leasing or contain these elements only in a restricted form. This can be illustrated on the basis of an examination of five central advantages of leasing and their constitutive features:

On the whole, we find that SMEs in Peru have far **better access** to leasing than to long-term credit. The main factor involved here is the guarantee provided by the leased asset, which continues to be the property of the lessor – although, for reasons bound up with risk assessment, leasing operators often also demand additional securities. Another positive aspect here is the short periods of time that nonbanks usually need to process leasing contracts. Banks, on the other hand, are often hampered in coming up with a prompt decision by their need to present applications to their central risk-assessment departments for approval.

This in principle more unproblematic access to leasing is furthermore bound up with the type of risk analysis on which the transaction is based: in theory, anticipated cash flows are more important to decisions on leasing contracts than a company's past credit ratings and equity base. However, only in rare cases is cash flow a relevant decision criterion in Peru, and to customers the process of risk analysis often seem highly intransparent. As regards the minimum sums for which contracts are signed, leasing operators are not always able to satisfy low-volume financing needs. The minimum sums demanded vary between USD 10.000 and 50.000, which appears very high, particularly for used machinery.

Leasing constitutes less of a strain on a company's **financial margins** than bank credit, a fact due above all to the lower immediate outflows of liquidity involved in leasing. In practice, however, Peruvian companies are often required to provide a deposit which may depend on a customer's creditworthiness and the marketability of the asset in question – although we did find some measure of willingness to adjust leasing rates for seasonal or volume-related factors.

The write-off modalities currently in effect in Peru provide SMEs a **cost advantage** in leasing compared with bank loans. The study thus confirmed the assumption current in theory that leasing is a lower-cost form of financing than bank credit. But leasing rates are high, especially for small companies. Moreover, more favorable terms for the purchase, insurance, and maintenance of a leased asset, factors assumed to make leasing more attractive, are as a rule not available in Peru.

In Peru leasing in fact offers SMEs a viable **instrument for their medium- and long-term financing** needs. The statutory minimum terms for leasing contracts vary between two years (movable goods) and five years (immovable goods). The actual terms offered are in fact longer, and the majority of companies perceive them as adequate. In industrialized countries **additional advisory services** and close contact with customers are often integral components of leasing agreements. Advisory services on management, accounting, or marketing are intended to boost customer market capabilities. However, these possible features of leasing are seldom to be observed in Peru.

Conclusions and recommendations

Peruvian SMEs are marked by strong dynamics and high levels of innovativeness, features that enable them to exploit competitive chances. In achieving sustainable growth, however, they are hampered by limited access to needs-oriented means of financing for their investment projects. Venture capital and leasing can provide a major contribution to eliminating this constraining factor in company financing.

In the view of the companies interviewed, **venture capital** is an adequate alternative means of financing for investments in capital goods. Peruvian SMEs express a high level of willingness to accept external investment partners, and this indicates that the establishment and consolidation of a venture-capital market in Peru can set important incentives for growth in the SME segment. However, the development of this instrument in Peru is faced with four important obstacles – tax regulations, a low number of institutional investors and experienced fund managers, and a lack of sufficient exit options. To promote the venture-capital market in Peru, both the Peruvian government and bi- and multilateral DC should focus on the following fields of action:

— To provide for an **adequate tax framework** in line with international standards, venture-capital funds should not be subject to income tax and should instead have a neutral status in tax terms. A bill currently under discussion in Peru would require investors to tax their investment earnings as income. Funds would be exempt from taxation and have only a channeling function. This arrangement would contribute to creating a clear and stable tax regime by ruling out the possibility of any double taxation (of investor and fund).

— To **enlarge and diversify the group of institutional investors**, it would be possible, first, to diversify the national pension system, which is at present limited four the four Peruvian AFPs. In order to do so a necessary step would be to create viable mechanisms geared to allowing a more flexible and less concentrated investment of pension funds as well as to stimulating private saving. One conceivable approach would be to introduce a second, voluntary pillar of the pension system whose funds would be administered by specialized financial institutions, possibly modeled on the US 401(k) Plan. Second, government should assume a more active role in the venture-capital market, for instance by stimulating development of the market with the aid of special investment vehicles. A helpful approach here would be to establish a fund that invests solely in private venture-capital funds active in Peru (fund-to-fund financing). Third, the investment regulations on public institutions should be amended to allow these institutions to invest in venture-capital funds.

— To alleviate the lack of experienced **fund managers** in Peru, it would be possible to arrange for conferences and seminars, grants for advanced training, and further instruments geared to the exchange of information – e.g. an Internet platform to facilitate contacts between investors and companies seeking capital. DC activities of bi- and multilateral organizations in the framework of "financial system development" should focus on providing such services and make the necessary resources available.

— To **improve exit options**, it would be essential to reduce the transaction costs bound up with initial public offerings (IPOs). To strengthen the company buyback exit option, it would be necessary to enlarge the critical mass of SMEs with growth prospects as well as to improve their administrative capacities. This is a task for both government actors and development cooperation. Measures should be focused, first, on enhancing the survival and growth capacities of young and innovative companies; these might include development of incubator facilities (like technology and startup centers), which could provide a crucial contribution. Second, it would be important to offer business development services (BDS) aimed at enabling SMEs to present themselves as serious partners prior to seeking investments and to lay the groundwork needed to buy back company shares. One step essential in this context would be improved information based on reliable company accounting. Third, conferences and seminars could be held to raise the awareness of the concept of venture capital and promote the exchange of information between investors and companies seeking investment.

As far as **leasing** is concerned, the findings of the present study indicate that this means of financing constitutes an important alternative for SMEs in Peru, though at present its outreach extends more to medium-sized companies than to small firms. Furthermore, certain individual features of leasing have not met the expectations placed in the instrument. This would be an important field of action for the Peruvian government and DC as well as for market actors themselves.

To extend the **outreach of leasing** both for small firms and in regional terms, the following approaches would be appropriate:

— For lack of a unified definition of SMEs and in view of the deficient state of the data available on them, both of which factors obstruct the development of a promotion and/or marketing strategy keyed to this customer segment, relevant government actors like the national banking oversight agency should step up their efforts aimed at collecting and statistically processing SME-specific data.

— At present the problem of refinancing for independent leasing operators constitutes a serious constraining factor limiting the expansion of leasing activities to include new customer segments as well as a high barrier to the entry of new companies to the market. Here financial cooperation could, among other things, focus more on providing refinancing credits. Bi- and multilateral financial cooperation institutions should offer appropriate services, focusing chiefly on medium-sized, independent leasing operators, since the latter are more oriented to SMEs.

— Furthermore, the risks associated with SMEs constitute an obstacle to an expansion of leasing activities to include small companies in particular. On the supply side this impression is substantiated by deficits in risk analysis as well as by decision-making procedures not adapted to the needs of SMEs. Measures bound up with the institutional advisory services provided in connection with technical cooperation and conducted in cooperation with private-sector actors like the Peruvian banking association could be used to foster the development of a more sustainable product technology and promote the willingness of leasing companies to reach out to new customer groups. On the demand side it would be necessary to focus at the same time on increasing company transparency and encouraging company formalization, tasks which could best be addressed by developing business development services.

Qualitative weaknesses in the supply of leasing services that are detrimental to an orientation of leasing business to SMEs include the usual demands for asset-unrelated collateral, decision-making procedures not adjusted to company cash flows, and relatively inflexible contract-processing procedures, especially outside Lima. Here the following approaches would be appropriate:

— The need to demand additional collateral security is closely bound up with the underdeveloped state of Peru's markets for used goods. A new Internet platform could be used to bring supply and demand more into line and increase market transparency. Furthermore, experiences from other countries indicate that creation of a fair for used machinery can provide a crucial contribution to increasing the levels of activity in the used-goods market.

— Problems in contract-processing procedures can be alleviated by reorienting risk analysis; this should be an integral component of the DC field of "financial system development." It appears that contract-processing procedures could be accelerated especially by shifting risk analysis from a bank's central risk-assessment department to its leasing department as well as by introducing standardized leasing contracts. Furthermore, a risk analysis geared to company cash flows can provide more reliable data than a risk assessment based solely on past credit ratings, and this can help reduce possible losses. If, moreover, a leasing operator is interested in actively influencing customer risk, he also has the option of using more intensive contacts to his customers and more transparent, cooperation-oriented risk analysis to help improve company financial management.

1 Introduction

Small and medium-sized enterprises (SMEs) are seen as having great significance for the development process. To cite an example, the strong economic upswing experienced in the US in the 1990s was closely linked to a favorable growth climate for service-related SMEs and high-tech startups.[1] If they are to fully utilize their manpower resources and innovative capacities, SMEs need to be sure that capital is either available or can be readily obtained. Financing bottlenecks do, however, constitute a crucial obstacle to investments in SMEs, a factor which sometimes means that potentially profitable projects fail to materialize.

In developing countries the long-term provision of financial resources is a source of major problems. It is true that liberalization of national financial markets and development of target-group-oriented financial institutions have contributed crucially to improving the supply of SMEs with financial services. But while the short-term capital needed to finance current assets is now largely available in urban regions, SMEs continue to be hampered by a chronic lack of financial resources tailored to their specific investment needs. And it is precisely these investments that play a central role for self-sustaining economic growth.

1.1 The Present Study's Background, Subject Matter, and Structure

The financing of investments as a rule means long-term financing. Long-term investments not only involve greater objective planning and earnings risks, they are also particularly susceptible to the consequences of unevenly distributed information. This constitutes an obstacle to financing. When, in addition, such investments are highly company-specific, e.g. investments in human capital or nonphysical assets envisaged by young and innovative firms, these risks/problems tend to be more pronounced and frequent. And this in turn makes it more difficult and costly for such firms to enter into the contractual arrangements typical of conventional credit-based financing, the final outcome being that sound and potentially profitable investments may simply not be made.

In the industrialized countries an alternative approach to financing projects that commercial banks regard as too risky for lack of sufficient security or adequate information is the use of quasi-equity or equity-substituting finance papers that enlarge the financial scopes open to business enterprises. Under this approach the lender shares the investment risk while at the same time acquiring a claim of possible higher profits. As far as the long-term financing of SMEs is concerned, venture capital and leasing are often seen as promising instruments for overcoming financing bottlenecks, though here, too, potential borrowers still have to solve information problems and find suitable lenders. Against this background the present study is intended to provide a contribution to addressing the following higher-level problem:

> *Do venture capital and leasing represent suitable alternative modes of financing for investments of SMEs in developing countries, and what conditions must be given to ensure that the use of these instruments is focused on specific target groups?*

The problem outline above is looked into with reference to the case of Peru. Unlike microenterprises, Peruvian SMEs mainly operate in the formal sector; they employ regular workers, are growth-oriented, and are thus in need of financing for their long-term investments. Realization of investment projects is often impeded by the shortage of long-term capital to be observed in Peru as well as in other developing countries. This shortage becomes manifest, first, in a lack of investment loans with appropriate credit periods. Second, looking beyond its banking system, Peru presently lacks sufficient alternative financing instruments. Positive experiences made in other countries have induced both international and Peruvian finance institutions to encourage the promotion of new approaches to financing.

1 Cf. Gerstenberger / Vögtle (2000), p. 23.

The study's objective is thus to look into the use of the alternative approaches offered by venture capital and leasing in the Peruvian context, examining the conditions under which leasing and venture capital may prove to be effective means of financing for the target group, SMEs. The study furthermore analyzes the crucial external conditions for the use of these new financing instruments, discussing their advantages and drawbacks and scrutinizing the interest shown by business enterprises and financial intermediaries in the use of these instruments. Finally, the study attempts to work out the policies and strategies needed to establish alternative means of financing, the aim being to provide recommendations for the relevant actors in the government sector, the donor community, and the business sector.

The study breaks down into seven chapters. Following the Introduction, Chapter 2 provides an overview of the financing problems faced by SMEs in general and investment financing in particular. Chapter 3 discusses leasing and venture capital as alternative means of financing for SMEs in developing countries and explains some of their most important features and advantages. Chapter 4 is concerned with the SME business segment in Peru. The chapter starts out by briefly outlining the present situation of Peruvian SMEs, then, based on the study's company sample, going on to look into the dynamics of SMEs as well as existing financing bottlenecks. Chapter 5, based on interviews, analyzes the Peruvian venture-capital market, presenting the most important actors and discussing, against the background given in Peru, the extent to which venture capital may represent a viable financing alternative for SMEs. Chapter 6 discusses leasing as a possible financing alternative for SMEs in Peru, examining the current situation of the Peruvian leasing market as well as the framework conditions given there. This is followed by a discussion of the prevalence of leasing among Peruvian SMEs and the possible advantages that leasing may or may not offer in this connection. Chapter 7 sums up the study's results and provides recommendations for public-sector institutions, bi- and multilateral development cooperation (DC), and market participants.

1.2 Methodological Approach

The study's results are based, first, on the authors' evaluation of the relevant literature on investment financing and on experiences made by German and international DC organizations with venture capital and leasing as financing instruments, and, second, on an empirical study conducted by the authors in the framework of an 11-week working visit to Peru from February to April 2002, with the latter constituting the core element of the analysis. The study is qualitative in nature. Its aim was not to come up with representative propositions for the SME sector, i.e. the demand side. The study's main aim was to look into a large share of the actors involved on the supply side with an eye to coming up with quantitative results for a number of cases. The overall project was conducted in close cooperation with the counterpart institution, the Peruvian national development bank, COFIDE (*Corporación Financiera de Desarrollo*).

The Supply Side

To look into the issue of **venture capital**, the study used semi-standardized questionnaire for interviews with 15 potential investors; these included four private pension funds (so-called AFPs), three private insurance companies, three public-sector institutions, two banks, and three institutions engaged in development cooperation.[2] In addition, open-design questionnaires were used to interview three institutions set to launch a fund in Peru as well as a number of experts in the field of venture capital. One aim of the survey was to come up with an overview of possible obstacles to and chances for the development of a venture-capital market in Peru. A further aim was to determine whether SMEs are given adequate consideration as a potential customer group for venture capital. As far as **leasing** is concerned, the authors interviewed 11 financial intermediaries,

2 The actors were selected with the aid of the national counterpart, COFIDE, as well as through interviews with experts, the aim being to cover the entire spectrum of potential investors for a Peruvian venture-capital fund.

three of them independent leasing companies and eight of them banks. The survey's aim was to obtain information on the products available and on supplier-customer structures as well as to identify possible obstacles to and chances for an expansion of leasing business to include SMEs.

The Demand Side

On the demand side, the authors used semi-standardized questionnaires to interview a total of 48 SMEs with an eye to examining their financing practices and any possible experiences they may have made with venture capital and leasing as well as to determining their assessment of the use of these instruments. With the aid of relevant institutions and business experts, the authors selected companies from two industries that appeared especially suitable for the purposes of the study, the textile industry and the agroindustry.[3] Branches of industry were defined on the basis of the assumption that SMEs[4] in these key sectors of Peru's economy, which are in the process of growth and modernization, are typified by a certain level of management dynamics, are innovative, and gear their operations to export markets or to national market niches. It was further assumed that companies displaying one or more of these characteristics will be faced with growing needs for long-term financing.

3 The criterion used for a rough selection of sectors was their relevance for the Peruvian economy, measured in terms of a given sector's share in GDP. This meant initially that the study had to choose between the following sectors: mining, manufacturing (including textiles and clothing), agriculture, fisheries, construction, transportation, and communications. Cf. COFIDE (2001), p. 12. Four further criteria were used for the final, fine selection: industry growth potential, relevance for the export sector, innovativeness, and SME-typical business structure.

4 In accordance with a definition commonly used in Peru, SMEs were classified in terms of their annual sales volume. Cf. Chapter 4.1 for more detailed information.

1.3 The Study's Relevance for Development Policy

The present study's relevance for development policy is bound up with the need, first, to foster SMEs as vehicles of a dynamic economic development and, second, to support Peru's financial system.

Experience in recent years has shown that developing countries too have no viable alternatives to integration in increasingly globalized markets. Development of a competitive private sector is a sine qua non for coming to terms with the conditions posed by an open, globalized world economy. Small and medium-sized companies boost a country's competitiveness and are at the same time vehicles of growth and employment. This is why development cooperation should accord particular attention to the group of SMEs.

The study focuses on SMEs active in the formal sector. Although independent small-scale and microenterprises (SSMEs) in the informal sector make up the majority of all companies active in most developing countries, they are for the most part characterized by weak productivity and low levels of worker qualification and offer very little social security. To the extent that SSMEs ensure the survival of their owners, these companies must be seen as having an important social function. But they for the most part lack the wherewithal to develop into competitive firms in modern, productive, and legally formalized business sectors.

Unlike SSMEs, SMEs are an integral component of any functionally specialized and competition-oriented business structure. Their high level of flexibility and adaptability enables SMEs to respond swiftly to changing economic and political framework conditions. SMEs contribute in this way to adapting an economy to the ongoing process of technoeconomic change. SMEs can service market niches that are uninteresting for larger companies, or they can position themselves as suppliers in value chains. A further chance open to SMEs lies in complementary specialization and cooperation among SMEs. For example, development of industrial clusters entailing intensive functional intercompany specialization and cooperation can serve to enhance the competitiveness of dynamic groups of SMEs.[5] They can in this way harness synergy effects to compensate for the handicaps involved in small-scale production. As suppliers or members of a cluster SMEs furthermore have better chances to overcome market-entry barriers such as minimum manufacturing quantities, in this way gaining access to export markets.

Integration in modern, functionally specialized organizational structures presupposes a willingness to accept and follow up on important technical innovations. This encourages companies to gear their activities to general innovativeness, development of entrepreneurial innovations, and international competitiveness and entails positive external effects for the overall economy: international competitiveness is a sine qua non for solid economic growth. While in many cases large companies reduced their workforces in the 1990s, SMEs are marked by highly **positive employment effects**.[6] SMEs not only create new jobs, they also create an above-average number of jobs per unit of capital and thus contribute in the longer-term to an improved employment picture in the formal sector. Creation of new jobs leads to higher increments in real wages and are thus a crucial factor in reducing poverty.[7]

But the development of private entrepreneurial activity depends crucially on provision of needs-oriented financial resources by an **efficient financial system**. The question of an optimal financing of investments and innovations – and not only for technology-oriented firms in forward-looking high-tech industries but also and above all for dynamic companies in the so-called old economy – is a core problem involved in coming successfully to grips with structural change and achieving long-term growth. Private-sector projects are as a rule financed via financial intermediaries, i.e. through the banking sector as well as through money and capital markets. Smoothly functioning financial systems have a salutary influence on the development process in that they boost saving rates and ensure that resources are deployed efficiently.[8] The use of financial intermediaries, who mediate between suppliers of capital (savers) and demanders of capital (investors), can serve to reduce the transaction costs involved in borrowing and lending.[9] Ensuring that scare savings are directed into the most productive investment projects has positive impacts on an economy's growth process. And identifying and financing promising pioneering firms constitutes a crucial contribution to mastering the process of technological change.[10]

One feature of many developing countries is their underdeveloped financial systems, i.e. their banking sectors and their financial markets in particular tend to be marked by inefficiency and low volumes. Peru's financial system, dominated by the banking sector, does not adequately fulfill its intermediary function. First, the size and activity of the banking system, seen in terms of the share of economic transactions handled by banks, are relatively underdeveloped.[11] One exacerbating factor here is that restructuring processes in Peru's banking sector that followed on the heels of the 1997 international financial crisis has led to a reticence on the part of banks to provide credit. Second, the share of operating costs in overall lending is higher than average, a fact that indi-

5 Cf. Qualmann (2001), p. 329.

6 Cf. Gerstenberger / Vögtle (2000), p. 23; Qualmann (2001), p. 328.

7 Cf. Altenburg (2001), p. 325.

8 Gurley and Shaw see a financial system's contribution to improving capital efficiency as its most important task. Cf. Gurley / Shaw (1955), pp. 115f.; World Bank (1989), p. 32.

9 This reduction of costs is due to the many-faceted transformation services provided by financial intermediaries, which include transformation of terms, scales, and risks. Cf. Lachmann (1997), p. 120.

10 Cf. World Bank (2002), p. 75.

11 The indicator used here is what is known as financial deepening, i.e. the ratio of M3 to GDP. Cf. Demirguç-Kunt / Levine (1999), p. 6. In Peru this ratio was 31 % in 1999. By way of comparison, the figure for Chile was 51 % in the same year. Cf. IMF (2000).

cates low levels of efficiency.[12] Weak competition due to a lack of alternative financing options has contributed to a situation in which banks and finance institutions have little incentive to lower their intermediation costs and profit margins with an eye to offering lower fees (interests charges).[13] Against this background it is essential to promote alternative financing instruments beyond the classic bank loan, and this would encourage the emergence of a more diversified financial system and improve financial intermediation.

2 Problems Associated with a long-term Financing of SME Investments

Financing business projects inevitably entails fundamental risks, be the borrower a large established corporation or an SME. Unlike the model world of the perfect capital market,[14] which is marked, among other things, by perfect competition and in which every market participant is in possession of all relevant information and there are no transaction costs,[15] exchange relations in real markets are not free of costs. Information asymmetries force partners to contracts to make provisions for risks, and in the case of finance contracts this leads to credit rationing and may, in extreme cases, even mean in effect exclusion of certain groups of businesses from the capital market.

In capital markets SMEs are faced with a number of company-size-related limitations that are especially acute in the field of investment financing and often impede the access of SMEs to capital. Companies are in need of both short-term and long-term capital.[16] In the short term, companies need capital to run their current operations as well as to finance the assets they need to produce. These current assets include all items that are not devoted to long-term business activities. Current assets include material goods and supplies (or the production resources needed to produce a company's products) as well as nonphysical goods like accounts receivable, checks, and cash balances.

Assuming that a company's aim is not only to survive but also to boost its productivity and expand, it will need long-term capital to invest in fixed assets. It will furthermore have to continuously reinvest in existing fixed assets to compensate for wear and tear and maintain its integrity. This would include fixed assets like real estate, machinery, and business equipment, but also nonphysical assets like licenses and concessions and deposits or payments on account.

The following section, which starts out with a general discussion of information-related problems involved in financing, looks into some of the special features of SME financing. This is followed by a look at some of the special characteristics of long-term investment projects.

2.1 Asymmetric Information and General Problems involved in the Financing of SMEs

Imperfect and unevenly distributed information and the transaction costs that result from this situation are chiefly relevant for markets in which goods and/or services are not exchanged at the same time. This is the case, for instance, with credit markets or labor markets. Unlike spot markets for consumer goods, the goods/services transacted here have the form of a right of disposal to future supplies of goods or services.

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12 While in the period between 1992 and 1999 the average operating costs of banks in 63 countries were 4 %, the figure for Peru was 10 % for the same period, Cf. Demirguç-Kunt / Levine (1999), appendix, Table 1.

13 Cf. Hallberg (2001), p. 11; MEF (2001b), pp. 14f.

14 On the theory of the perfect capital market, see e.g. Fama (1970), Mossin (1973), Rudolph (1979).

15 Cf. e.g. Nicholson (1998), pp. 401f.

16 Short-term capital is provided for periods of up to one year. Medium-term financing papers are those with terms between one and five years. All forms of financing that cover periods of five years or more are referred to as long-term. Cf. Thielmenn (1998), pp. 22f.

That´s why credit contracts entail a shift of the transaction into the future, and for the lender this means a high degree of uncertainty regarding the borrower's ability or willingness to perform on a contract.

As far as an investment project is concerned, the borrower generally has an information edge over the lender, e.g. as regards profit margins and the chances a product may have in a specific market. And when decisions are made subsequent to the conclusion of a credit contract, the lender is unlikely to be more than approximately as well informed as the borrower.[17] This information asymmetry potentially leads to two classic problems: adverse selection and moral hazard.[18]

Adverse selection is a risk that occurs before a contract is concluded. The key variable involved in any economic transaction is price, e.g. the interest rate agreed on in a credit contract. Whether or not a lender is willing to provide financial resources at a given interest rate will depend in this case on the risk or the likelihood that the borrower will repay the loan. Higher risk is as a rule compensated for by a higher interest rate. Under the condition of asymmetric information, however, it is either difficult or impossible to estimate risk. And for this reason banks gear their lending to an estimated average credit risk and demand a premium for the risk of default. One inevitable consequence of this is that borrowers who are willing and able to perform on a loan are saddled with higher interests rates and consequently often forced to withdraw from the market. The outcome is that only the best potential borrowers are selected. In other words, there is little leeway available to adjust interests rates in such a way as to compensate for risk. Thus, the average risk increases over time, a factor which leads to higher risk premiums. This aggravates adverse selection and can, in the extreme case, lead to a complete collapse of the market.

17 Cf. Leland / Pyle (1977), p. 371.

18 Cf. Frank (2000), pp. 197f., 214f.; Varian (1999), pp. 645, 647.

Once a contract has been signed, there is a further risk, namely **moral hazard**. This is a typical principal-agent problem. Once the entrepreneur (agent) has obtained the capital he needs, he is in a position to exploit his information edge over the lender (principal), e.g. by running greater risks or by misusing the capital he has borrowed. To cushion this risk, the lender will either demand high interests rates or be faced with a negative utility if he is forced to withdraw completely from an innovation project. However, aside from the decisions made by an entrepreneur, exogenous economic factors also play a role here, and thus a project's success of failure may not be wholly and unambiguously due to an agent's actions.[19] Verification problems make it very difficult for a lender to sanction such actions.

Both cases involve an incentive to reduce information deficits. To this end, the lender can procure information (screening) and the borrower himself can provide information (signaling). These measures, however, entail costs and may be seen as reasonable only if they can at the same time be used to reduce borrowing costs.

The information-related problems outlines here apply generally for the financing of businesses. With SMEs, however, this uneven distribution of information between lender and borrower is far more pronounced than it is with large corporations, and this in turn implies higher costs for reducing information deficits. At the same time, SMEs are confronted with a number of structural disadvantages in borrowing which exacerbate existing financing bottlenecks:

— The disproportionate **information asymmetry** involved in transactions with SMEs is due, among other factors, to often relatively intransparent company accounting systems. Balances are frequently faulty, and sometimes different balances are even kept for internal and external uses. Only in exceptional case are audits conducted by specialized external accountants. In extreme cases business accounting may even be seen as superfluous,

19 Cf. Franke / Hax (1994), p. 415.

with such companies perceiving absolutely no need to provide information. Furthermore, SMEs quite often have a very low public profile and seldom manage to build a reputation that would heighten the confidence of potential lenders. It is for this reason very difficult (and costly) to assess their ability and willingness to pay.

— One structural problem involved in the financing of SMEs is the high level of **fixed costs** bound up in capital transactions with them. The volumes of the financing required by SMEs are as a rule relatively low. But all borrowing of capital involves degressive fixed costs, and this means that costs accruing in credit transactions with SMEs tend to be relatively higher than they are for credit transactions with large corporations.[20] Since SMEs as a rule operate with relatively low capital volumes, the outcome for them is disproportionately high credit costs.

— The **risk situation** of SMEs also poses problems. Since the product range and sales markets of companies in this business sector tend to be no more than weakly diversified, SMEs find it difficult to provide or compensate internally for risks.[21] What this means is that SMEs are exposed to major earnings fluctuations and thus have a poorer risk profile than large corporations. They are furthermore more vulnerable to the effects of business cycles and less able to influence them.[22]

— Finally, the relatively low volumes which they demand, their limited self-financing capacities, and the limited information available on the products on offer in the financial market negatively affect the **bargaining position** of SMEs. The advisory services available to SMEs are often one-sided, and they tend to be more dependent on banks than larger companies.

All told, the problems outlined above mean in the end that SMEs are not perceived by existing financial institutions as an attractive customer group. At best, SME have access to high-interest loans or are cut off from altogether access to credit. For SMEs, the problems outlined above tend to be prohibitive when it comes to realizing long-term investment projects. This aspect will be addressed in the following section.

2.2 Specific Problems involved in Financing Investments of SMEs

Longer-term investments involve more pronounced objective planning and earnings risks, and the consequences of asymmetric information distribution tend to be greater here than they are for short-term investment financing. In such cases procurement of the information needed to reduce information deficits is accordingly more cost-intensive, a factor which further impedes financing. Moreover, it is important to distinguish between behavior-related information deficits that can be assessed and those that no amount of effort will suffice to predict. Precisely in countries with underdeveloped financial systems it is as good as impossible to predict fluctuations bound up with inflation, interest rates, or exchange rates. To cushion these uncertainties, lenders are forced, for instance, to seek relative certainty (e.g. by avoiding contracts with protracted repayment terms), to build reserves, and to diversify their portfolios as a means of compensating for risk. Since SMEs are as a rule highly vulnerable to external shocks, financial intermediaries tend to be particularly restrictive in providing long-term investment loans to this business segment.

The volume of a company's long-term investments in plant and equipment is furthermore greater than the volume of funds its needs to finance short-term working assets. In the event of failure this means correspondingly higher credit default costs for the lender. Another problem involved in long-term investments is the fact that returns on investment take a relatively long period of time to materialize. And while interest and redemption payments are due as soon as an in-

20 Cf. Schröder (1992), p. 137.

21 Cf. Gerke et al. (1993), p. 17.

22 Cf. Kaufmann / Kokalj (1995), p. 15.

vestment is made, it often takes years for returns to begin to flow. This time lag between expenditures and revenues aggravates a company's liquidity situation and can lead to insolvency of young or highly indebted firms that lack adequate reserves.

If lenders see problems in financing an investment, they will pass on the increased risk either in the form of higher interest rates or refuse to finance the investment. The risk here is that a higher interest burden may lead to an exacerbated risk situation, and potentially profitable investments may therefore either fail or not be realized in the first place.

This problematic is even more complex when the long-term financing in question is for **innovative investment projects**. There is no doubt about the great significance of company innovativeness as far as economic goals such as growth, employment, or successful participation in the process of economic change at the national and international level is concerned. Thanks to their high levels of flexibility and adaptability, SMEs are an important pillar of the innovation process. Often driven by dynamic management, SMEs tend to be quick to seize new technical opportunities and cash in on growth chances at an early stage of the game.

If a company introduces a new or markedly improved product or a new service to the market, and consumers accept this product, the company has good chances to realize high profits. In the short term product innovations mean high sales and turnover figures. In the medium and/or long term a company may use its so-called first-mover advantage to earn itself a name, a reputation. Their dynamic behavior gives such companies a competitive advantage that they can use to better position themselves in the market and to acquire more market power.

Apart from their chances and their need to engage in innovation projects, SMEs in particular are also faced with serious financing problems that may block a project in its initial phase. Increased planning and earnings risks and severe information deficits leave their mark here too[23] – to say nothing of the so-called market-entry risk. What is meant by **planning risk** is that in looking into innovative projects an entrepreneur is unable to fall back on the experiences he has made in past projects. It is unclear how the project will develop over time, how much capital will be needed, and to what extent available resources can be used.[24] The entrepreneur is also faced with an **earnings risk** bound up in essence with uncertainty as to technical feasibility and prospects for success in the market.[25]

Even in cases in which an entrepreneur is successful in developing a new product or process and planning a project, he is still faced with a high **market-entry risk**. New companies in particular often find it difficult to position themselves in a market dominated by experienced and established firms. They lack the confidence of a solid client base and are often unable to make up for the competitive advantages enjoyed by other companies, e.g. their economies of scale.

Another barrier must be sought in the fact of an especially acute problem of asymmetric information in the innovation process.[26] What is meant here is an information paradox, i.e. a company must on the one hand present its investment project in terms as simple and transparent as possible if it is to win over investors for a project. On the other hand, the investment's potential value consists precisely in its novelty, which implies an information edge over potential competitors. As soon as an innovator makes his new idea known, others may imitate it, a factor which would diminish its value. Protective property or patent rights are unsatisfactory here to the extent that they are too difficult to implement, too costly, or not sufficiently effective at the international level.[27]

23 Cf. Wittneben (1997), p. 30.

24 Cf. Klemm (1988), p. 58.

25 Cf. Wittneben (1997), pp. 32f.

26 Cf. Wupperfeld (1994), p. 49.

27 Cf. Kaufmann / Kokalj (1996), p. 6.

In the end, bank financing is often not a viable option on account of the risks and problem structures outlined above. Company-generated cash flows or internal resources for this reason play an important role in the financing of investments, though precisely SMEs are often hampered by a thin equity base. Additional equity or quasi-equity forms of financing can open up important new options here, as will be explained in the following section.

3 Alternative Financing Instruments for SMEs

Against the background of the above-described problematic involved in the (credit-based) financing of SMEs, the present chapter looks into proven and promising alternative financing instruments. It will start out by outlining some approaches pursued by multi- and bilateral development organizations. It will then go on to discuss some general features and advantages of venture capital and leasing, the two alternative means of financing most frequently promoted in this context.

3.1 Approaches to Development Financing pursued by bi- and multilateral Development Organizations

As used in the fields of research or practical development work, the term "development financing" refers in the narrower sense to the provision of investable funds and in the broader sense to the development of financial systems in developing countries and countries in transition. The latter usage includes, among other aspects, efforts undertaken to strengthen financial institutions which provide financing, investment, and payment services for other economic entities. As far as promotion of SMEs is concerned, this means reaching companies indirectly via efficient financial intermediaries instead of, as in the past, providing them with direct support, e.g. in the form of interest subsidies. The aim is to build financial institutions that are in a position to reduce both existing information asymmetries and transaction costs, in this way providing a sustainable supply of needs-oriented financial survives for a growing share of the target group.[28]

The development in the 1990s of target-group-oriented financial institutions contributed to achieving a decisive improvement in the number of small clients with access to financial services. Even established and financially sustainable microfinance institutions (MFIs) like the *Grameen Bank*, the *Bank Rakyat Indonesia*, the *Banco Sol*, and the *Caja los Andes* limit their loan business to providing short-term credits to SSMEs. Efforts aimed at servicing new client segments in the SME sector continue to be underdeveloped. One reason for this is that the potential in existing customer segments has not yet been fully exhausted and there is therefore no need to reach out to new customer groups outside the SSME segment. The other is that MFIs operate with credit technologies that have been specially tailored to SSMEs and are not wholly adequate to the task of longer-term investment financing.

As a means of overcoming the bottleneck in the financing of SME investments, multilateral development organizations like the World Bank and the International Finance Corporation (IFC) have proposed three alternative approaches: first, the use of loans to stimulate local commercial banks to provide medium- and long-term lines of credit for SMEs; second, promotion of venture-capital funds; and, third, support for leasing companies.[29] The present study focuses on the latter two financing instruments. This would appear to make good sense in that SMEs in Peru are already being promoted via the national banking sector, though thus far this approach has contributed little to overcoming the existing financing bottleneck.[30] One problem here is that commercial banks have

28 Cf. Schmidt (2000), p. 5.

29 Cf. IFC (1996), p. 4; World Bank Group (2001), p. 26.

30 The investment program of the Peruvian development bank COFIDE is made up of the PROPEM and PROBID credit lines, which are addressed to SMEs as their ultimate borrowers. Cf. COFIDE (2001), p. 32.

problem here is that commercial banks have been reluctant to make use of these SME-oriented credit lines, which has meant that relatively few SMEs have been able to obtain long-term loans.

On the other hand, the approach aimed at establishing venture capital as a means of supporting SMEs appears to hold considerable promise. Since the early 1980s, and even more since the 1990s, international development organizations have been developing **venture-capital funds** in developing countries and countries in transition. This development goes back on the one hand to the positive experiences made with this form of financing in industrialized countries[31] and is on the other hand due to an increased demand for capital in the countries in transition and the growing economic stability experienced by many Latin American economies once the debt crisis had been overcome.[32] One prominent actor here is the IFC, which has thus far invested USD 1 billion in a total of 100 funds, 85 of which are venture-capital funds.[33] The regional development banks have also worked out more and more approaches to promoting venture capital in developing countries. The Interamerican Development Bank (IADB), for instance, has created a fund (*Fondo Multilateral de Inversiones* / FOMIN) which is already cofinancing some 22 venture-capital funds in Central and South America. The anticipated earnings are expected to convince third-party investors of the attractiveness of innovative SMEs and to encourage them to invest in this business segment.[34] One example of a regional venture-capital fund is the EcoEnterprise Fund, which invests in socially and ecologically sustainable SME investment projects. The *Fondo Capital Activo de Bolivia* likewise supports Bolivian SMEs active in non-traditional sectors.[35] All told, the number of venture-capital funds investing in SMEs increased sharply in the 1990, and has continued to grow, first in Asia and since 1994 in central and eastern Europe as well.[36] In Latin America experience with venture capital has mainly been concentrated in Brazil and Argentina.

Promotion of **leasing** is the third widespread approach used to strengthen investment financing in developing countries. Here too, the IFC has been by far the most important actor involved in developing this alternative form of financing. In countries without any leasing activities the IFC is pursuing the goal of creating successful, independent leasing companies with a model character with an eye to encouraging imitators and providing an impetus for the development of leasing markets. In existing leasing markets the IFC seeks to promote competitiveness by supporting independent leasing companies and providing them incentives to become active in new market segments.[37] From 1977 to the middle of 2000 the IFC invested some USD 924 million in 92 investment companies specialized in capital goods; 90 % of these funds consisted of loans, the remainder was equity capital. In 22 countries IFC has participated in the establishment of new leasing companies; these countries include Bangladesh, Ghana, Egypt, Pakistan, Peru, South Korea, Sri Lanka, Thailand, and Vietnam. In other countries, e.g. in Brazil, it has supported leasing firms in positioning themselves in new market niches. The IFC's regional focus has been Asia, where it has invested USD 470 million. Its financial commitments in South America reached a level of some USD 170 million in the same period (Figure 1). In addition, the IFC has

31 As an example: between 1991 and 1995 venture-capital-financed firms in the US have achieved 30 % higher rates of growth and created 24.5 % more jobs than the most important US corporations. Cf. Nuechterlein (2000), p. 12.

32 Cf. Carter (1995), p. 2.

33 Cf. IFC [http://www.ifc.org/funds/] (accessed on 05 July 2001).

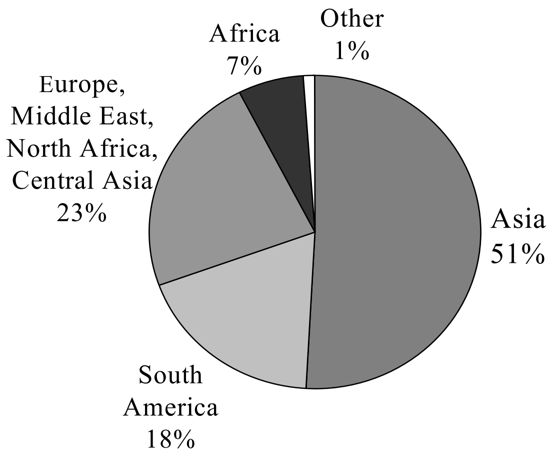
34 "We believe that there are many thousands of small businesses in the region which can offer attractive, competitive rates of return to third party investors.[....]. Our demonstration effect is to make profitable investments through these funds." MIF (1999), p. 2.

35 Cf. MIF [www.iadb.org/mif/investment_page/public.html] (accessed on 28 Feb.2001).

36 Cf. Aylward (1998), p. 2.

37 Cf. IFC (1996), pp. 28, 30, and 34.

Figure 1: Regional Distribution of Leasing Commitments, 1977 – 2000



Source: Authors' presentation, based on: Euromoney (2000), p. 21

raised some USD 445 million from other sources.[38] On the whole, the IFC's assessment of its commitment is positive, a fact which it documents on the basis of four factors: leasing company profitability, mobilization of private resources, consolidation of SMEs, and a deepening of financial systems.

Beside the IFC there are other donors actively engaged in promoting leasing for SMEs. The *Deutsche Investititions- und Entwicklungsgesellschaft mbH* (DEG), for instance, with its overall portfolio of over EUR 100 million, is presently active in the field of leasing in 17 countries, including India, Indonesia, Thailand, Uganda, Rumania, and Peru. It conducts its projects only together with Western technical partners, often co-financing leasing companies together with the IFC.

Against the background of the approaches outlined above, it will be necessary to look into some of the general features and important advantages of venture capital and leasing for SMEs in developing countries before moving on to the concrete case of Peru.

38 Cf. Euromoney (2000), p. 21.

3.2 Venture Capital as an Alternative Mode of Financing in Developing Countries

Venture capital as an alternative financing instrument to classic bank loans can provide a crucial contribution to financing long-term investment projects. Its most important advantages over traditional external financing must be sought in its ability to strengthen the equity base of firms in search of capital as well as in the advisory services and support it entails for the management of young companies in particular.

Concept and Key Features of Venture Capital

Both in the literature and in the discussion in the field of economics the terms private equity, development capital, and venture capital are sometimes distinguished in various ways, sometimes used synonymously. Some of these terms accent the uncertainty and risk involved in an investment. They apply mainly to firms with a special risk-chance profile, like that typical of young companies and startups in the fields of communication and information technology or biotechnology. Investments in such companies are usually made with the goal of gaining returns from increasing in the value of the equity investment in question. There are, however, also numerous examples of innovative, unlisted "old economy" companies that have good growth prospects and might thus also be interesting candidates for financing via venture capital. Investments in such companies are geared to earning regular profits.[39] In order not to marginalize any companies, and with an eye to doing justice to the broad range of potential means of financing available, the present study has opted for a broad definition of venture capital. In keeping with the practice of the German *Bundesverband deutscher Kapitalbeteiligungsgesellschaften* (BVK / German Venture Capital Association), the study uses the terms outside capital and venture or risk capital synonymously.[40]

Under the terms outside capital and venture capital, the present study understands all financing papers that a) are primarily liable in the event of bankruptcy, b) entail no legal requirement for the borrowing company to pay back the investment, c) involve no right of termination on the part of the creditor, and d) offer a profit-related claim to returns on investment. Such capital investments are as a rule bound up with rights of control, information, and involvement in decision-making.[41]

Outside or venture/risk capital is thus defined by the following features:[42]

— A **risk capital function**, i.e. unlike loans, venture capital is risk-bearing capital which involves no investment security and is used to service the claims of third parties in the event of bankruptcy.

— For the borrowing company such participation involves **no obligation to repay** the capital provided. The lender may sell his equity in the company at a point of time previously agreed upon, in this way recovering his investment. His **return on investment** is conditioned on an appreciation of the company's value or a participation in its profits. Guaranteed payments during the term of the investment are not customary.

— A **fixed-term investment horizon,** i.e. capital is provided to a company for a medium to long term (usually up to ten years), with the term being stipulated in advance. The investor has no option to terminate prematurely.

— The investor's **rights of control and codetermination** in the making of fundamental decisions are intended to compensate him for the lack of security involved in his investment.

— It is customary for the investor side to provide active **management support and guidance** for young companies or factories in financial difficulties.

Actors and Mode of Operation of the Venture-Capital Market

A functioning venture-capital market is characterized by interplay between a number of actors. Apart from the supply and demand sides, capital investment companies (CICs) play an essential role here as intermediaries.[43] Investors of venture capital range from commercially oriented investors like banks to private individuals or the state sector, all of whom are interested in making investments in innovative companies with growth potential. As a rule they invest not directly in equity-seeking companies but in funds set up and administered by capital investment companies. Due to their orientation toward companies with potential or innovative projects, venture-capital investments involve a higher-than-average risk. CICs, with their specific knowledge of the market, allocate the resources made available to them to various investment projects and are responsible for an optimal portfolio mix geared to minimizing

39 Cf. Geigenberger (1999), p. 2.

40 Cf. Butzmann (1999), p. 2; BVK, [www.bvk-ev.de/leitfaden/leitfaden.cfm], (accessed on: 07 Jan. 2002).

41 Cf. Kaufmann / Kokalj (1996), p. 8; Butzmann (1999), p. 2.

42 Cf. Butzmann (1999), p. 3.

43 The present study uses the terms capital investment company and fund administrator synonymously.

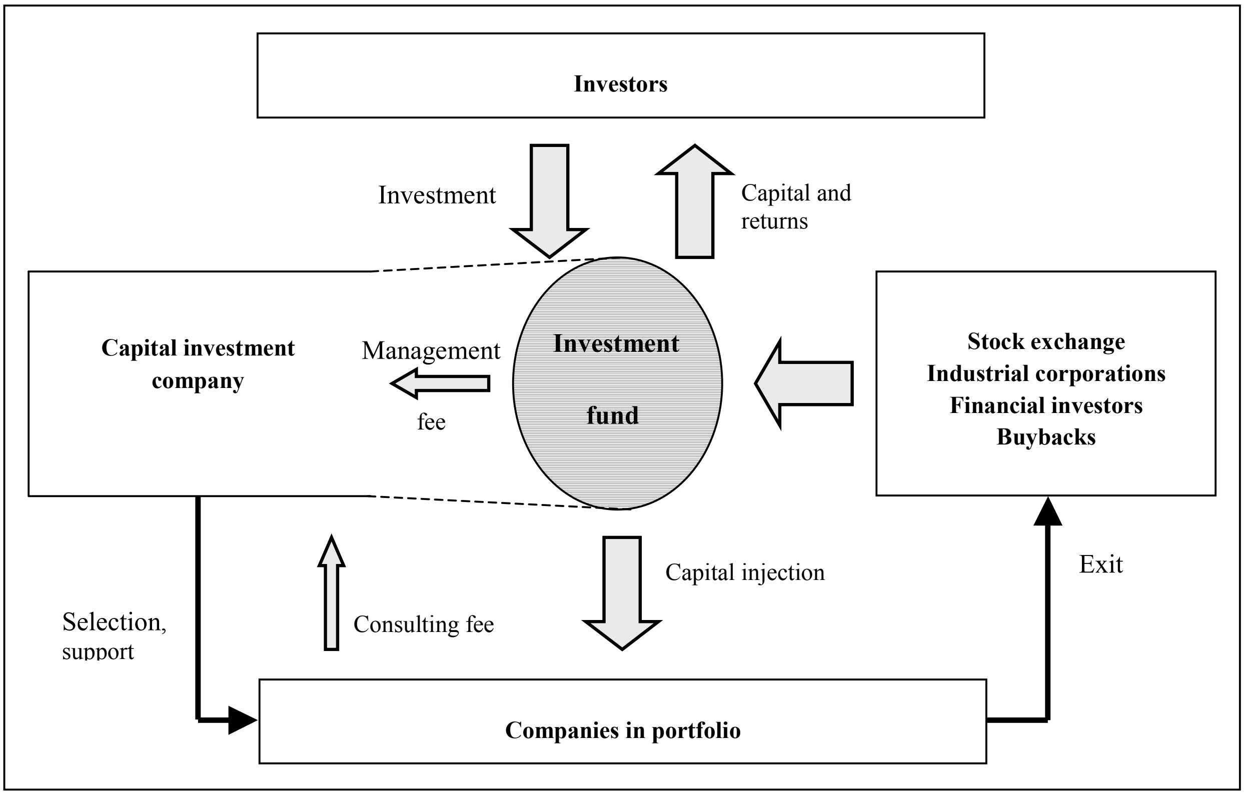
investment risks (Figure 2). In the ideal case there will be a network consisting of CICs that are specialized in different kinds of investment and intended to facilitate the termination of an investment or the sale of shares held.[44] While the use of an intermediary initially means additional transaction costs, the latter can be wholly compensated for by the fact that CICs have specific market information that enables them to reduce the risk of investment loss, e.g. by means of active control of and support for the management of young innovative companies.[45]

A company may need additional equity during various phases of its lifecycle, and the reasons for this demand may vary in nature. It is customary to distinguish between early-phase financing (seed and startup financing) and growth-phase financing for companies that are planning to expand or aimed to assist firms that have run into a liquidity crisis to return to a growth path. The investment is concluded with the disinvestment phase, in which an investor withdraws from a company, selling the company shares which he holds in the fund.[46]

Important Advantages of Venture Capital for SMEs and the Conditions required for Success

The use of venture capital offers advantages that make this form of financing particularly attractive for companies with good growth prospects. The main aspects involved here are the low strain on

Figure 2: Mode of Operation of a Capital Investment Involving a Capital Investment Company



Source: Authors' presentation, after Geigenberger (1999), p. 21; Baier / Pleschak (1996), p. 118

44 Cf. Wittneben (1997), p. 7; Geigenberger (1999), pp. 20 - 22.

45 Cf. Kaufmann / Kokalj (1996), p. 11.

46 For phases of financing, see Butzmann (1999), pp. 4f.; Geigenberger (1999), pp 48 - 54; Wittneben (1997), pp. 5f.

liquidity implied by venture-capital financing, access to long-term resources, and the support provided to company management:

— As its level of outside financing increases, a company is faced with growing costs for interest and redemption. This makes it more and more difficult for an investment project to earn the surpluses needed for this purpose.[47] In the initial phase of an investment a company normally is not expected to earn returns from its business activity. But financing via venture capital involves a **liquidity advantage**, since this form of investment entails no redemption payments and profit-related payments are due only when business successes begin to materialize.[48]

— Companies unable to provide sufficient security for bank loans can gain **access to capital** in this way. Because they are unable to provide adequate security, precisely young firms and small, underdiversified companies are often affected by credit rationing and thus forced to rely on financing papers that reduce investor risk without regard to collateral security.[49]

— An equity base bolstered by venture capital increases a company's **financial leeway**: this makes it easier for a firm to acquire additional financial resources from banks or government support programs, the leverage ratio of venture capital being roughly 1:2.[50] Participation of a CIC can thus also be seen as a mark of quality for the company involved. A CIC's commitment is regarded as a positive signal for investors, banks, or government investment-promotion agencies less familiar with the industry in question.[51]

— Such companies can profit from the **support provided by the investor**. Depending on the intensity of the support agreed on, the role assumed by the investor may range from that of the observer and controller to that of the business consultant or indeed temporary manager.[52] Most investors of venture capital have a store of experience in the industry concerned and/or specialized knowledge in the fields of financing, accounting, controlling, and tax law. They furthermore often have important contacts to key persons active in various areas such as banking and government agencies as well as to suppliers.[53]

Aside from the benefits for capital-seeking firms outlined above, investments in venture-capital funds also offer advantages for investors: as a new form of long-term investment with potential for high returns, venture-capital funds enlarge the supply spectrum in local capital markets. Since in this case returns are contingent on success, such investments tend to seek companies with growth potential and good prospects of earnings. It is, however, difficult to predict how such firms will develop, and this means that investment risks are relatively high. Against this background, investments in a fund run by a professional management are geared to reducing investment risk by means of diversification and advantages based on specialization and information. At the same time, this type of investment lowers the fixed costs borne by the individual investor.[54]

However, the prospective success of venture capital is bound up with certain framework conditions of an economic, legal, and institutional nature. Emerging venture-capital markets are often hampered by an inadequate number of investors, capital investment companies, and the lack of a critical mass of companies with growth potential. Moreover, existing legal frameworks are often not

47 Cf. Bisa (2001), pp. 52f.

48 Cf. Kaufmann / Kokalj (1996), p. 9; Butzmann (1999), p. 14; Schertler (2001), p. 99.

49 Cf. Christians / Schröder (2001), p. 103.

50 Cf. Butzmann (1999), p. 13.

51 Cf. Geigenberger (1999), p. 10.

52 Cf. Butzmann (1999), pp. 24f.

53 Cf. Geigenberger (1999), p. 9.

54 Cf. Carter (1995), p. 13.

conducive to the smooth operation of venture-capital funds, and exit options are often limited.

3.3 Leasing as an Alternative Form of Financing in Developing Countries

Experiences from a number of developing countries indicate that leasing can constitute an appropriate means of financing the investments of a good number of SMEs. Viewed against the background of an insufficient credit supply, leasing can be an effective approach mainly because the "rental character" of the transactions involved lessens the risk faced by investor and capital-seeker alike. The present chapter will start out by clarifying the terminology involved and then go on to look into the advantages of leasing from the viewpoint of the investor and the seeker of capital and outline the conditions that must be met if leasing is to become an established practice.

Concept and Main Forms of Leasing

One feature common to all leasing contracts is a separation of the legal ownership of an economic good from its economic utilization. The so-called lessee can, accordingly, make use of an economic good temporarily provided to him by a lessor[55] in exchange for a regular payment (the leasing rate). In essence, leasing thus bears a certain resemblance to a normal housing lease. But leasing transactions in the present sense contain elements that are atypical for housing leases, e.g. additional services provided by the lessor, or a lessee option to buy at the end of the term of a lease.[56] The literature distinguishes between different types of leasing:

Finance leasing, on which the present study focuses, is an alternative to credit-based financing of investment goods. During the term of a lease, which usually covers the better part of a good's service life, leasing contracts can as a rule not be terminated. One important difference to conventional leases is that in the present case the lessee bears the investment risk[57] and is responsible for all costs bound up with repairs, maintenance, and insurance. But a leasing contract may also provide for some additional services.[58] Leasing rates generally cover procurement or production costs, financing and administrative costs, and the lessor's profit margin (full amortization). At the end of the lease the lessee may have an option to buy or to renew.[59]

Operate leasing, on the other hand, is not an instrument used to finance medium- to long-term investments, since here the term of the lease is far shorter than the good's normal service life and the lessee has no interest in a long-term use of the good.[60]

With **sale-and-leaseback** a leasing company or a bank purchases investment goods, for the most part durable, and then leases the good back to the seller. This unlocks fixed capital, making it possible for the seller to realize a clear-cut financing

55 Leasing operators may include banks and manufacturers, but also independent leasing companies.

56 Cf. Bitz (2000), p. 109. If the good in question is automatically transferred to the lessee when the last leasing payment has been made, this is referred to as "sale on hire" and, at least in Germany, treated as a leasing contract for tax and balance purposes. Cf. Tacke (1999), pp. 5f. Under the *International Accounting Standards (IAS)*, however, the term is more broadly defined and refers to any temporary form of surrender of the use and benefit of movable and immovable property. Cf. Weinstock (2000), pp. 91f.

57 The investment risk is the risk that the good in question may be vulnerable to inadvertent destruction as well as to theft, obsolescence, or technical defects. Cf. Bitz (2000), p. 109.

58 Cf. Coyle (2000), pp. 35f.; World Bank Group (1997), p. 6; Wöhe (1998), p. 188.

59 Cf. Bitz (2000), p. 111; Wöhe (1998), p. 189.

60 As with conventional leases, the lessor bears the investment risk. The lessor benefits from this mode only when the good is repeatedly leased and finally sold. The lessor is therefore reliant on the good's condition and the existence of a functioning market for used goods. He often is responsible for repair, maintenance, and insurance costs. Cf. Coyle (2000), pp. 31 f.; World Bank Group (1997), p. 6; Wöhe (1998), p. 187.

effect while continuing to use the investment good involved.[61]

Notable Advantages of Leasing and Conditions required for Success

Leasing offers a number of benefits to the lessor and the lessee alike:

— For SMEs and farms in many developing countries leasing is the **only source of financing** available to realize long-term private investments. In view of underdeveloped capital markets and restrictive bank lending policies, the central strength of leasing is its reach and flexibility.[62]

— The fact that leasing is relatively accessible is closely bound up with the **risk assessment** of the financial transaction on which it is based: unlike a lender, a lessor has, in the leased good, a form of solid security and is thus faced with a low risk, even without additional guarantees. This of course presupposes that he is able to assert his ownership rights and that as yet unredeemed procurement costs can be recovered by selling the leased good in the market or by returning it to the producer.[63] Looking at the lessee side, the fact that outside collateral security or deposits are required only in exceptional cases goes some way toward widening the financing options open to a company. And in this case securities that are available can be used for other transactions.[64]

— Furthermore, the fact that a good is leased ensures that the **resources involved are clearly allocated**, and this implies a moral risk lower than that involved in borrowing. These risk-minimizing features of leasing also make it possible for banks engaged in leasing to develop untapped customer potentials as well as new markets.[65]

— For a company that, for lack of credit, has until now been compelled to use funds of its own to finance its investments, leasing offers the advantage of a **lower immediate liquidity drain**. And this makes it possible to reduce the high risk of insolvency implied by new investment projects, especially in their initial phase.[66]

— In addition, leasing agreements are often **more flexible** than credit agreements and can be adapted to individual lessee needs, e.g. by adjusting leasing rates for seasonal factors.[67]

Beyond thee advantages, a functioning leasing market may have positive impacts on a country's economic development: in this case leasing may boost private investment, and technical innovations can be used to build competitiveness. Taken together, these aspects can lead to sustainable economic growth and rises in the demand for labor.[68] The emergence of new actors, new products, and new investment potentials in a capital market may be expected to deepen a financial system and impart greater dynamics to it. This can mean further steps on the road to economic efficiency in the sense of adequate margins and financing options.

Yet it should be noted that the success of leasing is bound up with certain framework conditions that must be given at the macroeconomic, institutional, and legal levels. Internally, a leasing company's activities must be marked by cautious portfolio management, high cash-flow and risk-analysis standards, and a sound capital base.

61 Cf. Bitz (2000), p. 112.

62 Cf. World Bank Group (1997), p. 7. While there are no consistent figures available on the share of leasing agreements concluded with SMEs, the relatively low leasing costs of most of the leasing companies financed by the IFC and a large number of customers in some markets suggest that SMEs account for a significant percentage of their customers. Cf. IFC (1996), pp. 37f.

63 Cf. Kroll (1997), pp. 166f.

64 Cf. Bitz (2000), p. 124.

65 Cf. IFC (1996), p. 11; World Bank Group (1997), p. 10.

66 Cf. Kroll (1997), p. 155.

67 Cf. Kroll (1997), pp. 128f.

68 Cf. FTAA Consulting (1999), p. 10; IFC (1996), p. 12.

These conditions imply great challenges for leasing company management, and for this reason participation of a competent and committed (foreign) partner may be necessary, at least in the initial phase.[69] Developing countries often lack adequate refinancing capacities and the functioning second-hand markets needed to realize residual values. The tax legislation of developing countries, often marked by deficits in this respect, must be internally consistent and at least accord leasing the role of a promotion-worthy instrument on an equal footing with other modes of financing.[70]

The following chapter will look into the extent to which the advantages of leasing and venture capital are a promising option for Peruvian SMEs and whether the conditions required for a dynamic development of these instruments are given in Peru. With this in mind, the following section will analyze some characteristics and financing needs of SMEs in Peru.

4 SMEs in Peru and the Role of Financing

The following chapter first provides a brief outline of the makeup and the present situation of Peru's SMEs and then goes on to look into the structure and dynamics of the SMEs interviewed. The chapter then takes a look at the financing framework there, using the study's data to illustrate the financing situation of the companies included in the sample.

4.1 Peruvian SMEs: their Makeup and Present Situation

The Peruvian business sector is marked by a dual structure. There are on the one side a small number of modern firms that work with state-of-the-art technologies and are internationally competitive. On the other side we find a large number of formal and informal SSMEs that mainly secure the economic and social survival of their owners, but without generating enough income to accumulate capital, use modern technologies, or open up to new markets. Compared with its microenterprises, Peru's relative share of dynamic, competitive firms continues to be relatively small.

There is no unified, internationally accepted definition of the term SME, though the three most frequently used parameters are: *number of persons employed* (including the owner and the family members he employs), *fixed assets* (the value of machinery and equipment), and *annual sales*. In addition to these quantitative factors, qualitative criteria are also cited as defining features. With SMEs, for instance, there is generally a close link between ownership and liability for the outcomes of business activity, and the organizational structures of SMEs are often highly personalized.[71] Table 1 provides an outline for a tentative classification of Peruvian SMEs:

It is impossible to determine the exact number of SMEs in Peru, particularly in view of the fact that there are no exact, up-to-date figures available that accurately reflect Peru's business structure. An industry ministry (MITINCI) study analyzing business statistics for the period between 1990 and 1996 concludes that 98 % of a total of some 500.000 businesses are microenterprises, the remaining 10.000 firms being mainly SMEs.[72]

The small group of SMEs sees itself confronted with a number of problems that prevent these companies from utilizing their specific competitive advantages and developing into a one of the main pillars of the Peruvian economy. For instance, their generally low productivity is due, among other things, to insufficient and/or obsolete technical equipment. Low worker qualification levels, and inadequate know-how.[73] Peruvian

69 Cf. GTZ (1999), pp. 15f.; Havers (1999), pp. 48f.; IFC (1996), pp. 33f. and pp. 23f.

70 Cf. IFC (1996), p. 29; GTZ (1999), p. 9.

71 Cf. Wittneben (1997), p. 22.

72 Cf. Gallástequi / Villaran (1999), p. 134.

73 Cf. Documento Foro Nacional (2001), p. 8.

Table 1: Classification of SMEs			
Business type	**Number of persons employed**	**Annual sales in USD**	**Fixed assets in USD**
Microenterprises	Up to 10	Up to 125.000	Up to 25.000
Small enterprises	11 – 50	125.000 – 1.5 mio.	25.000 – 300.000
Medium-sized enterprises	51 – 200	1.5 – 20 mio.	300.000 – 4 mio.
Large enterprises	Over 200	Over 20 mio.	Over 4 mio.
Sources: García Dìaz (1998), p. 153; INEI (undated), p. 229			

SMEs are mainly concentrated in traditional industries with lower market-entry barriers and tend to produce simple consumer goods for the local market, which is characterized by permanent oversupply, low prices, and low quality.

If they are to remain competitive against foreign suppliers and large companies, Peru's SMEs must be enabled to play their own part in a business framework defined by functional specialization. This requires investments for modernization or expansion, and in most cases there are no funds available for the purpose.[74] Since in their investment-financing activities banks mainly focus on large companies, and SMEs have access, at best, to short-term, high-interest loans, these firms are unable to make necessary investments. This impairs their competitiveness, leads to declining wage levels, and in the end means insecure jobs and/or frequent layoffs.[75] To promote the growth potentials of Peruvian SMEs, it is therefore necessary to improve the access of this group of businesses to adequate financial services.

74 Cf. Barbachán (1999), p. 2.

75 Cf. Kuczynski / Zevallos (2001), p. 144; Barbachán (1999), p. 40.

4.2 Peruvian SMEs in the Textile and Agricultural Industries: Structure and Dynamics

The intention of present study was to select the dynamic, growth-oriented SMEs from the pool of the roughly 10.000 firms named above. Based on the assumption that such companies are most likely to be found in what is known as potential industries, two sectors were chosen for the sample, the textile and clothing industry and the agro-industry, which may be assumed to have a high potential for development and growth and a business structure typical for SMEs.

The Sectors

Peru's **textile and clothing industry**[76] accounts for a large percentage of the country's manufacturing industry[77] and is at the same time closely intertwined with some other sectors of the economy, e.g. agriculture. The sector is marked by a high degree of capacity utilization and average growth

76 The textile and clothing industry embraces the whole of the multi-stage manufacturing and distribution process for textile goods, from the fiber to the sale of finished articles of clothing.

77 The manufacturing industry accounts for an 8.6 % share of Peru's GDP. Cf. COFIDE (2001), p. 12.

rates of 10 %.[78] Furthermore, the textile and clothing industry is enormously important for employment, providing jobs for some 32 % of all persons employed in the manufacturing sector.[79] As far as exports are concerned, Peru's textile and clothing industry has notable comparative advantages, a fact due to the high quality of the primary goods it uses (e.g. alpaca wool and cotton), the sector's high level of integration in the vertical production process, a good supply of qualified workers, and the sector's relative proximity to its major sales market, the US.[80] And even though large companies continue to account for a major percentage of exports, the export share of SMEs is on the rise.[81] Since the early 1990s major investments have been made in the textile and clothing industry, a development that has been accompanied by technological innovation, the aim being to maintain and improve productivity and product quality. However, in this sector SMEs are increasingly hampered by their limited access to adequate financing, and the outcome is that they are unable to invest, or invest adequately, in technological innovations, a factor which has negative impacts on the productivity and competitiveness of the SMEs active in the industry.[82]

Peru's **agroindustry**, which accounts for 8.2 % of GDP, is an important and highly employment-intensive sector of the economy.[83] The country's comparative advantages in agriculture lie in its climatic and biological diversity and its real wage levels, which are relatively low in comparison to those of the industrialized countries.[84] In 2001, for instance, agricultural products accounted for an important share of 9 % of Peru's overall export earnings.[85] Although the growth rates for some traditional agricultural products like coffee have been declining for several years, a number of non-traditional products have recorded high rates of growth. The country already has developed processing chains and markets, e.g. for asparagus, mangos, marigold, grapes, and peppers.[86] Some of these products are exported mainly as fresh produce (e.g. marigold and grapes) while some others are in part processed in the country, e.g. canned asparagus and tomato paste or marigold meal.[87] The companies active in these areas are faced with high national and international competitive pressure, and the use of innovative processes is therefore essential here. If they are to effectively exploit their competitive advantages, SMEs active in the agroindustry are reliant on adequate financing for their long-term investments.

Company Structure

Due to the country's centralization, with its focus on the capital, it was necessary to conduct most of the study's interviews (32) in Lima. But to come up with a picture of the financing situation of SMEs in the provinces, interviews were conducted with an additional 10 companies in Arequipa and six companies in Cusco.

A total of 31 interviews were conducted in the textile and clothing sector, 15 of them with small companies and 16 with medium-sized firms. Of the 17 companies interviewed in the agricultural sector, eight were small and nine medium-sized. In keeping with the definitions used by many Peruvian financial institutions, the small and me-

78 Cf. Banco Wiese Sudameris (2001), p. 2.

79 Estimates of exact employment figures range between 150.000 (cf. Banco Wiese Sudameris (2001), p. 3) and 180.000 (cf. Barbachán (1999), p. 13). Some 15 % of these workers are employed in the textile industry and 75 % in the clothing industry. Cf. Barbachán (1999), p. 21.

80 Cf. Barbachán (1999), p. 78.

81 Between 1993 and 1997 SMEs accounted for 6 % of exports in the textile industry and 18 % of exports in the clothing industry, and – at least in the clothing industry – these percentage shares continue to rise. Cf. Barbachán (1999), pp. 30 und 32.

82 Cf. Banco Wiese Sudameris (2001), p. 11; Barbachán (1999), pp. 40 and 43.

83 Cf. COFIDE (2001), p. 12.

84 Cf. Apoyo Consultoría (2001), p. 7.

85 Cf. Prompex, [www.prompex.gob.pe/prompex/Inf_ Sectorial /Agro/Noviembre/Pag6.htm], (accessed on 17 Jan. 2002).

86 Cf. Apoyo Consultoría (2001), pp. 8f.

87 Cf. Apoyo Consultoría (2001), pp. 10 - 56.

dium-sized companies selected were classified solely on the basis of their annual sales figures (Table 2).[88]

Table 2: Annual Sales of the Companies Making up the Sample												
	Medium-sized companies, T&C industry			Small companies, T&C industry			Medium-sized companies, agroindustry			Small companies, agroindustry		
	∅	max	min	∅	max	min	∅	max	min	∅	max	min
Annual sales in mio. USD, Dec. 2001	8.3	20	2.4	0.585	1.5	0.0125	8.2	20	2	0.474	1.125	0.0125
Source: Authors' survey												

In evaluating the data, we found no noteworthy differences in the financing situation of companies in the two sectors, and for this reason the analysis of our interview data was, with a few exceptions, conducted on a cross-sectoral basis. Furthermore, we distinguished between companies in Lima and in the provinces only in cases where the factor of company location was found to play a particular role.

Looking at the employment intensity of the companies interviewed, we find that the agricultural sector creates fewer regular jobs than the textile and clothing industry, a factor bound up in particular with seasonal fluctuations in employment in the former sector. In addition to their regular workers, eight of the 17 companies interviewed employ seasonal workers, numbering, in some cases, more than 2000 persons. Three of the companies in the textile sector work together with independent suppliers.

As far as the **ownership structure** is concerned, the survey revealed that 39 of the companies concerned, i.e. the greater majority, are family-owned companies or companies founded and owned by the same person. In nine cases a minority partner was involved, either a friend of the owner or another company. Only six companies, five of them medium-sized companies from the agricultural sector, had an ownership structure involving different partners. The question of ownership is important for the development of venture capital to the extent that, as we found, companies with more than one partner tend to be more open to accepting additional partners than family-owned companies.

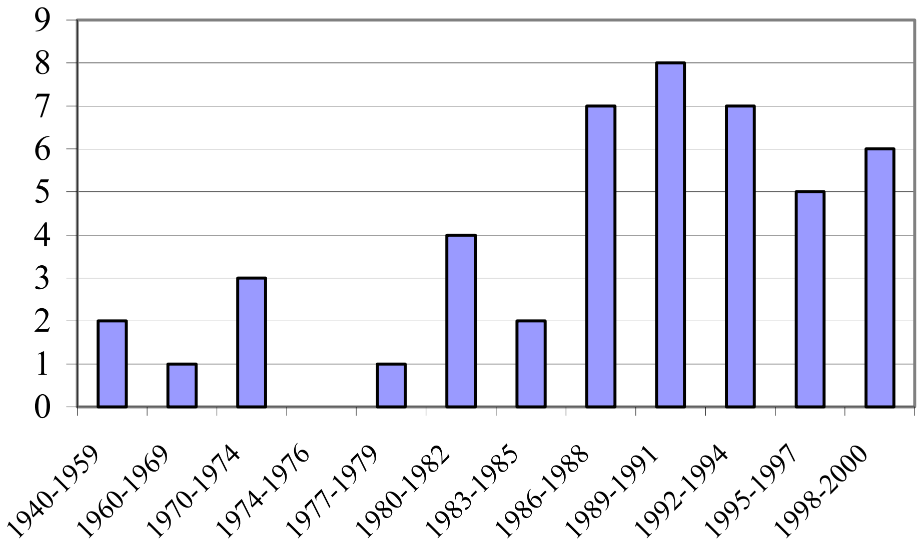
Our analysis of the **age structure** of the companies interviewed shows that nearly half (48 %) are young companies that were founded in the 1990s and thus have existed for less than ten years, which could be an indication of a special need for capital. 16 companies were founded in the 1980s, four in the 1970s, and only one has been in operation since the 1940s (Figure 3).

Investment and Innovation Activities

Productivity and competitiveness and the financing needs of SMEs are closely bound up with company investment activities and technological endowments. Generally speaking, modern and competitive technologies require sizable investments, while older, less productive technologies involve lower investments. Moreover, investment activity is an indicator of an entrepreneur's willingness and motivation to tackle new challenges, even under suboptimal conditions, e.g. in the face of scarce resources.

88 Among others, COFIDE defines companies exclusively on the basis of the parameter "annual sales", without reference to the parameters "workforce employed" or "fixed assets". For a classification of SMEs on the basis of their annual sales, see Table 1.

Figure 3: Year of Company Formation



Source: Authors' presentation

Our data on **investment activity** over the past three years show that only 11 % of the companies interviewed did not invest during the period under consideration. All other companies invested on average USD 457.000 per annum, which sums up to overall investments of USD 20.6 million. The median is USD 125.000 per annum. None of the companies interviewed directed 100 % of the sums they invested into replacement of machinery. The majority invested for expansion purposes, a fact which points toward dynamic management and growth in production. This investment activity is especially noteworthy in that the period under consideration was one marked by economic instability and recession.

The dynamics and creativity of SMEs can also be measured with reference to the innovation ratio implied by the investments made. While productivity growth is dependent on product and factor markets, what is needed for product market growth, input stocks remaining equal, is the introduction of new products. A **product innovation** may be based on the development of new products or merely on improvements of sales strategies, marketing, or designs.[89] The crucial factor is new ideas used by a company to secure competitive advantages and reach higher sales figures. Over half of the companies interviewed had introduced a product innovation in the three preceding years. While for some textile companies such innovation was restricted to a new collection, for others innovation meant coming up with a product unique to the Peruvian or a regional market.[90]

Aside from product innovation, **process innovation**, i.e. new, innovative production processes, may also mean reduced costs and sizable productivity gains. With five exceptions, all of the companies interviewed had made continuous innovations in their production processes in the preceding three years, e.g. by installing new computer systems or generally mechanizing operations.

89 Cf. Grömling / Lichtblau (1997), p. 13.

90 Examples would include the introduction to the Peruvian market of a certain synthetic thread or of particular materials for the construction trade.

The high level of investment and innovation in recent years points to the dynamics of the companies interviewed, and this is also confirmed by their future-oriented business planning. Our survey results on planned investment activities within the coming three years indicate that 70 % of our companies intended to invest in the foreseeable future. There is a difference here between small and medium-sized companies. While five of a total of 23 small companies did not plan to invest, for lack of capital among other reasons, nearly all of our medium-sized companies indicated that they intended to invest.[91]

In a comparison of the current level of business activity and the level anticipated in three years, companies in both sectors and companies from the SE and ME segment both see relative positive growth prospects (Table 3). Some of these companies even see growth of over 100 %, though in many cases this is predicated on the assumption that textiles and clothing articles made of Peruvian fibers will fall under the Andean Trade Preference Agreement (ATPA) and that Peruvian firms will gain improved access to financing resources.

4.3 Framework for Financing

Before looking into the financing situation of companies in our sample, we will, in the following section, discuss the framework conditions of the financing available to SMEs. In Peru the important elements include the institutional structure of the financial sector, monetary policy, and the volume and efficiency of Peru's financial system.

Table 3: Future Growth Expectations of the Companies Interviewed

	Total companies in %	Number of companies per sector			
		Medium-sized companies	Small companies	Textile companies	Agricultural companies
Strong growth (> 20 %)	48 %	12	11	14	11
Moderate growth (< 20 %)	33 %	10	6	10	6
Constant production level	17 %	3	5	7	2
Marked reduction (< - 20 %)	0	0	0	0	0
Moderate reduction (> - 20 %)	0	0	0	0	0
Not specified	2 %	0	1	0	0
Sum	98 %	25	22	31	19

Source: Authors' survey

91 Only two medium-sized companies from the textile and clothing industry intended to condition their investment decisions on the results of negotiations on APTA. In the framework of APTA the US is to grant the Andes countries, in particular those that show special commitment in the fight against drugs, tariff preferences on certain products. An enlargement of these preferred tariffs to include other products is currently under negotiation.

Institutional Structure of the Financial System

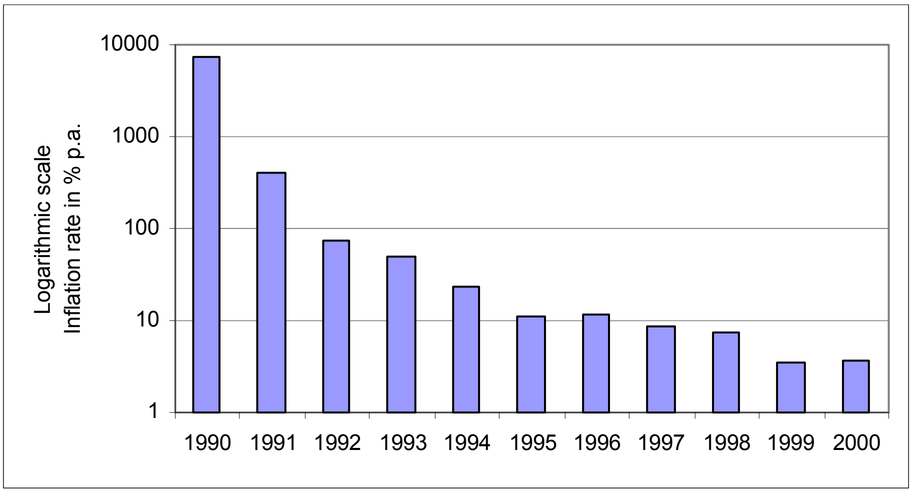
At the end of 2001 the institutional structure of Peru's financial sector had the following outlines: Aside from the central bank and the banking oversight authority SBS (*Superintendencia de Banca y Seguros*), the financial sector includes 15 private local commercial banks and five finance institutions. There are in addition 39 microfinance institutions, including rural and urban savings and loan associations, seven leasing companies, and six pawnbrokers active in Peru's financial market.[92] The numerous specialized government finance institutions encountered in the 1980s and primarily involved in directing financing resources into sectors assumed to hold promise for development were closed down in the wake of financial-market liberalization in the 1990s.

Monetary policy and some central features of Peru's financial system

Financial reforms conducted since the 1990s have substantially improved the framework conditions for financing in Peru. Apart from privatization of government-owned banks, elimination of interest-rate regulations, and introduction of supervisory standards in line with the Basel Concordat, one particularly important step was the establishment of an independent central bank. The paramount objective set for monetary policy was monetary stability, a goal that has been consistently pursued and has found expression in a continuous decline in inflations rates (Figure 4). An inflation rate of 2.5 % is anticipated for the year 2002.[93]

The monetary anti-inflation instruments used by the central bank have in some cases had the effect of restricting the expansion of the supply of financing resources available. For instance, commercial banks are required to hold **high minimum reserves** with the BCRB. The minimum reserve requirement for deposits in domestic currency is 6 %, and for deposits denominated in USD the figure is 34 %.[94] In a highly dollarized economy like Peru's, high minimum reserve requirements serve to limit money supply growth in foreign currency and to increase hard currency reserves as a buffer against the risk of any sudden outflow of capital abroad. On the other hand, these reserve

Figure 4: Annual Inflation Rate in Peru, 1990 – 2000



Source: Author's calculations, based on BCRP, [www.bcrp.gob.pe]

92 Cf. SBS (2002), p. 43.

93 Cf. BCRP (2002), p. 9.

94 Cf. IMF (2001), p.76.

requirements constitute a major burden for commercial banks, limiting the credit supply and inhibiting the mobilization of savings.

Moreover, **high interest rates** are an obstacle to outside financing (Figure 6). Since liberalization the BCRP has exerted no active influence on interest rates, and both interest rates and exchange rates are determined by the market mechanism.[95] However, liberalization was followed by a sharp rise in real interest rates, a trend that has only gradually been reversed since then.[96]

Another monetary indicator that gives cause for concern is the marked **dollarization** of the Peruvian financial sector. Currency substitution got underway in 1977 with the introduction of USD-denominated so-called CBME certificates, a liquid monetary investment vehicle aimed at restricting capital exodus and building currency reserves.[97] Contrary to the expectation that the degree of dollarization experienced subsequent to reorganization of the financial sector and stabilization of the domestic and external value of the nuevo sol would decline on its own, currency substitution continued to increase in the 1990s. If in 1989 42 % of all deposits and 34 % of all loans were denominated in USD, the corresponding figures for 2001 were as high as 71.5 % and 80.1 %, respectively.[98] This growing dollarization indicates that economic actors lack confidence in the domestic currency and are largely unwilling to enter into borrower-lender relationships based on the nuevo sol.

Dollarization also has implications for monetary and currency policy. On the one hand, the central bank's control capacity is limited since a large share of the money in circulation is beyond its influence. On the other hand, any deterioration of the domestic currency's external value implies risks for the stability of the banking sector and/or for companies with debts in foreign currency if the latter do not earn sufficient foreign currency. However, Peru's loss of monetary control capacity is no longer seen as problematic, indeed there have even been some calls for a complete dollarization of the economy.[99]

Volume and Efficiency of Financial Intermediation

In Latin America financial intermediation is largely dominated by the **banking sector**, an observation which holds for the structure of Peru's financial system as well. In 2001 Peruvian commercial banks handled some 90 % of all national lending operations and administered 85 % of all financial assets.[100] Bank deposits account for the main share of household saving, and bank loans are the most important mode of outside financing for businesses.

Two indicators can be used to estimate the **volume** of the banking sector, i.e. its size and activity. The first, quantitative indicator used is normally the ratio of M3 to GDP.[101] In Peru this ratio, also referred to as financial deepening, was roughly 31 % in 1999. While this means that the financial depth of the Peruvian banking sector has nearly doubled since 1992 (15.7 %), the figure is low by comparison with other countries. While the figure for Peru's neighbor Ecuador is 34 %, the corresponding value for Chile is 51 % (Figure 5). The second indicator of banking-system volume is the ratio of overall banking-system assets to GDP. Here the figure for Peru is roughly 37 %, while the corresponding figures for Chile and Ecuador (1998) are 60 % and 48 %, respectively.

95 Cf. BCRP, [www.bcrp.gob.pe/Espanol/Wotros/Pre-Fre-Polit.htm], (accessed on: 19 Jan 2002).

96 Cf. Kiefer (1998), p. 147.

97 Cf. Urljevic / Hector (1985), p. 236.

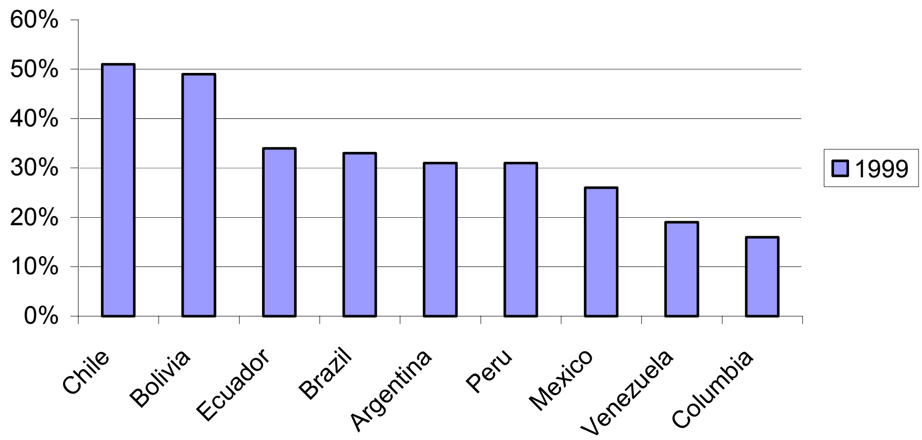
98 Cf. SBS, [www.sbs.gob.pe], (accessed on: 01 August 2002).

99 Cf. Müller (2001), p. 237.

100 Cf. SBS (2002), p. 43.

101 Cf. Demirguç-Kunt / Levine (1999), p. 6. In Peru this ratio, also referred to as financial deepening, was roughly 31 % in 1999.

Figure 5: Volume of Financial Intermediation Across Latin America (1999)



Source: Authors' calculations, based on IMF, Financial Statistics Yearbook

Banking-system **efficiency** is also measured with the aid of two indicators. The first indicator is formed on the basis of the ratio of operating costs to overall banking-system lending. Low relative operating costs indicate higher efficiency, and higher operating costs are a sign of inefficiency or a lack of competition in a banking system.[102] While in the period between 1992 and 1999 the average relative operating costs of banks in 63 countries under consideration were 4 %, the figure for Peru in the same period was 10 %.[103] The second indicator uses the net interest margin, i.e. the ratio of interest revenues to interest costs. Narrow interest margins indicate greater competition and higher efficiency. While the average value calculated for 63 countries in the period from 1992 to 1999 was 4 %, the corresponding figure for Peru was 8 %. However, this figure does include the additional fees charged, which further raise the actual interest margin. On the whole, the interest margins in Peru point to low efficiency in the Peruvian banking sector (Figure 6).

The share of financial assets mediated by the **financial market** is traditionally low in Latin American countries, a factor that is reflected in the Peruvian financial market. While in 1999 the private sector received loans amounting some USD 14 billion, the value of obligations and stocks issued by the nonfinancial private sector was only USD 543 million.[104] The main features of the Peruvian financial market are its low volume and the low liquidity of many stocks and bonds. The **volume** of financial markets can be determined with the aid of two indicators. Market size is reflected by market capitalization, i.e. the ratio of the value of all stocks listed at a given point of time to GDP. In the period between 1992 and 1999 Peru had an average ratio of 11 %. This figure is comparable with Ecuador's market size (11 %), but far lower than the figure for Chile (84 %).[105] In the year 2000 Peru's market-size figure was 20 %. Market activity (or market liquidity) is determined by forming the ratio of

102 One sign of a lack of competition in the Peruvian banking system is the high concentration of banks in it; this is measured as the loan and deposit share of the three largest banks in the system. In the last quarter of 2001 the share of the three largest banks in Peru (Banco de Crédito, Banco Sudameris, Banco Continental) was 63.3 % and 72.9 %, respectively. Cf. SBS (2002), p. 47. In addition, there is also a regional concentration of the banking sector in Lima – Callao.

103 Cf. Demirguç-Kunt / Levine (1999), Appendix, Table 1.

104 Cf. Instituto Apoyo (2001), p. 3.

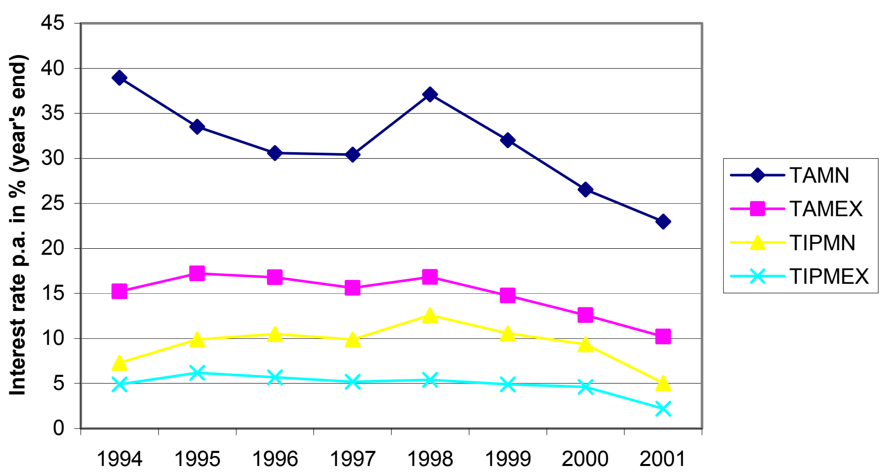
105 Cf. Demirguç-Kunt / Levine (1999), Appendix, Table 5.

trade to GDP. For the period between 1992 and 1999 the market-liquidity ratio was 4 %. Ecuador has a lower market-liquidity ratio (1 %), while the corresponding figures for Chile and Germany are 9 % and 28 %, respectively.[106] **Market efficiency** is measured on the basis of the ratio of market activity of trade to the overall value of stock. Here the figure for Peru was 8 % in the year 2000. This figure likewise indicates a relatively low efficiency of intermediation for Peru's financial market.

All told, Peru's financial sector cannot be said to fully fulfill its intermediary function, and this lack of financing capacity has highly adverse impacts on SMEs. At present Peru's underdeveloped financial markets thus do not offer any adequate alternative modes of financing for SMEs, and this in turn means that the country's banking system plays the dominant role in financing the private investments of this business segment. But bank loans are scare and costly. One particular obstacle to the development of business activity in Peru is inadequate access of businesses to long-term investment loans. If they are made at all, investment loans with appropriate repayment periods go mainly to large companies.[107]

Inadequate access to investment loans via the **banking system**, which are cost-intensive and/or limited in nature, is attributable to several different factors. Thanks to their often inadequate organizational and information structures, their lack of acceptable securities, and the fact that they are often not properly registered, Peruvian SMEs are rated by commercial banks as highly risky. Furthermore, transformation of short-term capital investments into long-term credits appears highly risky to many financial intermediaries, the result being that at present only relatively few long-term loans are made.[108]

Figure 6: Average Debit Interest and Credit Interest in the Peruvian Banking System, 1994 – 2002



Source : Author's calculations, based on BCRP, [www.bcrp.gob.pe] (accessed on: 30 May 2002)
TAMN: Interest on credit in domestic currency
TAMEX: Interest on credit in USD
TIPMN: Interest on deposits in domestic currency
TIPMEX: Interest on deposits in USD

106 Cf. Demirguç-Kunt / Levine (1999), Appendix, Table 5.

107 Cf. Barbachán (1999), p. 40.

108 Cf. Kiefer (1998), p. 149.

Aside from the "risk structure" of SMEs, an additional factor behind the reticence of banks to lend is the susceptibility to crisis and the lack of competition in the financial sector. For the financial system, the 1998 financial crisis meant growing liquidity and solvency problems. The restructuring processes that followed (mergers and closures) entailed a highly conservative lending strategy coupled with a policy of high interest rates.[109] Furthermore, The lack of competition for alternative financing options led to a situation in which banks and finance institutions are without any sufficient incentive to lower their intermediation costs and profit margins with a view to lowering their lending fees.[110]

At present the Peruvian **financial market** likewise offers no adequate financing possibilities for SMEs. For the most part, SMEs fail to meet the crucial criteria set by issuers of stock, e.g. transparency (of information). Moreover, the financing needs of SMEs are as a rule too low to permit issuers to cover their fixed costs. Current transaction costs in Peru required a minimum issue volume of USD 10 million;[111] this means that national issues of stock presuppose a certain company size and solvency, and this in turn constitutes a virtually insurmountable obstacle to SME access. Only a minority of large Peruvian companies have the option of financing their investments through the stock exchange.

4.4 SMEs from the Study's Sample: Financing Situation and Behavior

In Peru access to financing resources constitutes a twofold obstacle to business development. On the one hand, the great majority of Peruvian companies are excluded from the country's financial system and are forced to fall back on informal-sector sources of financing or to finance their investments from their own resources, a situation highly deleterious to their chances and prospects of growth. On the other hand, companies that have access to formal sources of financing are often faced with conditions that are so unfavorable that they hinder returns on capital or indeed block investments from the very start.[112]

The companies interviewed in connection with the present study belong to the group of business that have access to bank loans. When asked, 90 % of these companies indicated that they had recently obtained loans from commercial banks. The reason why the remaining 10 % did not seek bank loans to finance their investments must be sought in their risk aversion or their insistence on financial autonomy. Only two companies were refused bank financing loans because of their high credit risk.

Apart from the significant role played by bank loans in company financing, the most important means of financing for the companies in the sample were self-financing from profits, write-offs, and reserves. 94 % of these companies made use of this form of financing. This is followed, in order of ranking, by bank loans (90 %) and supplier credits (46 %). Other sources indicated included partner investments (36 %) and capital contributions of new partners (15 %).

This financing structure is reflected in the moderate debt ratio and the good equity base of the SMEs interviewed. While the small companies have an average equity ratio of 60 %, the corresponding figure for the medium-sized companies is 43 %. By way of comparison, the average equity ratio of German SMEs is 17.5 %, a fact which points to the traditionally high level of bank financing among German firms.[113]

As far as the terms of financing are concerned, the survey's findings show that the great majority

109 Cf. Instituto Apoyo (2001), p. 2.

110 Cf. Hallberg (2001), p. 11; MEF (2001b), pp. 14f.

111 Cf. Instituto Apoyo (2001), p. 2; MEF (2001a), p. 25.

112 Cf. MEF (2001a), p. 4.

113 In industrialized countries an equity ratio of between 35 % and 40 % is generally regarded as propitious for business development. Cf. Deutsche Bundesbank (1994), p. 78.

(78 %) of companies interviewed are dissatisfied with the financial services available, a fact due, as will be explained in more detail below, to insufficient access to bank loans, excessive interest rates, and short repayment periods.

Although in principle the SMEs interviewed have access to the formal financial system, the **supply of bank loans** available to them is **insufficient** and their requests for credit are often not met. The majority of these companies have, for instance, been turned down by finance institutions at least once on requests for loans. The reasons indicated were, first, their inability to provide sufficient security, second, their insufficient equity ratios, and, third, the high levels of risk posed by an investment project.

This insufficient access to bank loans is also reflected in these companies' high equity base, which is far in excess of the measure regarded as adequate in industrialized countries. Although this figure has to be adjusted for countries with higher interest rates or higher-risk sectors, the far higher equity ratio of up to 60 % mentioned above indicates a restrictive bank lending policy for certain business sectors.

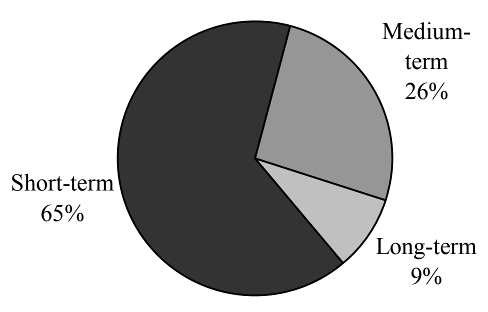
In the opinion of the firms interviewed, the financing bottleneck observed has negative impacts on business growth. All told, 34 of the 48 companies interviewed assume that they would have achieved better growth figures if they had had better access to bank credit. The companies often indicated that they were, at a given point of time, unable to take advantage of good market chances, or indeed that they had lost clients, for lack of sufficient credit lines. Only a small number of these companies sees their problem less in limited access to bank credit than in blocked access to markets. Only a few of our companies are risk-averse; i.e. they prefer to get along without outside financing, even though this means slow growth.

Against the background of an insufficient supply of outside capital, and despite their theoretically adequate degree of capitalization, 23 companies responded in the affirmative when asked whether they would have experienced more growth if more equity capital had been available to them. This view is shared in particular by firms from the agricultural sector, which repeatedly pointed out that their sector is marked by a lack of equity capital, a fact which constitutes a serious obstacle to development in the sector.

Apart from insufficient availability of outside capital, **high interest rates** pose a further obstacle to the development of SMEs. Only a few, in particular large, companies are granted reasonable interest rates that enable them to operate competitively. While the medium-sized companies in our sample pay an average interest rate of 11.5 % (in USD), small companies are forced to pay an average of 15.6 %. Apart from a few companies which have been able to make all of the investments they require despite the high interest rates demanded of them, the greater majority have been forced to refrain from making planned investments because of the high costs of credit. Furthermore, companies active in the export sector see high interest rates as a disadvantage to them in competition with foreign firms, which have access to financial resources on more favorable terms.

If we look at the **repayment periods** of financing contracts, our sample indicates that short-term periods tend to be predominant (Figure 7). In the

Figure 7: Repayment Periods for Credits to Firms in our Sample



Source: Authors' presentation

majority of cases the credit agreements signed have repayment periods of less than one year.

Only 9 % of our companies indicate that their loans have – on average – a term of over five years.

We must note here that repayment periods are as a rule somewhat longer in the agricultural sector. For instance, the longest repayment periods granted to companies in the sample – on average 5.4 years – were accorded to agricultural enterprises, while companies from the textile and clothing sector were granted no more than an average of 2.4 years. On the whole, the great majority of the companies interviewed were dissatisfied with the terms offered by banks, noting that these were not in line with company needs. Only 12 companies were satisfied with repayment periods, and these are precisely the companies that were granted longer-term loans.

These short repayment periods impacted on our companies in two different ways: on the one hand, these companies have been unable to make certain investments. On the other hand, to be able to invest despite this situation, these companies fall back on other financing mechanisms such as short-term working capital loans, which in turn can seriously jeopardize a company's liquidity. All told, short-term outside financing constitutes a grave problem for the companies interviewed in that this approach increases cash-flow pressures and at the same time requires these firms to tie up the few securities available to them, which means that the latter are no longer available for long-term, future-oriented investment projects.

To come up with a more exact picture of the importance of the lack of long-term credit in relation to other bottlenecks affecting company development, we presented the companies interviewed with a list of possible problems.[114] We found that the lack of long-term credit is perceived as the major obstacle to company development. In declining order of importance, the companies specified the following factors as obstacles: fluctuations in demand, lack of equity, and national and international competition. On the other hand, our companies saw availability of qualified manpower as unproblematic (Figure 8).

For the future, the majority of the companies interviewed, and in particular the small firms in the textile industry, see continuing problems in financing investments. In view of the present lack of alternatives, the companies indicated that they intended to fall back on the same financing instruments that they had used in the past. This could entail negative impacts on the liquidity in their sectors, since, as noted above, company operating resources are in many cases used to finance investments.

The results of the survey reflect the predominately insufficient supply of financing provided by the Peruvian banking system for SMEs, in particular as far as long-term instruments are concerned. Especially in view of the fact that most of the companies interviewed expect to grow, a better supply of financial resources tailored to the individual needs of SMEs would contribute both to a more efficient allocation of capital and, in the long run, to economic growth. Against this background it would appear reasonable to promote alternative financing mechanisms and the markets associated with them, especially since this could be expected to increase competition in the national financial system, and this in turn could set incentives for Peruvian banks to direct more of their attention to SMEs as a target customer group.

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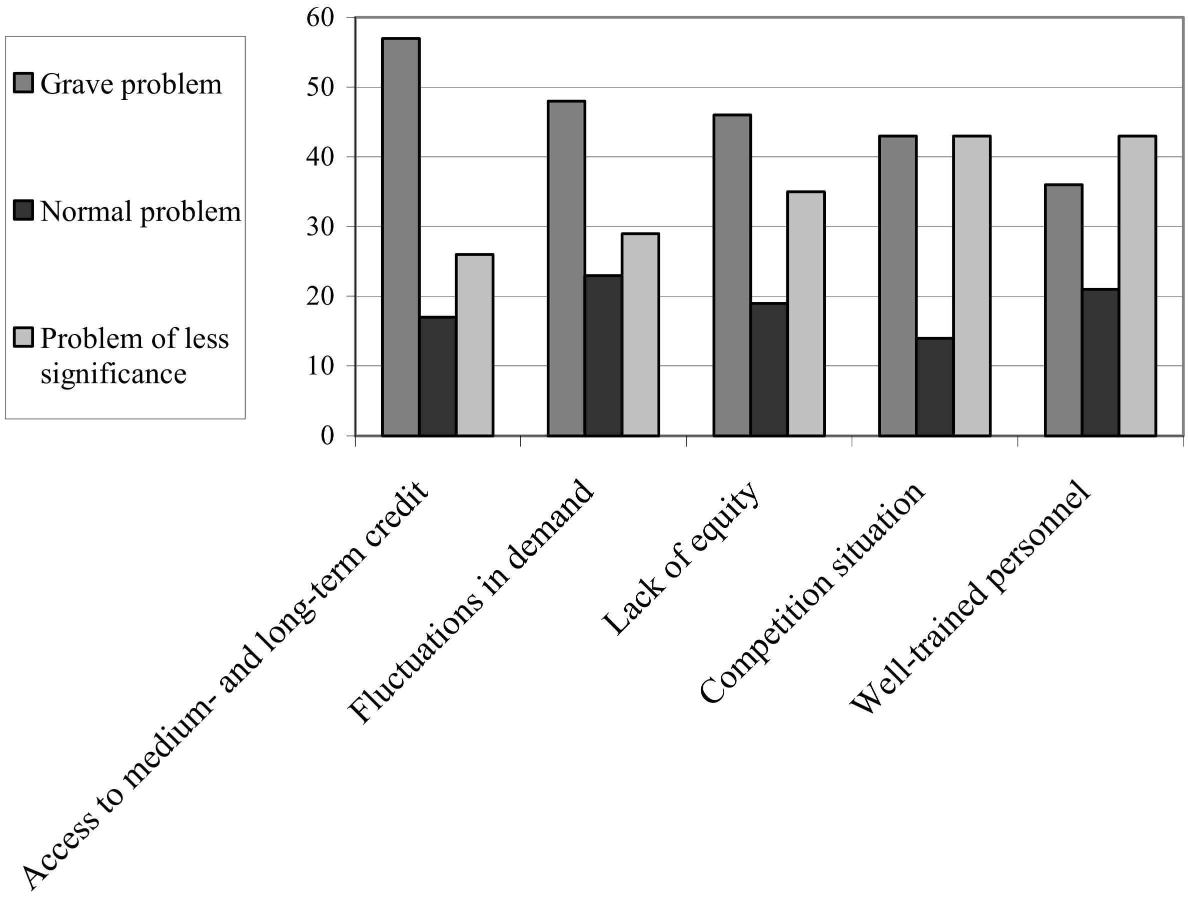
114 In this context the companies were asked whether they would rate the aspects named as a "grave problem", a "normal problem", or a "problem of less importance".

Figure 8: Aspects with Impacts on Company Development[a]



Source: Authors' presentation
[a] In percentage of mentions

5 Venture Capital in Peru

Projects that banks are unwilling to finance because of the higher degree of risk they entail, can often be efficiently financed through mechanisms based on equity instead of outside capital. The following chapter deals with the development of the venture-capital market in Peru. It starts out by looking into the current situation of the Peruvian venture-capital market and then goes on to analyse, on the basis of the survey data, the economic and legal conditions required for the development of a venture-capital market and the institutional setting, i.e. potential investors, CICs, and companies, involved. The results of the survey are based on interviews with experts as well as on interviews conducted with 15 potential investors and three institutions that are interested in launching a fund in Peru. Section 5.7 also makes use of the interviews conducted with the 48 companies of our sample.

5.1 Development of the Venture-Capital Market in Peru

Due to the advantages offered by venture capital for company financing (see Section 3.2), efforts are being made worldwide to set up venture-capital funds. In Peru, too, this alternative mode of financing is being supported by public- and private-sector actors like the national securities oversight commission (*Comisión Nacional Supervisora de Empresas y Valores/*CONASEV), the Ministry of Economics and Finance (*Ministerio de Economía y Finanzas*/MEF), COFIDE, and the trade association *Procapitales*, in particular with a view to improving the at present underdeveloped Peruvian venture-capital market. It was only in the early 1990s that the country's first investment funds emerged; but their activities concentrated primarily on large national enterprises. At present there are a total of four such funds registered with the oversight commission, two of them specialized in real estate financing, one in stock, and one in short-term investments.[115]

While there at present no venture-capital funds are registered in Peru, two foreign funds are operating in the Peruvian market: FAPE (Box 1) and CDC Capital, a venture-capital fund run from Bolivia.

Box 1: FAPE *(Fondo de Asistencia a la Pequeña Empresa)* – a Fund for the Support of small Companies

FAPE is at present the only venture-capital fund in Peru specialized in supporting small and medium-sized companies, which are defined by FAPE as firms employing fewer than 100 persons and having annual sales figures of less then USD 2 million and fixed capital assets of less than USD 500.000. Under the management of the US Small Enterprise Investment Fund (SEAF), FAPE, registered in Panama in 1996, began investing in Peruvian SMEs in 1997. The fund, which has total capital assets of USD 7.25 mio., is financed by multi- and bilateral institutions like the Multilateral Investment Fund (FOMIN), the Netherlands Investment Bank (FMO), the *Caja Andina de Fomento* (CAF), and the Peruvian development bank COFIDE. Between 1997 and 2001 FAPE made a total of 17 investments ranging between USD 60.000 and USD 350.000 per company and acquired company shares ranging between 25 and 49 %. In late 2001 SEAF transferred its fund-management responsibilities to APOYO, a Peruvian institution.

The experience gained thus far by FAPE has not been entirely positive. For instance, the development-oriented objectives aimed for by investors – e.g. creation of new jobs, productivity growth, and upgrading of the formal status of companies – have proven successful in some cases. At the same time, two profitable buybacks of shares, terminating investments, have proven clearly that capital investments in SMEs can be profitable and that such investments can in fact be effectively terminated.

However, the fund has been faced with major profitability problems. For instance, the volume of the fund, some USD 7.5 mio., has turned out to be economically inefficient. The general assumption is that to operate profitably a fund specialized in small enterprises has to demand a standard fund-management fee of roughly USD 500.000. FAPE's small size and the management fee of 7.7 % it demanded led to a 30 % loss of its capital assets within its first four years of operation. Especially in its first two years, FAPE invested mainly in small enterprises, and for this reason its average investment level was only USD 180.376. The necessary "standardization" of small firms, which required considerable additional technical support, e.g. in accounting, led to substantial costs, and it thus turned out that it is particularly difficult to achieve a reasonable cost-income ratio in this market segment. A further obstacle emerged in the conflict of interests between commercial and development-oriented goals. Due to its original development orientation, for instance, FAPE's organizational structure lacked an incentive system sufficient to operate profitably and achieve good project results. Furthermore, frequent replacements of board members led to losses of valuable experience and prevented any continuity in the fund's decision-making process and "investment philosophy."

All in all, the experience of FAPE illustrates that there are in the Peruvian market both demand for venture-capital investments and a sufficient number of SMEs with major growth potential. Furthermore , three factors essential to the success of a venture-capital fund appear to be: an adequate fund structure (investments volumes), qualified personnel, and a unified orientation to the fund's objective.

Source: Expert interview conducted with SEAF on April 19, 2002

115 Cf. CONASEV, [www.consev.net.gob.pe/Portal/Estadistica/Anuario/Anuario2001.pdf], (Accessed on: 27 April 2002).

Aside from these two active funds, four other venture-capital projects relevant to the Peruvian venture-capital market must be mentioned here: MERHAV, a group of private investors that operate in a manner comparable to that of venture-capital funds, and VIP (Value Investments Peru), which likewise cannot be classified as an institutional venture-capital fund, since the capital it invests stems not from a fund but from one individual investor. An additional fund interested in venture-capital investments, the PPF (Peru Privatization Fund), is in the process of liquidation and thus no longer invests, and the CFI (*Corporación Financiera de Inversiones*) does not actually invest itself, though it does plan new equity-investment projects. The low number of actually active equity-investment funds and quasi-equity instruments indicates that the Peruvian venture-capital market is very limited. At the same time, however, there is considerable interest in developing this market and launching new funds geared to financing SMEs. At present some two or three institutions have plans to initiate venture-capital funds.

5.2 Essential Conditions for the use of Venture Capital: the present state in Peru

The basic condition required for the development of venture capital as an alternative source of financing for SMEs is the existence of a conducive economic and legal framework and a functioning and active capital market.

Positive **economic development** and confidence in future economic stability are factors that are particularly important for the use of venture capital, since in providing such capital investors enter into a medium- to long-term obligation. Above-average yield expectations can, furthermore, best be achieved if the companies concerned have a positive economic setting in which to develop their growth potential. As the case of Chile clearly shows, one aspect essential to the emergence of a venture-capital market in developing countries is the point of time at which the first funds are set up: the first venture-capital funds in Chile went into operation in 1993/94, in a period of economic upturn which soon weakened, drifting into recession in 1998. Many of the investments made in the boom phase proved unsuccessful, and the growth and yields expectations of these funds failed to materialize. Furthermore, the negative experience made here proved for several years to be an obstacle to the further development of the Chilean venture-capital market, a factor which illustrates the important signal effect of initial efforts to establish venture-capital funds.[116] The Peruvian fund managers interviewed in connection with the present accordingly study see positive prospects for investments in particular when such investments are made in a recessionary phase and are then able to profit from gains made during a subsequent upturn of the business cycle.

Following a period of weak, or indeed even negative, economic growth in Peru over the last three years, experts are now predicting growth of 3.0 % to 3.7 % for the year 2002.[117] In other words, at present the investment climate for venture capital can be seen as quite positive in Peru. However, asked for their assessment of the relevance of economic development, fund managers on the whole tended to see this factor as less significant, noting that careful selection and support of companies can lead to positive results even under unfavourable economic framework conditions. On the other hand, the investors interviewed see a positive economic picture as an important factor for the success of venture-capital funds.

A further important condition for the smooth functioning of a venture-capital market is a stable and clearly defined **legal framework**. In industrialized countries investors can fall back on a functioning legal framework and enforce their rights in court. This is not always the case in developing countries. While many such countries have func-

116 Cf. Equitas Partners (2001), pp. 6f. The present study also found that this negative development of venture-capital funds was also due in part to a lack of experience on the part of fund managers.

117 Excepting Bolivia und Ecuador, Peru thus has the most positive growth prospects of all countries in Latin America. Cf. Sangmeister (2002), p. 5.

tioning tax and company laws, these laws often hinder flows of private capital and make it difficult and time-consuming to enforce claims. The most important problem areas for venture capital are bound up with protection of the rights of minority shareholders, the options open to companies to restructure their capital, concrete legislation governing investment funds, and corporate taxation.[118]

The present study looked into existing legislation with an eye to its application to venture-capital funds. Furthermore, potential investors were asked for their assessment of whether the present legal framework constitutes an impediment to the development of the venture-capital market. The study found that a large majority of investors regard the legal framework in Peru as adequate and conducive to investment. Compared with other countries of the region, it was noted, there are no problems involving protection of minority shareholders or company buybacks of shares, and as far as its legal framework is concerned, Peru is seen as having regional competitive advantages.

While it has no specific legislation covering venture-capital funds, Peru in 1996 enacted a law on investment funds[119] that also allows for venture-capital funds. The law was amended in January 2002, one of the aims being to facilitate the establishment of investment funds. To this end, the amended law raises the maximum share that one investor may hold in a fund from 25 % to 33 %. For a period of three years (as opposed to the period of six months previously provided for), the organizers of new funds are now allowed to hold a share larger than this maximum figure,[120] and so, theoretically, one investor could launch a new fund, which would then be required to seek at least two new shareholders in the course of three years. Another step decided on to facilitate the establishment of new investment funds was to permit investors to contribute nonmonetary assets to a fund.[121] Some other important amendments to the law include measures aimed at protection of investors; the latter are now entitled to a refund of their investment if they wish to withdraw from a fund, e.g. because of an amendment to fund statutes,[122] and now are better protected against any possible irregularities on the part of CICs.[123]

The administrative regulation on the law on investment funds[124] was also revised and was set to come into effect in June of 2002. In this new regulation the supervisory authority, CONASEV, sets out highly detailed individual regulations, ranging from the establishment of a fund and its entry in the official list to the liquidation of a fund. But the new regulation also leaves a number of points concerning investment funds open, or in some cases even works to their disadvantage. For instance, the new regulation contains a provision according to which a fund is permitted to begin investing only when all of its investors have fully paid in their shares, specifying a time frame of nine months for this purpose.[125] Investment funds normally operate with so-called capital calls, i.e. the funds committed are called in by investors when needed.

The following section looks into the official regulations on various potential investors. But it should be noted here that our some of interviewees voiced criticism of the lack of coordination among the competent government authorities.

118 Cf. Mayoral / Baptista (2001), p. 5.

119 Cf. Ley de Fondos de Inversión y sus Sociedades Administradoras (Decreto Legislativo N° 862, amended on 19 Jan. 2002 by Ley N° 27641).

120 Cf. Ley de Fondos de Inversión y sus Sociedades Administradoras, Article 28.

121 Cf. Ley de Fondos de Inversión y sus Sociedades Administradoras, Article 5

122 Cf. Ley de Fondos de Inversión y sus Sociedades Administradoras, Article 3.

123 Cf. Ley de Fondos de Inversión y sus Sociedades Administradoras, Article 13 A-C.

124 Reglamento de Fondos de Inversión y sus Sociedades Administradoras (Resolución CONASEV N° 002-97-EF/94.10). The new regulation was to come into effect in June 2002 (Resolución CONASEV N° 074-2001-EF/94.10).

125 Reglamento de Fondos de Inversión y sus Sociedades Administradoras (Resolución CONASEV N° 002-97-EF/94.10), Articles 45 and 53.

One examples cited is that the supervisory authority responsible for banking and insurance, SBS, has not adapted the regulations on pension funds (AFPs) to take account of the new provisions of the amended law on investment funds. While the new law raises the maximum share of a fund held by one investor from 25 % to 33 %, Peru's private pension funds (AFPs), the most important investors in the Peruvian capital market, continue to be restricted to a share of 25 %.[126]

Another important aspect bound up with the legal framework in Peru is **tax legislation**. A majority of potential investors regard the latter as an obstacle to the development of the venture-capital market in Peru. What is at issue here is the fact that funds are required to pay income tax, and for them this means a double tax burden, since investors are also obliged to pay income tax on their earnings from a fund. Until now this case has been avoided by granting temporary exemptions on the tax on capital gains earned from listed funds.[127] Among those who see themselves as particularly discriminated against by the existing arrangement are the four private pension funds (AFPs), which are entirely exempt from taxes and now see taxation of investment funds as a threat to the returns they offer compared with other possible investments. One of our interviewees emphasized that he would not invest in a venture-capital fund as long as the tax situation remains as it is. Furthermore, representatives of the AFPs noted critically that the new legislation fails to set any clear-cut incentives geared to promoting the investment-fund market.

There is, however, also a draft bill on the agenda that would tax investors instead of funds, which would be in line with standard international practice. Another proposal provides for temporary tax exemptions for earnings from share sales made outside the stock exchange.[128] While this proposal aims specifically to promote investment funds, it would not entail the final clarity on taxation called for by some potential investors.

Finally, a smoothly functioning and active **capital market** would mean more transparency concerning the investment behavior of institutional and private investors, a factor of some importance in successfully terminating investments in venture capital. One crucial factor for CICs is the existence of a high-volume primary market in which company shares are placed in initial pubic offerings and in which CICs can sell their company shares as profitably as possible.[129] Between 1990 and 2000 Peru experienced only eight initial public offerings, which meant that at the end of 2000 only 0.7 % of the securities in circulation – 2.2 % of GDP – was attributable to initial public offerings; this places Peru far down the list behind other countries in the region (Figure 9).[130]

The weakness of the primary market for company shares is due on the one hand to the high transaction costs involved in placement and on the other to a low-volume secondary market. Without a liquid secondary market it is impossible for a buyer to resell a newly issued share profitably at a given point of time. The volume of sales in the secondary market developed positively in the wake of liberalization in the early 1990s, but it has declined sharply since 1997 (Figure 10).

126 Cf. Reglamento de la Ley del Sistema Privado de Pensiones (Decreto Supremo N° 004-98-EF), Article 65.

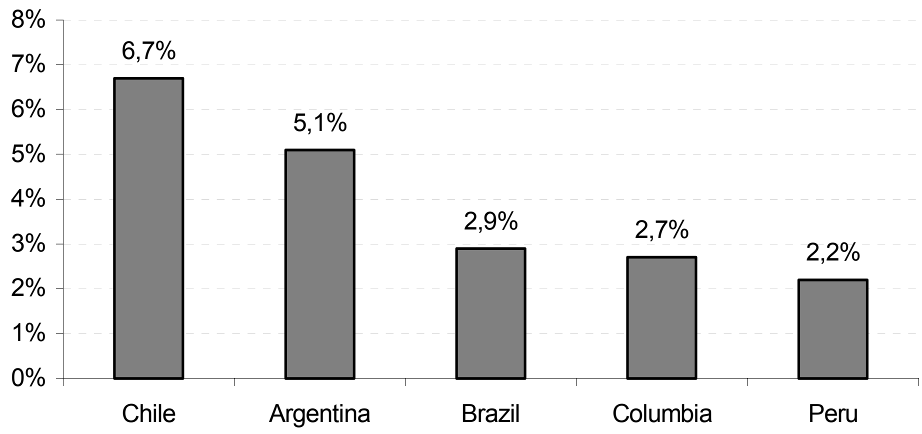
127 Cf. Texto del Impuesto a la Renta (Decreto Legislativo N° 774), Article 19. This tax exemption was set to end on 31 Dec. 2002, though the experts interviewed expect it to be renewed.

128 Cf. MEF (2001a), p. 45.

129 In Germany initial public offerings doubled as a percentage share of possible exit variants in the 1990s, a fact due mainly to the establishment of the *Neuer Markt* in 1997 and the growing acceptance of investments in securities among the German population. Cf. Geigenberger (1999), p. 28; Kaufmann / Kokalj (1996), pp. 68f.; Butzmann (1999), p. 27.

130 Cf. MEF (2001a), pp. 18 - 21.

Figure 9: The Importance of the Stock Exchange as a Source of Financing in selected Latin American Countries (2000)[a]



Source: Ministerio de Economía y Finanzas (2001), p. 18

[a] Measured as the ratio of shares issued to GDP. Data for Peru from 2000, all other country data from 1998

A deteriorating economic picture that forced many investors out of the market highlighted the market power of the small number of institutional investors, in particular AFPs, whose buy-and-hold policy prevented the development of any markedly active trading in shares.[131] One other factor contributing to the decline in demand was a law that permits private pension funds to invest 7.5 % of their assets abroad.[132]

5.3 The Position of Potential Investors on Venture Capital as an Instrument of Financing

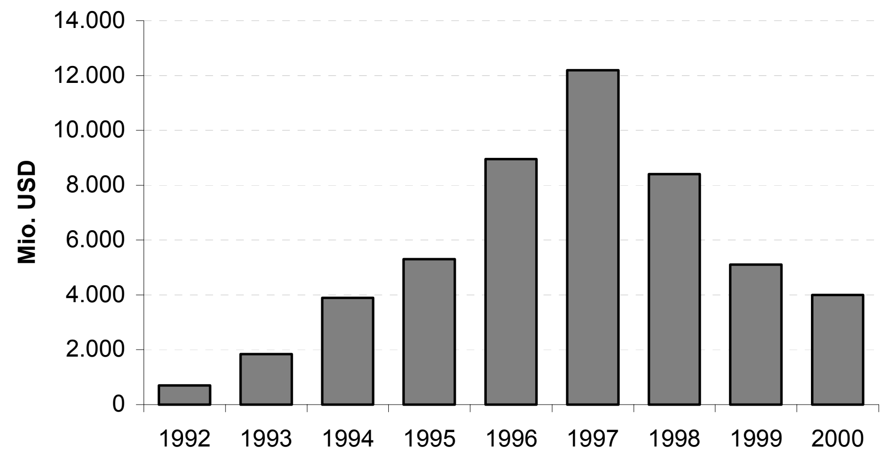
In general terms, venture capitalists include both commercially oriented investors like large corporations, insurance companies, and pension funds and private investors interested in earning above-average returns.[133] On the other hand, as an investor the public sector must bear in mind factors such as business promotion and creation of new jobs. As a rule, investors invest in funds set up and run by capital investment companies. Direct investors active outside this structure include both large corporations that acquire shares of other companies for strategic reasons and private persons. These private agents are referred to as business angels. They are normally successful businesspeople interested in reinvesting their capital in young companies. Here, too, the one incentive is the expectation of higher returns than would be possible with traditional investments; the other, perhaps no less important, is the pleasure of doing business. Since this mode of financing is not organized in fixed structures, it is customary to refer to it as informal venture capital. Business angels tend more to help close the capital gaps of small businesses, whose investment volume is too low

131 Cf. MEF (2001a), pp.48 - 50.

132 Up to 2000 they were only allowed to invest 5 % of their assets in foreign companies. Cf. MEF (2001a).

133 On the characteristics of individual investors, see e.g. Sidler (1996), pp. 24 - 29.

Figure 10: Volume of Sales in Peru's Secondary Market, 1992 – 2000



Source: Ministerio de Economía y Finanzas (2001), p. 49

to be interesting for CICs, and they often provide intensive management support as well.[134]

According to the experts interviewed, the following potential venture-capital investors can be made out in the Peruvian setting. The companies and institutions named have sizable resources at their disposal and regularly invest them in the Peruvian financial system.

— Peru's four major **private pension funds** (AFPs), which manage growing assets currently amounting to some USD 3 billion and have invested them mainly in bank deposits as well as in stocks and bonds of large Peruvian enterprises and finance institutions.

— Peruvian **insurance companies**,[135] which have assets of roughly USD 380 million and, as of December 31, 2001, had invested assets amounting to USD 630 million in securities.[136] In particular the country's seven life-insurance companies, with their long-term and relatively predictable investment horizon, are prospective investors of venture capital.

— **Public institutions** that administer long-term funds and invest them in the market, e.g. the government pension insurance corporation (*Oficina de Normalización Previsional*) or the public-sector health insurance corporation (EsSalud).

— **Commercial banks**, which the recent economic crisis has left with a good number of financially troubled companies in their portfolios and which might, in this situation, well have a more pronounced interest in providing turnaround financing.

134 Cf. Geigenberger (1999), pp. 29f.; Butzmann (1999), pp. 11f.

135 All told, there are 17 insurance companies active in the Peruvian market.

136 Cf. SBS [www.sbs.gob.pe/estadistica/financiera], (accessed on: 05 July 2002).

— **National and international DC institutions** like the Peruvian refinancing and development bank, COFIDE, the *Caja Andina de Fomento* (CAF), the IADB, or the IFC.

At present there are no business angels active in Peru. But there is at least one large company there that operates as a direct investor, supplying small companies with equity capital. Its main interest in doing so is evidently less expectations of returns than strategic corporate aims.

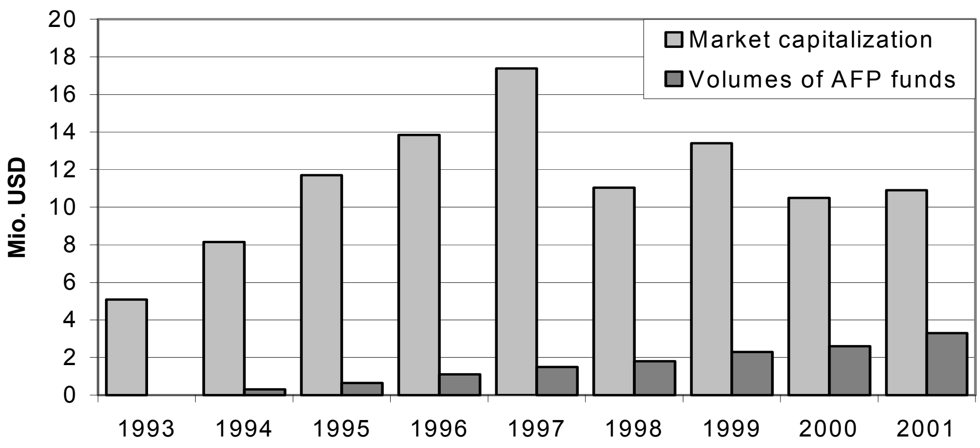
Fifteen potential investors were interviewed in connection with the present study (four AFPs, three insurance companies, three public institutions, three DC institutions, two banks), the aim being to analyze their position on venture-capital funds and to explore their willingness to invest in this instrument.

5.3.1 Private Pension Funds

In 1993 three private pension funds, so-called *Administradoras de Fondos de Pensiones* (AFPs), were set up in Peru on the Chilean model; these funds focus on individual provision for old age instead of the traditional generation-oriented system of provision.[137] The volume of these funds has been growing constantly, and, with their investment volume of USD 230 million p.a., these AFPs have for some years now been the largest and most important investors in the Peruvian capital market.

Together with Peru's insurance companies, the AFPs are the most important demanders of long-term investments in the Peruvian capital market. Due to the long-term nature of pension insurance, the AFPs, should, according to their own estimates, invest at least half of their portfolios for periods of five to seven years. In fact, however, their present average period of investment is more medium-term, a fact which the AFPs attribute to a lack of long-term investment opportunities in the Peruvian market. The continuous growth of pension funds runs parallel to a market capitalization that has declined sharply since 1998 (Figure 11), and what this development ultimately means is considerable difficulty in the medium term in meeting the demand for investment opportunities in the Peruvian market.[138]

Figure 11: Market Capitalization and Volumes of AFP Funds, 1993 – 2001



Source: Equitas Partners (2001a), p. 23

137 Cf. Müller (2001), p. 241.

138 This increased demand has to be satisfied in the national market, since the AFPs are permitted to invest only 7.5 % of their portfolios abroad and AFPs indicate that nearly all of them have just about fully reached this quota.

Pubic regulations on AFPs, for which the Peruvian central bank and the SBS are responsible, expressly permit private insurance funds to participate in investment funds, including venture-capital funds: they are allowed to invest up to 12 % of their portfolios in such funds.[139] The AFPs interviewed indicated that at present they would be prepared to invest up to 2 % of their portfolios in venture capital, which means in effect that legal regulations are currently not an obstacle to the development of venture-capital funds. The SBS, however, restricts AFPs to a maximum fund investment share of 25 %,[140] which, in view of the low number of potential investors in the Peruvian market, could constitute a hindrance to the development of investment funds.

In addition to legal restrictions, every institution has internal investment regulations of its own which are as a rule far more restrictive and may be seen as an expression of the risk-management policy of AFPs. This is reflected in the makeup of their portfolios: looking at all of the investors interviewed, it is the AFPs that hold the highest percentage of stock in their portfolios, though they invest only in grade AAA to AA- securities, i.e. those with the lowest risk.

Still, compared with the other potential investors interviewed, the AFPs turned out to be highly interested in the concept of venture-capital funds. Three of the four pension insurance companies interviewed are willing to invest USD 4 to 7 million in venture-capital funds. The fourth AFP is more reticent and prefers to hold off on investments until the Peruvian venture-capital market is better developed.

Asked about their expectations concerning a venture-capital fund's returns, maturity periods, and share fungibility, the AFPs responded in part in very different terms. Their profit expectations vary between 12 % and 30 %, the average profit expectation being 20 %. The AFPs are willing to invest their capital for up to ten years, a period in line with current proposals on venture-capital funds in Peru. Even though AFPs generally attach great importance to investment fungibility, they are interested in investing in venture capital, despite the fact that fund shares, even if they are officially listed, are unlikely to be tradable in the Peruvian market.

Asked to comment on the most important obstacles to the development of the venture-capital market in Peru, the AFPs saw the most serious problem in a lack of fund managers with experience in the national market (Table 4).[141] This was also expressed in their assessment of limited exit options as the second most important obstacle, since, as two AFPs stated, termination of a fund's investments in businesses is one of the most important tasks of fund managers. The third important aspect noted by all AFPs asked to comment on the development of the venture-capital market is Peru's current tax legislation, which diminishes profit expectations by taxing investment funds.

5.3.2 Insurance Companies

The product structures of AFPs and life insurance companies share many basic elements and may thus be expected to develop similar investment behaviors as far as maturity periods, profit expectations, and risk assessment are concerned. Accordingly, the insurance companies interviewed complained of an insufficient range of investment possibilities in the Peruvian market. In their opinion, the main problem is a lack of long-term papers. Still, one of the three insurance companies interviewed expressed its interest in the idea of venture capital and would be willing to invest some USD 500.000 in a fund. Pointing to the high

139 Cf. Texto Unico Ordenado de Ley del Sistema Privado de Administración de Fondos de Pensiones (Decreto Supremo 054-97-EF), Article 25, Resolución 052-98-EF/SAFP, Article 20, and Circular 030-01-EF/90.

140 Cf. Reglamento de la Ley del Sistema Privado de Pensiones (Decreto Supremo N° 004-98-EF), Article 65.

141 The persons interviewed were presented a list containing nine possible obstacles. The possible responses were: "highly relevant", "relevant", problem of "low relevance"; cf. Appendix 1.

risk of venture capital, the other two stated their unwillingness to consider any such investments.

As in the case of the AFPs, the legal restrictions on investments do not constitute an obstacle that would prevent insurance companies from investing in venture-capital funds. The relevant SBS regulation permits investments of up to 10 % of their portfolios in investment funds.[142] Thus far, though, only one insurance company from our sample has made use of this provision, investing 1 % of its portfolio in a real-estate fund. Generally speaking, the makeup of these portfolios reflects a certain reticence toward high-risk forms of investment. Two of the companies interviewed indicated that close to their entire portfolio is made up of bank deposits and fixed-yield securities. At least one of these companies rates even investments in stocks as too risky, even though the legal regulations on investment permit insurers to invest up to 20 % of their portfolios in company shares.[143]

Another important reason for their reticence toward venture capital, it was noted, is the structure of their payment obligations to their clients. These require regular and constant revenues that are not possible with investment in venture capital.

Asked about the development of the venture-capital market in Peru, our three insurance companies also saw the most important current obstacle in a lack of experienced fund managers in the national market. They rated limited exit options, the legal framework, and tax legislation alike as the second most important obstacles, a finding that accords with the responses made by the AFPs (Table 4).

5.3.3 Public Institutions

The three public institutions interviewed indicated that they had each invested over 95 % of their portfolios in savings deposits and fixed-yield securities and are concentrating their investments on short-term papers because of the uncertain economic picture. The determining variable of their investment policy is investment risk; profit concerns are of only secondary importance to them. In other words, public institutions turn out to be even more risk-averse than insurance companies.

The legal restrictions on investments by public institutions oblige the latter to invest 70 % of their portfolios in the national financial system.[144] These institutions are thus free to invest 30 % of their capital in accordance with their own internal investment regulations. In other words, the reticence shown by this institution toward venture-capital funds is also due to internal investment restrictions, which are highly detailed and risk averse in tendency. Moreover, these institutions tend to transfer the negative experiences they have made with other funds, e.g. real-estate funds, to venture-capital funds. One exception is an institution that has already entered into talks with a fund initiator and is considering an investment of USD 1.5 to 3 million in venture capital.

As in the cases outlined above, representatives of public institutions were also asked about possible obstacles to the development of the venture-capital market. For them the greatest hindrance is the low level of liquidity in the Peruvian market and the low level of share fungibility which this entails, which is another indication of their risk aversion.

142 Cf. Reglamento de las Inversiones Elegibles de las Empresas de Seguros (Resolución SBS 039-2002), Article 5.

143 Cf. Reglamento de las Inversiones Elegibles de las Empresas de Seguros (Resolución SBS 039-2002), Article 5.

144 Cf. Lineamentos para la Inversión de Entidades del Sector Público en el Sistema Financiero (Decreto Supremo 040-2001-EF), Article 9.

Table 4: Ranking of the most important Obstacles to the Development of the Venture-Capital Market, based on the Responses of the Investors interviewed[a]

	AFPs	Insurance companies	Banks	Public institutions	COFIDE and DC institutions	Fund managers and experts
1	• Lack of experienced fund managers	• Lack of experienced fund managers	• Tax legislation • Limited number of investors	• Limited fungibility of fund shares	• Limited exit options	• Lack of experienced fund managers • Tax legislation
2	• Limited exit options	• Limited exit options • Legal framework • Tax legislation		• Limited exit op-tions • Lack of company transparency	• Lack of transpar-ency on the part of entrepreneurs • Lack of company transparency	
3	• Tax legislation		• Lack of company transparency • Limited fungibility of fund shares			• Limited exit options

Source: Authors' survey

[a] See Appendix 1 for a complete list of possible obstacles.

5.3.4 Commercial Banks

Another group of potential investors interviewed in connection with the present study are Peru's commercial banks. The assumption was that commercial banks would be highly interested in expanding their range of products and offering their clients a new mode of financing. This could prove particularly interesting for clients that are faced with liquidity problems and unable to obtain additional capital, even though they have growth potential. Turnaround financing could serve to substantially reduce the default risk for lending banks.

Instead of commercial banks, the study conducted interviews with two investment companies, each of which is associated with a major bank. The first confirmed that the bank in question was interested in investment financing for businesses and stated that the bank was planning to develop a venture-capital fund of its own, the main aim being to strengthen companies whose undercapitalization is due to a lack of investor confidence.[145] This investment company sees the country's present tax legislation as the major obstacle to the development of the venture-capital market in Peru, and thus also to its own decision to set up a new fund of its own. For it, the second most important obstacle is the present lack of company transparency. For this reason the planned fund envisages using controlling stakes or certain provisions in its investment agreements to exert a larger measure of control over the companies in which it invests.

The second investment company interviewed administers, among other things, an investment fund with long-term investment objectives, although in fact only roughly 10 % of the fund is invested in long-term papers. Asked about government regulation of investment activities, it stated that the stock exchange oversight authority, CONASEV, has gone some way toward easing its regulations and that at present there were practically no restrictions on investment activities. This fund's internal regulations are also very broadly formulated, permitting it, for instance, to invest up to 25 % of its portfolio in grade BBB to BB+ securities. The company at the same time indicated that for the long term it invests only in grade AAA to AA- papers, while for the short to medium term it was able to invest in grade A- papers, another piece of evidence pointing to the reticent risk strategy of Peruvian investors. Due to the high risk involved, this investment company is also uninterested in investing in venture-capital funds. In its view, the main obstacle to the development of the venture-capital market is the low number of investors active in the Peruvian market (Table 4). It noted that investor risk perception would have to change before venture-capital funds would be able to operate successfully in Peru.

5.3.5 The Peruvian Development Bank COFIDE and DC Institutions

National and international DC institutions, which in essence represent the role and the interests of public-sector investors, are likewise potential investors in the Peruvian venture-capital market. The present study interviewed COFIDE in its role as the national development bank, as well as the CAF as a multilateral institution, and the Netherlands development Bank FMO as an examples of bilateral DC with a view to determining their assessment of the venture-capital market and their willingness to invest. All three of these institutions are partners of FAPE and thus already have experience with venture capital in Peru. In general, they stated that they were planning to continue supporting this financing instrument with an eye to strengthening both SMEs and, in the long term, the Peruvian capital market. Two of these institutions are in contact with fund initiators, and all three are considering further investments in a venture-capital fund. As far as investment levels are concerned, one institution indicated that it planned to invest roughly USD 1.5 million. At present COFIDE could invest only up to USD 8

145 The investment company indicated that the bank was planning to set up an independent venture-capital fund with a volume of USD 50 million to finance business expansion and startups. The bank itself intends to contribute USD 10 million and hopes to raise the remaining funds from national and international DC institutions such as IADB, CAF, DEG, or COFIDE.

million in venture capital since internal regulations prevent it from investing over 2 % of its own capital in this financing instrument. Moreover, COFIDE is not permitted to hold more than 20 % of a fund's shares.

As regards the development of the venture-capital market, this group of potential investors sees important obstacles on the side of Peruvian companies. The reluctance of entrepreneurs to accept outside capital and the rights of control it implies and the lack of transparency in many companies constitute, in their opinion, central obstacles to the development of venture capital funds. The potential investors from this group explained their assessment by pointing to a lack of entrepreneurial culture and a generally short lifespan of family-run companies, which often do not survive the third generation.

Summing up the results of our survey of potential investors in venture capital, we find that nearly all of our interviewees were familiar with the instrument. Eleven of our interviewees had already been approached by institutions planning to launch a fund and seeking investment. Furthermore, all of our interviewees were dissatisfied with investment opportunities available in the Peruvian market.[146] Most of them voiced criticism of the low number of issuers and the lack of long-term investment possibilities.[147] It thus appears that investors are faced with a situation marked by unsatisfied demand for investment opportunities.

As far as obstacles are concerned that hinder the development of venture-capital funds in Peru, our interviewees frequently mentioned three aspects of the institutions under consideration here (Table 4): lack of experienced fund managers, national tax legislation, and restricted exit options offered by funds specialized in company shares.[148] The fact that investors perceive the lack of experienced fund managers as an important obstacle to the development of the venture-capital market once again highlights the significance of the fund manager as intermediary, which will be examined in more depth in the following section.

5.4 Management and Structure of a Venture-Capital Fund

On top of the willingness of potential investors to invest in venture capital, two further factors of crucial significance for the success of venture-capital funds are the fund management of capital investment companies and the structure of the funds themselves. The following section starts out by looking into the role played by CICs. Based on our supply-side survey results, it then goes on to examine the importance of fund managers in relation to other key factors crucial to the development of the venture-capital market in Peru. The section, likewise based on our survey results, concludes by looking into the possible structure of a Peruvian venture-capital fund.

CICs and Fund Managers

Fund managers play a crucial role in the development of venture capital. Venture capitalists invest in a fund set up and managed by a CIC. In the ideal case the fund manager, in possession of perfect information, operates in a highly intransparent investment market, and his information edge enables him avoid any processes of adverse selection. The fund manager's specific market knowledge contributes to diminishing the risk of investment failure, e.g. by reliably assessing risks and by supervising and advising the management of young innovative companies.[149] The focus of such funds on SMEs calls for special knowledge on internal company structures, successful growth strategies, and disinvestment strategies. Thanks to his right to information, a fund manager is in a position to constantly evaluate the situation of the individual companies in his portfolio and pass this

146 The three national and international DC institutions were not asked this question.

147 It was mentioned in this connection that eight major companies account for 90 % of all new issues.

148 For a more in-depth discussion, see Section 4.6.

149 Cf. Kaufmann / Kokalj (1996), p. 11.

information on to investors. Generally speaking, a successful fund management will consist of a group of experts that have experience in capital investment sufficient to enable the fund to make sound and profitable investments.

The present survey asked supply-side interviewees for their assessment of various aspects that contribute to the success of a venture-capital funds (Table 5).[150]

Table 5:	Ranking of the Importance of Aspects relevant to the Success of an Investment Fund[a]
1	Fund manager quality
2	Economic growth
3	Legal and tax framework
4	Sectoral portfolio diversification
5	Composition of investors
6	Capital market development
7	Portfolio diversification geared to business phases

Source: Authors' survey
[a] The ranking corresponds to the frequency of mentions by the entrepreneurs interviewed

It is not surprising to find that the most important aspect mentioned by our interviewees is **fund manager quality**. In this respect, we can identify in Peru a number of bottlenecks that bound up mainly with lack of experience in the Peruvian market.[151] While the total number of institutions planning to launch venture-capital funds is low at present,[152] our interviewees mostly criticize the fact that the institutions presently active in the field, lack a track record in venture-capital management, especially at the national level. According to our interview partners, both institutional and financial backing for fund managers could raise the confidence of many potential investors in venture-capital funds.

The results of the survey indicate that the second most important factor seen as bearing on the success of a fund is **economic growth**, followed by the **legal and tax framework**.[153] Furthermore, our interviewees identify the **sectoral diversification** of a fund's portfolio as a further aspect bearing on its success, since this factor can contribute to minimizing investment risk. But at the same time experts also emphasized that the Peruvian market, small and underdeveloped as it presently is, generally leaves little room for any specialization of fund portfolios. Half of our interviewees also see the **composition of fund investors** as an important aspect.[154] It was noted that the right composition could prove conducive to investor confidence in a fund and its management. On the other hand, our other interviewees, including experts, emphasize that the key factor is not investor composition but the CIC itself or the constitution of the fund in question.

The survey also identified **capital-market development** as an additional key factor for the success of a fund, particularly in view of the fact, as was noted, that this factor is bound up with new disinvestment options, e.g. initial public offerings. But some of the persons interviewed disagreed, stating instead that development of the venture-capital market represents a mechanism through which, in the end, the Peruvian capital market will continue to develop. **Portfolio diversification keyed to company development phase** is seen as the least important factor bearing on the success of a fund. It should be noted in this connection that some potential investors reject early-phase financing, stating that the investment risk is particularly high in this phase of company development.

150 Specifically, 10 potential venture capitalists and experts were presented the list of aspects set out in Table 5 and asked to rank them as "highly relevant", "relevant", or "not relevant".

151 See Section 5.1.

152 Asked which institutions had already approached them, the majority of potential investors were unable to recall more than one or two.

153 Cf. Chapter 5.2 on the significance of the economic, legal, and tax frameworks.

154 Bi- and multilateral Investors in particular see the composition of investors as a relevant factor for ensuring that a fund's investors share a unified "vision".

Fund Structure

To gain some idea of the possible structure of a Peruvian venture-capital fund, several different experts on the supply side were asked for their views on optimal size, investment volume per company, and possible percentages of company assets. While the results indicate a necessary **fund volume** of some USD 20 million,[155] **investment level per company** depends on the business segment to which a fund is addressed. However, existing proposals on venture-capital funds in Peru suggest that an investment volume of at least USD 1 million per company is necessary,[156] a fact that indicates Peru's first funds will have to focus on medium-sized companies. The majority of our interviewees envisage **shares of company assets** not in excess of 50 %, though in some cases this would presuppose additional control rights over the company in question, e.g. the right to nominate a company's chief financial officer.

5.5 Company Openness, Transparency, and Critical Mass

Aside from the key factors named above as essential for the success of a fund, the companies receiving venture capital are an additional critical factor in the development of a functioning venture-capital market. In connection with SMEs, two obstacles are generally specified that have to be overcome:

— the disinclination of small and medium-sized companies to open up to outside investors;

— a low level of transparency and willingness to provide information, i.e. a lack of sufficient corporate governance.

Our supply-side survey on the **openness** of Peruvian SMEs clearly indicates that the majority of potential investors anticipate little willingness on the part of Peruvian SMEs, which are mostly family-run, to accept a new partner. Some interviewees, however, emphasized that many companies in Peru now see the need to modernize and develop new markets, a fact which will influence their willingness to accept a strategic partner. Our interview partners on the whole thought that Peruvian SMEs should be better informed and schooled on the advantages involved in accepting new partners.

Aside from their closed company structures, another factor criticized was the lack of transparency of Peruvian SMEs, and it was noted that SMEs in Peru are for the most part marked by a low degree of formalization and inadequate accounting practices, factors which make it impossible to assess investment risks. This view was rejected by some of our interview partners, who noted that having a fund manager involved in the making of company policy would automatically increase transparency. Furthermore, funds always procure information on prospective partner companies, since every investment decision is preceded by a process of due diligence. Even though it is accordingly necessary to improve the level of transparency of Peruvian SMEs, there is confidence in the CICs and their ability to provide adequate control mechanisms, so that the investors will be offered the security they need.

A further condition required for the development of the Peruvian venture-capital market is that prospective companies must have reached the **critical mass** needed to ensure good investment possibilities. Venture-capital funds look for companies that have the potential to develop into competitive, export-oriented firms that are capable of seeking their place in global value chains. In this connection, our supply-side survey shows that a close majority of potential investors are of the opinion that there are not enough SMEs in Peru in a position to actually be able to meet the conditions required for a financial investment of this kind. However, the remaining interview partners rejected this view, claiming that the Peruvian

155 Generally speaking, the majority view was that fund volume had to be large enough to prevent any rise in fixed costs per investment. This assessment is line with FAPE's experience, i.e. that a fund volume of USD 7.5 million is insufficient to cover the costs of fund administration and management. See Box 1.

156 Cf. Questus (2002), p. 5; Apoyo Consultoria (2001), p. 20.

market offers a sufficient number of interesting prospective companies.

5.6 Current Disinvestment Options in Peru

Since venture-capital investments are always limited in time, investors are in need of a secure time frame, usually five to ten years, at the end of which they can profitably terminate their investment. A properly functioning venture-capital market should therefore offer sufficient possibilities to disinvest, i.e. or to sell the shares acquired in connection with such an investment. There are up to four exit options available here:[157]

- **Company buyback**, in which the original partners repurchase the shares concerned.
- **Sale to an industrial investor (trade sale)**: this exit option involves selling the shares concerned to another company, which as a rule purchases them in pursuit of its own strategic objectives.
- **Sale to a financial investor (secondary purchase)**: here the shares in question are sold to another investor, usually another capital investment company specialized in later phases of financing.
- **Initial public offering (IPO)**: in the eyes of the investor, an IPO is the most attractive exit option. On the stock market share prices are determined, among other things, by expectations of future company development, and this offers the share-selling investor the possibility of participating in anticipated future company appreciation. However, high transaction costs make this exit option feasible only for larger companies.[158]

In connection with the survey we asked our potential investors about options for terminating capital investments and the relevance of these options for their investment decisions. All of the interviewees emphasized the relevance of viable exit options, and the majority of investors noted a close link between the options available to terminate an investment and their decision whether or not to invest in a venture-capital fund. But our investors expressed no preference for one of the exit options mentioned and were entirely aware that in Peru some exit options are not given at present. Accordingly, they noted that the most important consideration is that a CIC has a clear idea of the ways in which an investment can be terminated.

Exit options are in fact limited in Peru at present: a secondary purchase by another investor is unlikely since in Peru there is no network of specialized CICs that purchase shares with an eye to company phases and sizes. IPOs are not really a viable option for SMEs at present either, a fact due to the low anticipated demand for SME shares, which, thanks to their naturally high risk, are unlikely to attract many potential investors in Peru. On the other hand, the transaction costs bound up with an IPO are prohibitive, since issues of stocks or bonds are economically viable only when they exceed a volume of roughly USD 10 million.[159]

Sales of shares to another company and buybacks are, according to our interviewees, the most likely ways for a venture-capital fund to terminate its investment and withdraw from the companies concerned. However, in recent years there have been virtually no mergers or acquisitions involving SMEs. Many potential investors are evidently quite reluctant to purchase minority shares of SMEs, so that this exit option is likely to be used only in isolated cases. Buybacks of shares by their

157 Cf. Butzmann (1999), pp. 26f.; Kaufmann / Kokalj (1996), pp. 48f.

158 In Germany only roughly 14 % of such investments are terminated via an initial public offering. In capital-market oriented Anglo-Saxon countries, however, IPOs play a larger role. Cf. Kaufmann / Kokalj (1996), p. 48. In the year 2000, company buybacks were the most important exit option in Germany (26 %), followed by trade sales (24 %), IPOs (14 %), and secondary purchases (7 %). 27 % of such investments were written off as a total loss. Cf. BVK, [www.bvk- ev.de/fakten00/ fakten.cfm?page=8], (accessed on: 14 Jan.2002).

159 Cf. MEF (2001a), p. 41. Nevertheless, one of the institutions asked about this issue, and interested in setting up a venture-capital fund, sees some exits via IPOs as entirely feasible.

original owner therefore appear to be the most realistic exit option for Peru. But some potential investors fear problems in financing buybacks. This is the background of the frequently expressed view that is it imprudent to invest more than USD 1 million per company: an investment of this size (plus company appreciation) is easier for the company owner to raise, or is generally easier to resell, at the end of the term of investment.

5.7 Venture Capital: Financing Instrument for SMEs in Peru?

The following two sections examine whether venture capital constitutes an interesting alternative mode of financing for SMEs. The first step consists of a demand-side analysis, based on interviews with 48 companies, of the willingness of firms to seek venture capital. A second step, based on supply-side interviews, then examines the inclination of potential investors to invest in a fund for SMEs.

5.7.1 The Demand Side: SME Willingness to use Venture Capital as an Alternative Mode of Financing

Since venture capital is still in its infancy as a financing instrument in Peru, the concept is largely unfamiliar to Peruvian companies. The results of our survey indicate that 77 % of the companies in our sample were wholly unaware of venture capital as an option, while 23 % were familiar with the concept. While small and medium-sized companies do not differ significantly in their knowledge of the concept, there is a difference between the two sectors examined: venture capital was less familiar to companies in the textile and clothing industry than it was to companies in the agroindustrial sector. Three of the 48 companies interviewed are already using venture capital as a means of financing.

The interviewees unfamiliar with venture capital were given a brief rundown on the use of the instrument, and then some of the **key features** of the instrument were explained to them in detail.[160] It turned out that these companies would welcome **support and advisory services** for the management of their firms, be it in the field of accounting, marketing, or in establishing contacts, and see this as the most important feature of venture capital. The majority of companies also regard the **equity function** as positive, since an equity base strengthened by outside investment would boost the "soundness" of their companies and a capital investment would at the same time imply an active investor interest in company operations.

Furthermore, most companies assume that a capital investment by a new partner would improve their **access to bank loans**. According to the companies interviewed, Peruvian banks focus less on a company's equity ratio than on its reputation and the securities it can provide. Taking on a new and reputable partner could accordingly serve as a "mark of quality" which enhances bank confidence, making it easier for such companies to acquire additional financial resources. This assessment was confirmed by the experience of one company that already uses venture capital to finance its investments. Since Peruvian banks usually condition their loan decisions on a company's ability to put up security, a further advantage of such a capital investment is that it would enable them to acquire additional real estate, in this way enlarging their borrowing capacities. The fact that a venture-capital investment is as a rule terminated at the end of an **investment period** of five to seven years is seen as positive by the majority, while three companies saw this investment period as too short.[161]

Such a capital investment is as a rule bound up with investor **rights of information and codetermination**. While a large number of company owners stated their general willingness to provide

160 The companies were presented a list containing some of the key features of venture capital; they were then asked whether they would rank it as "positive", "negative", or "not relevant" for their company.

161 Two companies explained their assessment by noting that in agriculture a period of five years is not sufficient to make profits.

information on their companies, the smaller companies tended to be less open than the medium-sized firms. Beyond the right to information, the right of codetermination in company management turned out to be the most critical point. A slight majority of our interviewees see an advantage here to the extent that under this provision a company may benefit from the decision rights of qualified investors, or an investor may in this way be better able to minimize his risk. It should be noted here that a full quarter of all interviewees rejected any right of codetermination, insisting on their own autonomous management rights. Still, the companies interviewed proved on the while to be more open-minded on this issue than we had anticipated.

It is not surprising that the **above-average earnings** expected by investors prior to the termination of their investment are seen as negative by most companies interviewed. According to some companies, it is impossible in Peru to earn annual returns of 20 % to 30 %, either in the textile and clothing industry or in the agroindustry. Instead, the large majority of companies interviewed regard annual earnings of between 10 % and 25 % as realistic. This is surprising in view of the fact that some of the companies interviewed anticipate growth rates of 25 % to 300 % over the coming three years and would thus be in a position to meet the earnings expectations of investors. Our survey data further indicate a disparity between small and medium-sized companies, since seven of the eight of the companies that could earn high profits are small companies. The reason for this is that smaller companies are as a rule forced to pay interest rates of around 15 % (and in some cases even up to 45 %). Furthermore, some interviewees pointed out that if the ATPA is enlarged, companies in the textile and clothing industry could double their revenues and therefore meet higher earnings expectations.

Three additional control questions were asked to verify company assessments of venture capital as an alternative means of financing. The first question was whether the companies would recommend other companies to take on a new partner if they were unable to find any other alternative sources of financing to realize an investment. Nearly 93 % answered in the affirmative. The second question was whether our companies would themselves be prepared to take on a new partner. Here only 71 % answered in the affirmative. In other words, nearly one third would be unwilling to do so, a finding which in most cases can be attributed on the one hand to the owner's desire to remain independent and on the other to the fear that a new partner might expect too high returns. The third question, formulated somewhat more generally, concerned venture capital as a means of financing. The responses indicated that a total of 93 % of our interviewees see venture capital as an adequate means of investment financing for their sector. The underlying assumption of our companies here is that even though both the textile and clothing industry and the agroindustry have great potential, they will remain unable to realize long-term investment projects as long as they lack sufficient access to capital.

On the whole, the majority of companies regard some key features of venture capital as positive and are open to the idea of taking on a new partner. This finding permits us to assume that venture capital could prove to be a viable alternative source of financing for companies in both sectors. At the same time, however, our findings indicate that a great number of companies would make use of venture capital only under certain conditions, which include sufficient investor knowledge of the given sector, realistic earnings expectations, and a restriction of investor stakes to minority holdings.

5.7.2 The Supply Side: Willingness to Invest in a Fund for SMEs

One crucial condition for the development of venture capital as an alternative means of financing for SMEs in Peru is the willingness of potential investors to put their money into a fund geared specifically to this business segment. A large majority of the 15 potential investors interviewed stated their willingness in principle to invest in medium-sized companies.[162] Only two public-sector institutions stated their unwillingness to invest in medium-sized enterprises, a finding that can be attributed to the marked risk aversion of this group of investors.[163] As far as small businesses are concerned, this reticence is shared by the large majority of potential investors. Only four of our interviewees stated their willingness to invest in a fund specialized in small companies; these potential investors include an AFP as well as two institutions that pursue development goals.[164] But these institutions too express a preference for medium-sized companies or a diversified portfolio made up of investments from different business segments. On the whole, our supply-side survey results indicate that potential investors are hesitant to invest in small businesses because of the high risk associated with the segment and would be far more willing to invest in a fund specialized in medium-sized companies. Despite this reticence, however, 10 of our 14 potential investors regard venture capital in principle as an adequate long-term financing instrument for Peruvian SMEs, even though they noted that certain conditions would have to be given if the use of this instrument is to have prospects of success, one of these being the creation of a business culture conducive to investment.

6 Leasing as an Alternative Means of Financing for Peru's SMEs

Leasing as a financing instrument alternative to classic investment financing based on bank loans can contribute decisively to providing SMEs with the medium- and long-term financing they need. As opposed to venture capital, this instrument already constitutes an important component of Peru's financial system. Accordingly, the present study, looking into the field of leasing, focuses on the question of how relevant leasing in fact is for the financing of Peruvian SMEs and/or what obstacles may be blocking an expansion of leasing activities to include SMEs.

The following section presents an overview of the significance and structure of the Peruvian leasing market. This is followed by a look at the providers in the Peruvian market and a discussion of our system of categorization and our sample. The chapter then looks into the most important framework conditions required for the successful use of leasing and analyzes the extent to which Peruvian SMEs makes use of the instrument of leasing, examining the concrete makeup of leasing services in the Peruvian market and the degree to which these services meet the financing needs of SMEs.

6.1 Significance and Structure of the Peruvian Leasing Market

The Role played by Leasing in the Peruvian Financial System

The role played by leasing in an economy can be determined with reference to two factors: first, the absolute volume of investments financed by means of leasing and, second, the so-called leasing ratio, i.e. the relationship between leasing-based investment and overall gross investment in an economy. In Peru the leasing ratio was 16.7 % in 1999, compared with 12.5 % for Brazil and 4.1 % for Chile in the same year (Figure 12).[165] In terms of the absolute volume of leasing investments, Peru ranks 33rd worldwide and fourth in Latin America.

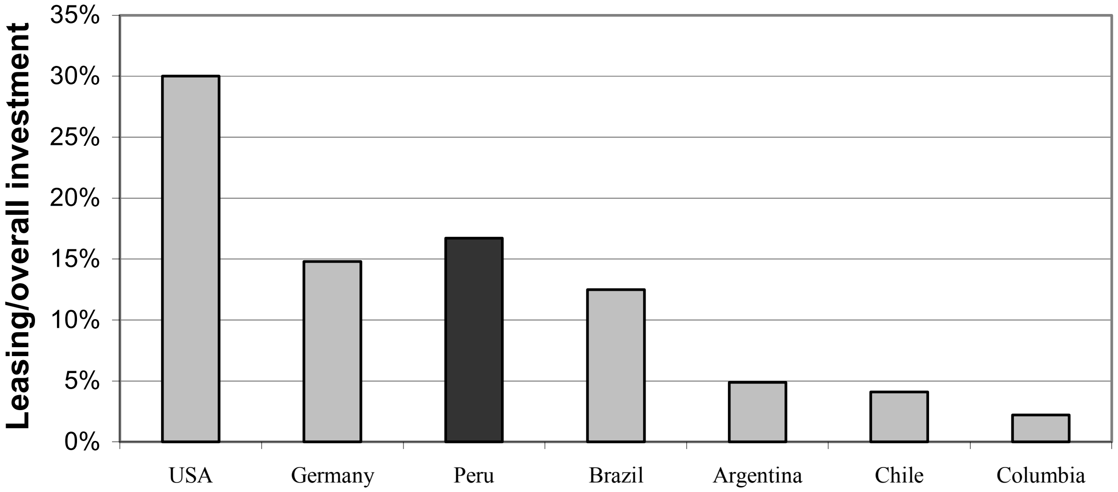
162 Some of our interviewees emphasized their special interest in the segment of medium- to large-sized companies.

163 Cf. Section 5.3.

164 These are the two multilateral organizations CAF and FMO and the public-sector development bank COFIDE.

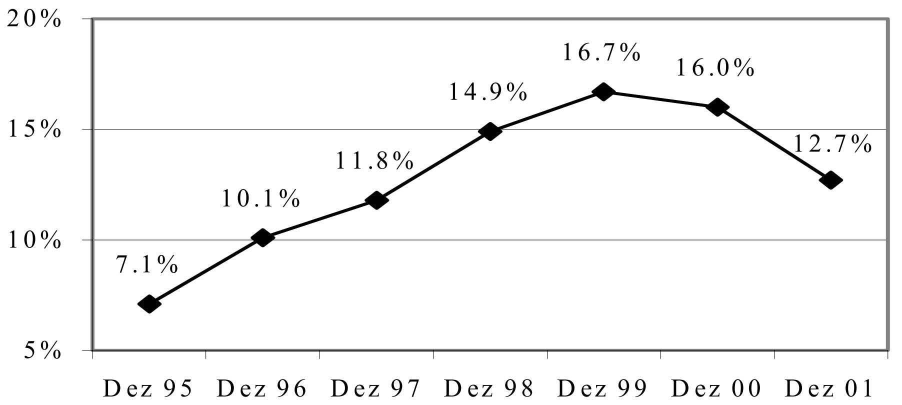
165 The prevalence of leasing in an economy can also be measured on the basis of a second definition of the leasing ratio: the value of leasing-based investment as a share of a country's GDP. In Peru investments financed through leasing account for 1.52 % of GDP, while the corresponding figures for Chile and Brazil 1 % and 0.88 %, respectively. Cf. Euromoney (2000), p. 6.

Figure 12: Peru's Leasing Ratio, an International Comparison (1999)



Source: Euromoney (2000), pp. 3 and 28; authors' presentation

Figure 13: Development of the Leasing Ratio in Peru, 1995 – 2001



Source: América Leasing [www.americaleasing.com/alsaweb/frame_infoleasing], (accessed on: 26 April 2002)

Since leasing was introduced in Peru 20 years ago, the value of new leasing agreements concluded p.a. increased constantly until 1998. Between 1995 and 1999 it quadrupled, reaching a value of some USD 2.3 billion. Since 1998, in parallel to the downturn in business activity in Peru, this absolute value has, however, been on the decline.[166] On the other hand, the leasing ratio has continued to rise even in times marked by low economic growth. Between 1995 and 1999 it rose from 7.1 % to a maximum value of 16.7 %, though the figure also has declined since 1999, a fact probably due to a change in the law enacted in December of 2000 and the uncertainty it has caused in the leasing sector (Figure 13).[167]

166 Cf. América Leasing (2001), p. 27 and IFC (1996), p. 40.

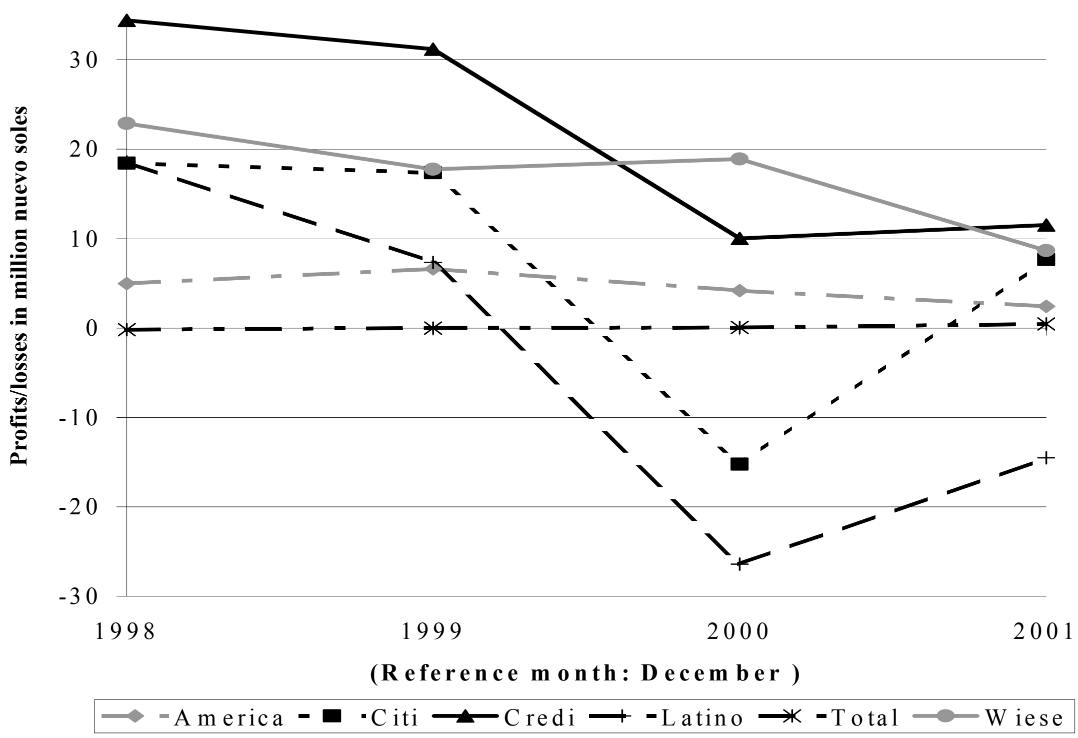
167 See Chapter 6.2 for an in-depth discussion.

Looking at their operating results, however, we find that most of the leasing companies interviewed began to turn a profit again in 2001. According to information provided by them, only two leasing companies recorded losses due to restructuring, although one of them expects to be making profits again in the current year. Data provided by the regulatory authority SBS on six of our seven leasing companies indicate a generally positive picture for four of them (Figure 14).[168]

Leasing Agreements per Sector and Type of Leased Good

Looking at the structure of leasing portfolios broken down by sector, we find that the manufacturing industry is the most important customer segment for both leasing companies (33 %) and banks (43 %).[169] Within this sector, the textile and clothing industry accounts for 6 % of all new leasing agreements.[170] By comparison, 5 % of the portfolios of

Figure 14: Earnings of Peruvian Leasing Companies, 1998 – 2001



Source: SBS, [www.sbs.gob.pe], (accessed on: 26 April 2002)

168 The poor profit picture of Latino Leasing is due to the bankruptcy of the Banco Latino. Latino Leasing now operates independently of Peruvian banks; its main partners are IFC (some 50 % of the company's equity) and CAF (45 %).

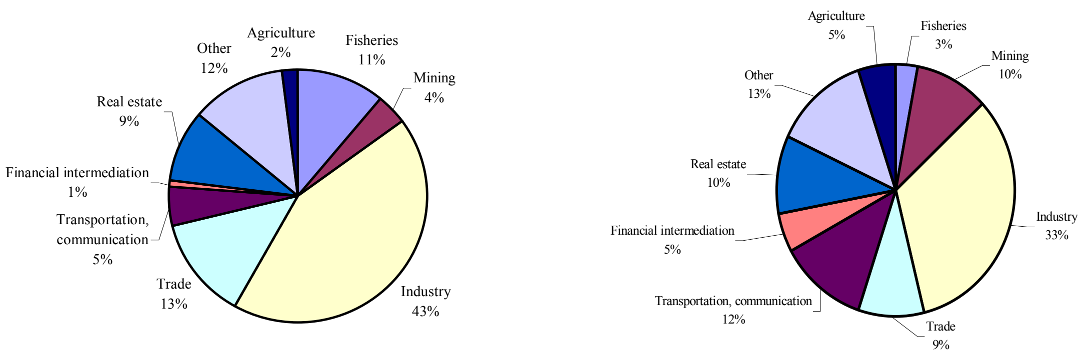
169 Leasing companies and banks are the most important providers of leasing services in the Peruvian economy. See p. 53 for a detailed breakdown of Peruvian leasing companies.

170 Cf. Asociación de Bancos del Perú (2001), p. 120.

leasing companies and 2 % of bank leasing operations go to the agricultural sector (Figure 15).

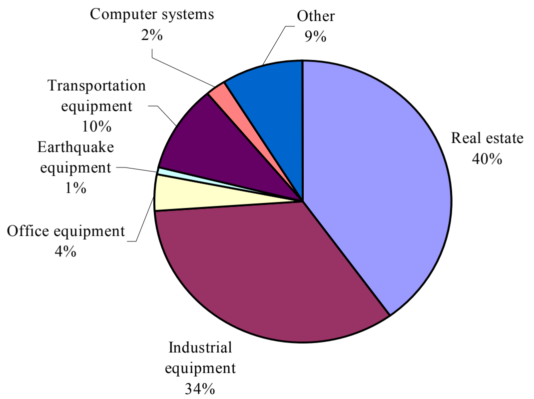
When we break portfolios down for types of leased goods, we find that the most important leasing assets traded in Peru are real estate, industrial machinery and other industrial equipment, and transportation units (Figure 16).

Figure 15: Leasing Portfolios of Banks (left) and Leasing Companies (right), by Sector (2001)



Source: SBS, [www.sbs.gob.pe], (accessed on: 26 April 2002); authors' presentation

Figure 16: Leasing Portfolios of Leasing Companies and Banks, broken down by types of Leased Good (aggregated), (2001)



Source: SBS, [www.sbs.gob.pe], (accessed on: 26 April 2002); authors' presentation

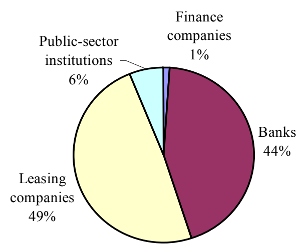
Providers in the Peruvian Leasing Market

At present there are 23 leasing operators active in Peru. The SBS breaks them down as follows:[171]

— banks (13),
— leasing companies (7),
— finance companies (2), and
— public-sector institutions (1).[172]

In the year 2001 leasing companies accounted for the major share of leasing transactions (49 %), followed by banks (44 %). On the other hand, the two finance companies and COFIDE together accounted for a share of only 7 % of the total value of new leasing agreements (Figure 17). The leasing sector is thus marked by a high level of concentration: on the one hand, there is a limited number of competitors, on the other hand the three largest providers account for 48.5 % of all leasing operations. 83.7 % of all leasing activities are transacted by the ten largest providers. The ranking presented in Table 6 illustrates the market shares of individual leasing operators.

Figure 17: Structure of Leasing Operators



Source: SBS [www.sbs.gob.pe], (accessed on: 25 April 2002)

The Sample of Leasing Operators

Eleven of the Peru's leasing operators were interviewed in connection with the present study. For several reasons it appeared appropriate to include only banks and leasing companies in the sample. One reason was that finance companies are specialized in the leasing of vehicles – which are, judging from their customer structure, more likely to be consumer goods than investment goods. Another is that COFIDE, the only public-sector institution that finances leasing agreements, serves the final borrower only indirectly, via the financial system.

Instead of taking over the SBS system of categories, the present study worked with a modified breakdown of Peruvian leasing operators based on their ties to banks. The present study defines as "independent leasing operators" all providers that have neither direct ties with nor financial backing from banks. Operators that are part of a bank are generally referred to as "bank-affiliated leasing operators," regardless of whether or not they are fully integrated in a bank, operate as specialized departments of a bank, or are bank affiliates.[173]

The modified classification used for the present study appears justified for the following reasons:

— Experiences from many developing countries indicate that independent leasing operators tend more than bank-affiliated leasing operators to concentrate on the SME segment.[174]
— A providers' refinancing and institutional backing play an important role for his sustainability.

The breakdown used by the present study indicates that there are in the Peruvian market 14 bank-affiliated leasing operators – the eight largest of

171 This is the breakdown of the leasing sector used by the SBS. Cf. SBS [www.sbs.gob.pe/estadistica/financiera], (accessed on: 25 April 2002).

172 The only public-sector institution involved in leasing is COFIDE.

173 Examples of leasing operators which the SBS breakdown regards as leasing companies and the present study sees as independent leasing operators would include the bank-affiliated leasing operators Wieseleasing, Credileasing, and Citileasing.

174 Cf. IFC (1996), p. 24.

Table 6: Ranking of Leasing Operators[a]

	Leasing operator	Current leasing agreements		
		(in 1000 n. soles)	(in 1000 USD)	Percentage share
1	Wiese Leasing	927.941	280.025	18.02
2	Credileasing	800.276	241.499	15.54
3	Banco Santander Central Hispano	767.450	231.593	14.90
4	Latino Leasing	341.289	102.991	6.59
5	Banco de Crédito del Perú	336.036	101.406	6.53
6	COFIDE	311.608	94.034	6.05
7	Banco Sudamericano	226.802	68.442	4.40
8	Citileasing	223.806	67.538	4.34
9	Banco Wiese Sudameris	209.055	63.087	4.06
10	Banco Continental	163.990	49.487	3.18
11	Interbank	144.282	43.540	2.80
12	América Leasing	144.245	43.529	2.80
13	Banco Financiero	132.503	39.985	2.57
14	Banco Interamericano de Finanzas	126.490	38.171	2.46
15	Banco de Comercio	100.634	30.368	1.95
16	Volvo Finance	76.945	23.220	1.49
17	Bank Boston	70.947	21.410	1.38
18	Banco Standard Chartered	15.420	4.653	0.30
19	Mitsui Masa Leasing	10.799	3.259	0.21
20	Leasing Total	9.560	2.885	0.19
21	BNP Paribas Andes	3.019	911	0.06
22	Banco del Trabajo	2.293	692	0.04
23	Daewoo	585	177	0.01

Source: SBS [www.sbs.gob.pe], (accessed on: 25 April 2002)

[a] Measured in terms of current leasing agreements, as per December 31, 2001

which were interviewed – and four independent leasing operators, three of them indicating that the focus of their efforts was on the financing of investment goods.

6.2 Important Framework Conditions for the use of Leasing: the Present State in Peru

Apart from internal company-level factors, the success of leasing as an instrument depends on external economic, institutional, and legal framework conditions. An important economic factor that must be borne in mind is that a country's leasing market develops in parallel to its economic situation and investment activity. And one of the reasons for the absolute decline in leasing investment to be observed in Peru in recent years is the economic slump the country has experienced since 1999.

The institutional framework

In institutional terms, the first condition required is an efficient financial system that covers the transaction and refinancing function and generates sustainable leasing operators. Important aspects here include licensing of leasing companies and a smoothly functioning insurance system. The present study pinpointed four factors that are of particular interest for the development of leasing in Peru:

- the refinancing situation of leasing operators,
- the stage of development of Peru's insurance market,
- the significance of Peru's used-goods markets for leasing, and
- the dollarization of the country's financial system.

Viable means of refinancing must be available to SME-oriented leasing operators if leasing is to become a practicable and widespread option for SMEs. Our survey indicates that independent leasing companies focusing more or less on a clientele in the SME segment tend to be more actively concerned with a refinancing of their operations and to concentrate more on finding reliable, competent partners than leasing operators that are affiliated with banks. On top of their ability to refinance their operations with the aid of their parent company, the latter also have the option of issuing bonds in the national capital market to procure the financial resources they require. It should be noted here, however, that in the recent past two bank-affiliated leasing operators have run into difficulties as a result of solvency problems on the part of their parent banks. Furthermore, most of our interviewees, dependent and independent alike, rejected the assumption that SMEs are the first customer group to be refused new leasing agreements when a leasing operator runs up against refinancing problems. This, they noted, is unlikely because good profit margins can be achieved in the SME segment.

A further important condition for an adequate development of leasing is a smoothly functioning **insurance system**. Leasing operators have to adequately insure the **goods they lease** out in order to cover the risk they bear as owners of the goods in question. The Peruvian legislative has taken account of the condition by obliging leasing operators to acquire insurance protection either on their own or through their customers. In all, this aspect was seen as unproblematic in Peru.

However, the stage of development of Peru's **used-goods markets** poses a central obstacle to the development of leasing. All of the leasing operators interviewed underlined the great significance of these markets for their risk assessment, pointing to the insufficient size and specialization of these markets. For the lessor, the risk on a leased good is fully covered only if he can recover its residual value in the event that a customer defaults. If this condition is not given, the lessor is forced to demand additional guarantees and higher deposits from his customers, and this factor restricts the effectiveness of leasing as a financing instrument for SMEs.

According to information provided by the leasing operators interviewed, the **Peruvian leasing market is even more highly dollarized** than the rest of the economy: nearly all leasing operators transact over 90 % of their leasing business in USD. While the leasing operators interviewed indicated that they offer their customers a choice between USD and nuevo sol, this option is seldom used, which means in effect that the currency risk is borne by the customer.

The Legal Framework

A framework consisting of laws, ordinances, and other legal regulations is an essential condition for the operation of a leasing market. This does not automatically imply the existence of any specific leasing legislation. But what is crucial here is that the various legal regulations in force are mutually consistent. One important factor is secure property rights for the leasing operator. Another is a legal status for leasing that is at least equal to that of other financing instruments, e.g. as far as tax laws are concerned.

As regards property rights, the crucial issue for the lessor is how reliably and quickly he is able to enforce his **property rights** to the leased good in the event that a customer defaults. In formal terms, Peruvian legislation is comparable to the picture in Germany, and accordingly if a customer files for bankruptcy, the lessor has a right to recover the leased good without undue effort, since it is not seen as constituting part of the debtor's assets. Although the Peruvian system of justice is in part marked by corruption and protracted and complex procedures, the leasing operators interviewed do not see property-rights issues as a serious problem.

The effects of Peru's **tax legislation** are seen differently. In December of 2000 the tax laws covering leasing, which were perceived as unfavorable by larger, bank-affiliated leasing operators, were fundamentally reformed (Box 2). In their eyes, the old legal framework was more flexible and offered customers better tax advantages. Moreover, two leasing operators are exempt from the amendment and continue to operate under the old terms, which leads to distortion of competition. The smaller, independent leasing operators, on the other hand, see the amendment in a less negative light, both in terms of tax benefits and as regards the special position accorded to two competitors. The reason for this is that they, with their more or less smaller volumes of leasing business, derived less benefit from the tax arrangements previously in effect, and they are not in direct competition with the operators exempt from the new regulations. But they too are calling for more clarity and more continuity in national legislation in order to strengthen confidence in the Peruvian leasing market. The companies interviewed were clearly uncertain and underinformed about the new amendment, and this is certainly one factor involved in the downturn in the demand for leasing services in the past two years.

Having outlined the framework conditions relevant for leasing, we will now turn to the specific role played by leasing for Peruvian SMEs. The following section starts out by looking into the quantitative side of leasing, i.e. its dissemination among SMEs in Peru. The section first analyzes the information provided by leasing operators on their customer structure and SME orientation and then looks into the use of leasing by the companies interviewed, broken down by sector, company size, and location.

Box 2: Peru's amended Tax Legislation

On December 30, 2000, an amended version of Peru's so-called leasing law – in effect since 1984 – came into force (Decree No. 299). Owing to a few remaining unclear points, these amendments were again modified in April of 2001.

Under the **old version,** the lessor was able to capitalize and write off the leased asset without undue delay. The lessee in turn was allowed to fully deduct his leasing rates from his income tax. The condition attached to these tax breaks was that the term of leasing agreements not be below 13 months (for movable goods) or 36 months (for immovable goods).

The tax implications of the **amended law** may be summarized as follows:

- The lessor remains the legal owner of the leased asset. However, in keeping with the *International Accounting Standards* (IAS), the lessee capitalizes the good and can write it off on a straight-line basis.
- The lessee can write off the leased asset at an accelerated rate if the leasing agreement contains the new minimum terms of two years for movable goods and five years for immovable goods.
- Today, however, the lessee is allowed to deduct only the interest element of his leasing rate from his taxes.
- The possibility of an accelerated writeoff has been completely eliminated for *sale-and-lease-back* agreements. The reason for this was that this type of agreement was originally intended more as an instrument to safeguard a company's liquidity than as a tax-saving scheme.

These amendments provide for exemptions for two foreign leasing operators who have concluded official continuity agreements with Peru (*convenio de estabilidad*).

Source: [www.americaleasing.com/alsaweb/frame_infoleasing.htm], (accessed on: 26 April 2002); [www.americaleasing.com/alsaweb/PreguntasFrecuentes.htm], (accessed on: 26 April 2002); Gestión Special (2002), p. IV

6.3 The Dissemination of Leasing among Peruvian SMEs

The Importance of SMEs as a Customer Group for Peruvian Leasing Operators

It is impossible to say anything definitive about the dissemination of leasing among SMEs without **reliable statistical data**. However, the Peruvian oversight authority SBS does not require banks and leasing companies to provide any data on the breakdown of their customer structures in terms of sales figures. One consequence of this is that we lack SME-specific data at both the official level and the company level. Another is that the data available are not sufficiently comparable. Most leasing operators were unable to provide detailed data on the relative significance of SMEs in their overall portfolios. Furthermore, banks differ considerably in their operational definitions: as far as annual sales are concerned, for instance, the upper limits for small companies range between USD 700.00 and 3 million; the lower figure cited is not even half the upper limit used for the present study, and the upper value is twice as high as our upper limit. Only two of the independent leasing operators involved in cooperation with bilateral donors[175] use the definition of SME on which the present study is based.

The statistical problems referred to above make it as good as impossible to come up with any reliable data on the **customer structure of bank-affiliated leasing operators**. Proceeding on the data available, we find that small companies account for some 3-10 % – in one case max. 15 % – of the leasing volume and 10-35 % of the clients of bank-affiliated leasing operators. As far as medium-sized companies are concerned, the data available fluctuate sharply between 30 % and 75 % of the overall volume of leasing business. The percentages for overall customer figures accordingly range between 10 % and 55 %. One noteworthy fact in this segment is that the banks interviewed[176] set an upper turnover limit of USD 10 million to distinguish between medium-sized and large companies.

The data on the **customer structure of independent leasing operators** indicate a somewhat more favorable picture: the two operators mentioned above – both of whom use the definition on which the present study is based – were able to provide exact data on percentage shares of both overall leasing volumes and overall numbers of customers. Accordingly, small companies account for 35 % / roughly 50 % of their leasing volume and 55 % / 70 % of their clientele. Both leasing operators report that medium-sized companies account for 35 % of their leasing volume and 20 % of their clientele. The third independent leasing company indicated that it has transacted 70 % of its leasing business with SMEs.[177]

In all, it can be noted that bank-affiliated leasing operators have a more marked presence in the SME segment than has been assumed until now – although this presence is mainly focused on the segment of medium-sized companies. Small companies account for a more or less insignificant share of the volume of the leasing business they transact with SMEs.[178] The independent leasing operators that were able to provide any more exact data on their customer structures transact far more of their business in the small-company segment. To sum up, we find that leasing business with medium-sized companies is already relatively well established among the leasing operators in-

175 This year América Leasing and the Inter-American Investment Corporation (IIC) concluded an agreement on a credit line of USD 5 million aimed at further developing leasing business with SMEs. The most important partners of Latino Leasing (today: Qualita-Leasing) are IFC und CAF.

176 Since bank-affiliated leasing operators are closely bound up with bank structures, the terms bank-affiliated lessor and bank are used synonymously here.

177 The definition of SME used by the last-named leasing operator lacks transparency and is difficult to quantify, since for it turnover figures are less important than factors like growth potential, technical know-how, and the fact that a company has survived the economic turmoil of recent years.

178 The Banco Santander must be mentioned in this connection; referring to its overall commitment in the SME segment, it indicated a share of 50 %.

terviewed, while small companies are far less apt to make use of this instrument.

Asked about their general assessment of leasing business with SMEs, the majority of leasing operators emphasized that leasing with SMEs is a highly promising business, especially in view of the profit margins that can be realized in this segment (an average of 8 %).[179] On the other hand, the profit margins indicated for large companies amounted to only 2 %. Moreover, it was pointed out, large multinational corporations have the option of seeking financing abroad at more favorable terms. Accordingly, five bank-affiliated providers and one independent leasing company expressed their interest in a stronger commitment in the SME segment.[180] However, only four of these companies already have concrete plans or are currently implementing a product geared to the specific needs of this segment.

This discrepancy is due not least to some typical problems involved in business with SMEs. In the eyes of the leasing operators interviewed, the informal status of many SMEs poses an important obstacle to their further concentration on the SME segment, in particular on small companies. It was noted that a further factor closely bound up with the issue of informality[181] is inadequate company accounting and financial management. Some additional problems pointed to in our interviews included lack of company knowledge on leasing and the fact that low-volume leasing business entails average costs that tend to be too high. On the other hand, possible gaps in demand and problems with company access to foreign exchange were not thought to play a role here, though it was noted that smaller, independent leasing operators assign greater importance to the aspect of foreign exchange than larger-sized banks, which have fewer problems with refinancing. Finally, the reticent information policy of some companies is not seen as a major obstacle for leasing operators.

The study examined leasing operators' willingness and awareness of the need to lower administrative costs as an indication that they are in fact interested in focusing more heavily on the segment of medium- and – above all – smaller-sized companies. Administrative costs are fixed costs and are therefore disproportionately higher for small leasing transactions than for larger volumes of business.

Most banks were unable to provide any data on their administrative costs per leasing contract and saw no possibilities to lower their costs. One bank had in the past planned to introduce a standardized and simplified leasing contract, but the project failed to materialize. The smaller independent leasing operators appear to be better informed on their administrative costs; and one of them is already engaged in comprehensive efforts to reduce his costs, e.g. by using a website to transact part of his leasing business.

If overly high administrative costs in fact constitute an obstacle that prevents leasing operators from focusing more on SMEs, this situation is unlikely to change much. New approaches and efforts aimed at lowering costs can be observed only in isolated cases. Nor is this surprising in view of the weak competition among Peru's finance institutions and the lack of alternative means of financing available to SMEs there.

The Importance of Leasing for the SMEs Interviewed

On the demand side the question here was: How familiar are the companies interviewed with the

179 The profits margins indicated for medium-sized companies range from 4 % to 8 %, those for small companies vary between 5 % and 15 %.

180 The two other independent leasing companies already have markedly SME-oriented portfolios; two banks expressed no intentions of becoming more active in this segment.

181 In Peru informality is also widespread among larger, registered companies. Among other things, this may mean that a certain amount of business is transacted without any invoicing, or that part of a companies workforce is not registered. The reason why this constitutes an obstacle to the use of leasing is that such practices make it impossible to cash in on the tax benefits associated with leasing and difficult for leasing companies to estimate the risks involved.

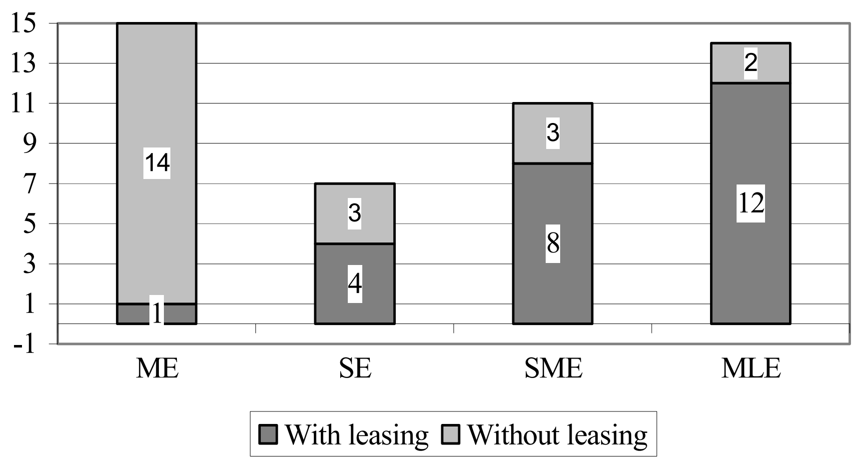
concept of leasing and to what extent do they make use of the instrument? Furthermore, we must look also into the issue of whether leasing is used more to finance capital investments than consumer goods. This issue has implications for development to the extent that in the former case leasing would prove to be an instrument ideally suited to promote investment.

Since leasing has been in use for some 20 years in Peru and the country's leasing ratio, 12.7 % in 2001,[182] is relatively high, leasing can be assumed to be a widely known instrument there. Although, as anticipated, small companies turned out to be less familiar with the concept than larger firms, the disparities are not that large. If, on the other hand, we look at the use of leasing among the SMEs interviewed, we find some clear-cut differences. We will now break the sample down to reflect differences between company size (sales),[183] company location,[184] and business sectors.

Looking at **company size** as a distinguishing feature, we find a pronounced imbalance: only one of our 15 companies with a sales volume of USD 125.000 - 750.000 has already made use of leasing. Even though the differentials between the remaining company groups are less pronounced, we can still note here that the use of leasing tends to vary according to company size, i.e. the larger a company is, the more it is likely to make us of the instrument (Figure 18).

If we look at the use of leasing as a function of **company location**, we find a marked regional differential between the capital and the towns of Cusco and Arequipa. While the large majority of companies in Lima have already made use of leasing as an instrument of financing, the majority of companies interviewed in Arequipa and Cusco had yet to do so. In Cusco, moreover, none of the companies interviewed was able to name another company that uses leasing as an instrument of financing, and half of our interviewees in Cusco thought that there were no leasing services available there. This assessment is consistent with the actual presence of leasing operators throughout the country: only four of the leasing operators

Figure 18: Use made of Leasing in Peru, broken down for Company Size[a]



Source: Authors' presentation
[a] In number of mentions

182 Cf. América Leasing, (2001), p. 5.

183 It here seemed reasonable to break the sample down further to reflect micro enterprises (sales of USD 125.000-750.000), small enterprises (USD 750.000-1.5 million), small- to medium-sized enterprises (USD 1.5-10 million), and medium- to large-sized enterprises (USD 10-20 million).

184 Arequipa, Cusco, or Lima.

interviewed are represented throughout Peru, the others operate only or mainly in Lima.[185]

Looking at **business sectors**, we find that leasing is more widespread among our textile companies and in the agroindustry, even though agroindustrial companies differ markedly from the rest of the sector as far as their management, profitability, and (export-) market orientation are concerned. This finding is matched in part by the information provided on the supply side. The great majority of leasing operators indicated that they served SME clients in the textile sector, while the agricultural sector played less of a role for them. The reasons given for this were sharp fluctuations and poor management in the sector. However, a look at the data available to the oversight authority, SBS, concerning the distribution of the overall business volume of leasing companies across sectors does not wholly confirm this impression: textiles and leather (6 %) do not account for a significantly larger share of the volume of leasing business than the agricultural sector (some 4 %).

We can confirm the thesis that (finance) **leasing mainly serves as an instrument to finance investment**. Asked for the types of goods they finance via leasing or for the procurements they planned to make, our companies most frequently named machinery, followed by real estate (land and buildings), and small vehicles. This is in line with the information provided by the supply side, according to which machinery accounts for the largest share of the goods leased to SMEs. While real estate invariably accounts for the greatest share of the overall portfolios of leasing operators, as far as leasing business with SMEs is concerned, real estate takes second place to machinery.[186]

Finally, it can be noted that nearly all of the companies interviewed are familiar with leasing as a concept and have already financed investments through leasing or indicate a positive attitude toward leasing. However, we found marked disparities as far as the use of leasing is concerned: the smaller the company is, so it appears, the more difficulties it has gaining access to leasing. Furthermore, companies in Cusco or Arequipa are faced with far more worse conditions in obtaining finance leasing than SMEs located in the capital.

6.4 The Advantages of Leasing in Theory and in Peruvian Reality

Leasing is seen as offering a number of important advantages specifically for SMEs. The present chapter looks into whether and to what extent these advantages are in fact given. In connection with our empirical survey, we asked representatives of both the supply side and the demand side for their opinions on certain advantages. Our first aim was to determine the importance for companies of each individual key feature of leasing. Our second aim was to work out the conditions under which leasing is provided in Peru and to determine whether and to what extent SMEs are in fact in a position to profit from the positive features of leasing.

6.4.1 Access

Against the background of the cost-intensive and limited access to investment borrowing given in Peru, leasing is an important source of financing for Peruvian SMEs. Company motivation to use leasing as an instrument of financing is a reflection of the limited options available in the Peru-

185 Furthermore, some companies in Arequipa und Cusco complained that although the larger banks had branch offices there, they were required to consult with their headquarters in Lima on any decision, particularly bearing on credit, and that all further correspondence had to be conducted directly with Lima. The consequence, it was noted, was a more or less inflexible provision of financing arrangements.

186 One bank affiliated leasing operator explained this with reference to the higher investment volumes involved, noting that they were beyond the reach of smaller companies.

vian financial system. In the view of the companies interviewed, the main reason why leasing is attractive is that it is often the only financing instrument available, or that access to it is relatively uncomplicated. However, in Peru there are still obstacles to a more broadly effective use of leasing, as is shown by the following list of conditions for an adequate access to it:

— The main factor behind the less restrictive stance of finance institutions on the provision of leasing services to SMEs is as a rule the fact that **leased assets can serve as security**. This means that companies that lack sufficient investment capital can in this way gain access to outside financing. And, at the same time, leasing provides such companies with the option of using unencumbered real estate etc. to obtain further financing.

  Our empirical survey clearly indicates that companies attach great significance to the aspect of asset-unrelated security: the large majority of our companies saw the possibility of using leased assets without having to provide any additional security as "very important."[187] But of course theory is not always wholly in line with day-to-day practice: roughly half of our companies have been asked to provide additional security, and on this point there appears to be no clear-cut relation between company size and demand for security. It is, however, noteworthy that agricultural companies have been more frequently required to provide security unrelated to the asset in question than have companies from the textile and clothing industry. This fact is due to the view of leasing operators that the textile sector is a highly promising branch of industry, while the agricultural sector involves high risks.

  For their part, leasing operators confirm that the risk involved in leasing is lower than that involved in credit. But they also point to the common Peruvian practice of demanding additional security from customers. The reasons cited for this practice include the high default risk of small and medium-sized companies and the limited possibilities available to lessors to recover the value of leased assets in cases of default. For lack of adequate secondary markets, leasing operators fear that they will be unable to recover the market value of a leased asset in cases of customer insolvency.

— The generally greater ease of access to leasing is furthermore bound up with the **type of risk analysis** on which the financial transaction is based. As a rule, future-oriented financial information plays a more important role here than past company performance data: in making decisions on leasing contracts, the anticipated cash flow is more important than a company's capital base and past credit ratings. This is a relevant aspect especially for young companies that have no past credit rating and often have a relatively thin equity position.

  A majority of the companies interviewed see a future-oriented risk analysis as adequate and extremely useful. But in practice investor risk assessment is rarely transparent. Many companies see risk analysis as a kind of black box and are unsure of what providers are actually interested in knowing. In most cases providers simply demand to see all company data. It is, however, clear that anticipated cash flows are given insufficient attention in risk analysis. Over half of the companies that operate with leasing claim that there is no difference between leasing contracts and bank loans as far as the requirement to provide company data is concerned, or that in both cases cash flow and past credit rating are of equal significance.

  Our interviews with leasing operators confirm this observation. Even though most leasing operators see the factor of cash flow as very important, it is only in rare cases that this factor plays a crucial role in the final decision. Not one leasing operators accepts cash flow as the sole and decisive indicator, and for many providers a negative past credit rating and/or a weak capital base are exclusion criteria. Bank-affiliated leasing operators state, though, that it is not absolutely essential for a leasing customer to be a client of the bank in question

187 43 of 48 companies share this view.

when a contact is finalized. It is, however, crucial that the company in question does not have a negative record with the central Peruvian credit-rating agency, Infocorp, the SBS, or suppliers.

— Another feature that is often seen as facilitating access to leasing are the **rapid processing and decision-making procedures** involved in the process.[188] The fact that a leased asset remains the property of the provider during the contract period facilitates risk analysis and speeds up contract procedures. This saves time and means relatively low transaction costs for the lessee.

The large majority of demanders regard it as very positive that leasing contracts can be concluded without undue delay. Most companies already experienced in leasing confirm that this financing instrument is in fact provided with less delay than conventional bank loans. Only one fifth of our interviewees claimed that in this respect there is no difference between leasing and bank loans. Furthermore, several companies indicated that the speed of contract processing differs greatly from leasing operator to leasing operator.

An interesting fact in this connection is that independent and bank-affiliated leasing operators have very different perceptions of the time needed to implement leasing contracts. All of our independent leasing operators claim that leasing services are provided far more quickly than bank loans. Two thirds of our bank-affiliated providers note that although leasing may not be faster, it is at least easier to obtain than a bank loan. In contrast to the bank-affiliated leasing operators, the independent leasing companies proved to be very accurately informed on processing times. Banks normally refer the decision process and risk analysis for leasing transactions to their central risk-appraisal department, which renders the overall process more time-consuming and less transparent.

— Another factor that makes leasing an effective and more easily accessible instrument of financing is – compared to investment loans – the **low minimum amount** at which a leasing operator is willing to conclude a contract. This makes it possible for companies to meet low-volume financing needs. It is also important to note here that many companies are interested in leasing used goods for reasons of cost. If the minimum volumes set for a leasing contract are too high, this type of financing is often not an option.

The minimum leasing volumes demanded by providers in Peru range from USD 10.000 to 50.000. Only in exceptional cases are contracts concluded under USD 10.000. Yet in some cases, e.g. leasing agreements on used machinery, this lower limit is too high, and in many cases this puts an end to financing plans.

188 Cf. IFC (1996), p. 10.

Box 3: América Leasing S.A. – an SME oriented Leasing Company

América Leasing S.A. was founded in Lima in 1995 as an independent leasing company. With its **assets** of USD 51.7 and a **contract portfolio** worth USD 647 million, the company ranks 12th among Peruvian leasing operators. América Leasing has a market share of 3.7 % of the overall Peruvian leasing market and a 6.9 % share of specialized leasing business. With its 7.1 % **return on equity**, the company is distinctly above the market average (4.5 %). In 2001 América Leasing successfully concluded a due diligence process with the IIC, which provided it with a five-year credit line on international terms. This credit makes it possible for América Leasing to further diversify its sources of financing and enhance its competitiveness.

América Leasing is by far the strongest of the 23 **SME-oriented leasing operators** active in the Peruvian market. According to its managing director, SMEs account for 90 % of the company's customers and 83 % of its business volume; the figures for small companies are 70 % and 48 %, respectively. The definition used here is the same as that on which the present study is based. The company's portfolio of leasing contracts is highly diversified and spread mainly across the sectors of industry, trade, transportation, and services. Its positive **risk diversification** is mirrored in the types of leasing assets it finances, the most important of which are real estate, industrial equipment, and vehicles. With its average **contract value** of USD 86.000, América Leasing is far below the Peruvian market average of USD 222.000. The minimum contract volume set by the company is USD 10.000, though in exceptional cases it is prepared to accept lower amounts.

The **leasing contracts** offered by América Leasing are in many respects more attractive than those of most of its competitors. The lessee is free to decide whether his contract is denominated in domestic or foreign currency. The leasing contracts as a rule have terms ranging from two to five years, and in some cases up to eight years. The company demands asset-unrelated security from only 15-20 % of its clients, and requires deposits averaging 20 %. Moreover, América Leasing's management attaches great significant to intensive contact with its customers and visits them on a regular basis. It also sends information to its clients every three months. Every six months América Leasing calls in balance information from its customers in order to keep track of their financial situation. América Leasing takes a proactive stance on services, offering its customers both accounting and management support and advice on the financing instruments and leasing assets most appropriate for them.

Another positive feature of América Leasing's activities is the advanced state of the **IT solutions** it offers. By using software it has developed itself, América Leasing has managed to keep its administrative costs relatively low, even for low-volume leasing contracts. It is also the only Peruvian provider that has a detailed and informative website that permits clients to concluded certain contracts online.

On the whole, the case of América Leasing illustrates that leasing services optimized for SMEs can offer advantages for both sides. Its customers can profit from the enhanced services offered by América Leasing, including more advisory services and intensive support. For América Leasing itself, business is highly profitable on account of its higher margins, a fact mirrored in the company's success. Seen in overall economic terms, the company contributes to creating favorable conditions for the development of SMEs and the formalization of companies in this group.

Source: Interviews with the managing director of América Leasing on 03 July 2002 and 25 April 2002; América Leasing (2001).

6.4.2 Financial Margins

Another advantage associated with leasing is the fact that this instrument constitutes less of a burden on company financial margins than other forms of financing, especially when the concern is to finance long-term investments. This aspect is of great significance mainly for SMEs in developing countries, which have very limited access to long-term capital and lack sufficient resources of their own.

— In industrialized countries these improved financial margins are due above all to the fact that leasing companies as a rule **finance 100 % of leasing assets** and do not require the lessee to provide a deposit. Unlike the case of self-financing or bank financing, this approach does not burden a company with an immediate cash outflow, a factor which lowers the high risk of insolvency in particular at the outset of a project.

Most of our interviewees (some 90 %) regard 100 % financing as an important or highly important element of leasing.[189] However, only one third of the companies that have already made use of leasing have been able to finance 100 % of their investments; and the majority of companies interviewed were asked to provide a deposit ranging from 10-40 % of the value of the assets to be leased (the average being 20 %).

According to our leasing operators, only in rare cases is 100 % of a leasing asset financed, and the average deposit required varies between 20 and 30 %. The reason cited by leasing operators for their need to ask for a deposit is that in a country like Peru, in which secondary markets are underdeveloped and economic development is subject to sharp fluctuations, deposits constitute an important component of risk-reduction strategies. Furthermore, for a minority of our interviewees deposits are an important signal of client commitment that mirror lessee confidence in a planned investment.

— Another key feature of leasing, one which increases company financial margins, is a level of **flexibility of contractual arrangements** that is generally not given in conventional credit agreements. This offers companies the option of adapting both leasing rates and time frames to their individual financing needs. This means, for instance, that a company whose sales are dependent on seasonal factors can opt for a leasing contract stipulating high rates for high-revenue months, and vice-versa. And this makes it possible to a-void liquidity bottlenecks at given periods of an investment.

It became clear in the course of the study that companies that have not yet made use of leasing place more emphasis on flexible contractual arrangements than companies that already have experience with this financing instrument. One possible explanation could be that companies that have already made use of leasing are generally in a better financial situation than others and therefore less dependent on this flexibility. The results of the survey showed that leasing has been flexibly adapted, in one way or another, for roughly half of the companies in the sample. In most cases this flexibility meant leasing rates adjusted for seasonal factors. It is, however, noteworthy that one quarter of the companies interviewed were unaware of the theoretical possibility of flexible contractual arrangements.

Two thirds of our supply-side leasing operators claim to be highly flexible in their contractual arrangements. They spoke of seasonally adjusted rates and the possibility of interest-free start-up years. But our providers also pointed out that this flexibility is restricted to the period until a leasing contract takes effect. Once the contract is finalized, it is no longer possible to alter its terms. If the lessee fails to make payments, the lessor is entitled to repossess the leased asset.

6.4.3 Cost Advantage

Costs are one of the most important factors involved in any kind of financing. Leasing is often said to be a more a more **economical form of financing** than borrowing.

Fifty percent of the persons interviewed for the present study confirmed that in their case leasing turned out to be more inexpensive than a comparable bank loan. But it was also often pointed out that the cost advantage of leasing must be sought not in the instrument's price or interests costs but in the tax breaks it offers. In cases where leasing has turned out to be more costly than a comparable bank loan, companies have still opted for leasing because their applications for credit-based financing were rejected by banks.

On the supply side we find one significant difference between the statements made by bank-affiliated and independent leasing operators.

189 The responses possible were "very important", "important", or "unimportant".

Without exception, the independent leasing operators indicate that leasing is less costly than a normal bank loan. If companies did not have the possibility to write off the interest share of a finance leasing transaction, there would be no price differential between it and a bank loan.

Some of the possible cost advantages of leasing are thus due to non-interest elements that were analyzed in the framework of the present study:

— Peru's **tax framework** plays a key role in making leasing more attractive and in lowering costs. A large majority of the companies that have already made use of leasing underline that tax-related aspects are one of the most important motives to opt for leasing as a means of financing investments. But it is also noteworthy that the other companies interviewed were far less familiar with this aspect of leasing. There is a great need for information and publicity work here if leasing is to become better known as an interesting alternative means of financing.

— A further cost advantage can result from the fact that due to their bargaining power vis-à-vis manufacturers, leasing operators are in a position to obtain **more favorable terms** for the purchase, maintenance, and insurance of leasing assets than companies themselves.

In Peru, however, most of the leasing offered is finance leasing or operate leasing.[190] What this means is that maintenance of a leased asset is not part of the services provided by the leasing operator, who thus assumes no responsibility for this aspect. Even in the procurement of leasing assets Peruvian leasing operators show little initiative: only in rare cases does a leasing operator negotiate directly with a wholesaler. The consequence is that lessees benefit neither from low procurement costs not from better conditions on equipment maintenance.

190 See Chapter 3.3 for a discussion of the different forms of leasing available.

6.4.4 Medium- and long-term Financing

As a rule the term leasing refers to the medium- to long-term 'rental' of capital goods. In view of the generally short terms of loans granted in Peru, the terms provided for leasing play a significant role for the companies concerned. The average terms for leasing agreements on movable capital goods named by the companies interviewed ranged between two and five years; and the contracts concluded for immovable capital goods specified terms ranging on average between five and eight years. Most of the companies interviewed see these terms, which are in line with the minimum terms set by law, as appropriate.[191] Roughly one third of our interview partners would, however, prefer longer-term leasing contracts. In the agro-industrial sector in particular, five years are often not sufficient to cover a project cycle.

The information provided by leasing operators on the average terms of leasing contracts confirms the information given by the demand side. It is noteworthy that a bank that, owing to the terms set out under the so-called *convenio de estabilidad*,[192] is not obliged to comply with the legal regulations on minimum periods in fact offers contracts with shorter terms than both other banks and independent leasing operators. Still, leasing continues to be the preferred instrument for financing medium- to long-term investments.

6.4.5 Additional Services

Finally, compared with classic bank loans, leasing often entails the provision of additional services, which might include support for company management, accounting, or marketing activities. Family-run companies, for instance, often tend to neglect some important business aspects, including accounting. The external support provided by a leasing operator can contribute to formalizing such firms and enhancing their market capability.

191 See Chapter 6.2 for a discussion of the minimum terms set by law for leasing.

192 See Box 2.

Companies that have not yet made use of leasing as a rule also see these additional services as a helpful and desirable element as long as the costs they entail remain at reasonable levels. Only a few of the companies interviewed were reticent and showed no interest in company support elements, preferring to manage their company's leasing affairs themselves. The survey furthermore found that only a limited number of the companies that already have experience with leasing have been offered any additional services. Most of them have not even considered the possibility of accepting management, accounting, or marketing support from their leasing operator.

7 Summary of the Study's Empirical Results, and Conclusions

The conclusions and recommendations presented in this chapter are based on the following findings of our company survey:

- Even in a Peruvian setting that was found to be not particularly dynamic, we identified a number of companies in the SME segment that are marked by both great potential and high levels of investment activity.
- But these companies are unable to grow sustainably as long as they do not have an adequate access to capital that permits them to meet their financing needs.
- Targeted promotion of SMEs would enable this business segment to take advantage of its comparative advantages and develop into a mainstay of the Peruvian economy. The instruments of venture capital and leasing discussed in the present study have an important role to play here.

The study's findings are meant to serve as an action orientation for the provision of a set of financing instruments geared to the needs of SMEs. As discussed below, the addressees include both the Peruvian government and actors from the private sector and development cooperation.

7.1 Promotion of the Venture-Capital Market

As the empirical study shows, venture capital represents, in the view of the companies interviewed, a reasonable alternative means of financing capital investments. On the one hand, venture capital can be used to strengthen their equity base, and on the other hand companies can in this way make use of the advisory and support services provided by fund managers. The fact that the SMEs interviewed showed themselves to be relatively open to a more stringent requirement to provide company information as well as to accept the control function of an external financier stands in contrast to the assumption of the supply side that many companies would reject these conditions. Moreover, a large number of the companies interviewed indicated that they were in a position to meet the high earnings expectations of funds (20-30 %). Their willingness to accept outside investors is accordingly high and permits the conclusion that the establishment of a venture-capital market could set important development incentives in the SME segment.

However, in the view of the supply-side actors interviewed, there are **three central obstacles** to the development of a venture-capital market:

- the tax framework,
- the low number of capital investment companies with sufficient experience and institutional backing, and
- the limited exit options available.

Above and beyond these concerns expressed by the actors involved, the results of the study point to a **fourth serious bottleneck** that constitutes a drag on the development of the venture-capital market: both the number of investors expressing interest in investing in a venture-capital fund and the levels of the investment volumes under discussion indicate that the number of institutional investors active in the Peruvian venture-capital market are insufficient to guarantee any sustainable provision of venture capital. On the whole, only four to six institutional investors showed active interest in the concept. Adding up these potential commitments of capital, we arrive at a figure of max. USD 30-40 million that would be available to set up venture-capital funds, a figure that would – assuming a uniform orientation of investor interests – suffice to establish two funds.

To overcome these bottlenecks, both the Peruvian government and bilateral DC could focus on a number of different fields of action indicated by the weaknesses diagnosed above:

Adequate Tax Framework

As opposed to natural persons, venture-capital funds should not be subject to income tax and should instead have a neutral status in tax terms. The criticism of the present tax system voiced by our interviewees focuses in particular on two points:

— Current tax practices lower the profitability of venture-capital funds, placing them at a disadvantage compared with other capital investments. This must be emphasized in particular in view of the fact that interest and capital gains realized in the stock market are temporarily exempt from taxation.[193]

— Positive experiences have been made in other countries like Chile, Uruguay, or Venezuela, in which funds have a only channeling function and are themselves not obliged to pay taxes. This is in line with the recommendations of the IFC.[194]

New legislation currently under discussion could provide clarity and encourage the development of venture-capital funds. The proposed legislation would require investors to declare their capital gains as income. Funds, on the other hand, would be tax-exempt and have only a channeling function. This arrangement would also contribute to the development of a clear-cut and stable system of tax legislation by ruling out the possibility of double taxation (on investor and fund alike), which has thus far been avoided on the basis of temporary – and regularly renewed – tax exemptions. It would thus be important for this bill to be passed as soon as possible.

Capital Market Development

The further three obstacles named above are an expression of Peru's' relatively shallow and underdeveloped capital market. A functioning capital market is the sine qua non for any broadly effective use of venture capital. Efforts geared deepening this market and rendering it more efficient contribute to reducing these impediments. In general terms, the following measures can contribute to promoting the capital market:

— First, it would be possible to continue on with the most recent approaches aimed at integrating new issuers, like trade in low-volume papers (*valores de emisión no masiva*), stepped-up issues of government bonds, and revision of the framework for short-term papers.

— Second, it would be possible to take steps toward improving investor protection, e.g. by unifying the criteria used to rate securities and by revising the legal corporate framework for listed companies.

— Third, it would be essential to guarantee more liquidity on the stock market. Possible approaches here would include the introduction of after-hours trading and adjustment of the guarantees required for short-term papers.

Aside from these general recommendations, it would be important to introduce some additional measures specifically geared to overcoming the above-named obstacles. These will be outlined in what follows.

Enlargement of the Number of Institutional Investors

The currently limited number of institutional investors is a factor detrimental to the establishment

193 See Texto del Impuesto a la Renta (Decreto Supremo N° 774), Article 19. This exemption is in force until 31 Dec. 2002, though it is expected to be extended.

194 Cf. Carter (1995), pp. 14f.

of venture-capital funds. Three points could be addressed in this connection to create a viable base of investors:

— Even though reform of Peru's pension system has provided an important impulse toward diversifying country's institutional landscape, the AFPs continue to constitute a quasi-oligopoly, in particular as far as long-term financial investments are concerned. This de facto concentration of financial resources on four institutions makes the establishment of a venture-capital fund contingent on the investment decisions taken by the AFPs. Furthermore, in view of the present lack of any other long-term savings products and the obligatory character of pension payments, the control of long-term private savings by pension funds is an important factor involved here. One possible approach to promoting a future diversification of institutional investors would entail the reform of the **national pension system**. What is called for here is viable measures aimed at bringing about a more flexible and less concentrated investment of pension contributions and at the same time stimulating private saving. One conceivable approach would be the introduction of a second, voluntary pillar of the pension system; the resources involved could be administered by specialized financial institutions, for instance on the model of the US 401(k) Plan (Box 4). Other approaches aimed at stimulating private saving have been implemented e.g. in Chile and Mexico. In Chile tax breaks are granted for certain forms of investment, including voluntary contributions to the country's private pension system and home loan and savings contracts. Mexico's *Patronato de Ahorro Personal* is a program for small savers that guarantees savers a positive rate of interest if they meet certain conditions, e.g. regular payments into the program. Another possible incentive could be a lottery linked with contribution payments: starting at a certain minimum amount, the contributor automatically becomes a player in a lottery, and the sums won are directly remitted to the winner's savings account.[195]

— Furthermore, government can also assume a greater role as an investor in the venture-capital market by boosting the development of the market with the aid of special vehicles of investment. One promising approach would be the creation of a fund that invests exclusively in private venture-capital funds operating in Peru. This so-called **fund-to-fund financing** operates on a principle analogous to the indirect financing of end customers practiced by COFIDE. It is not least due to this parallelism that COFIDE

Box 4: The 401(k)Plan – Private Pension Arrangements in the US

Since the early 1980s the so-called 401(k) Plan has been the most important pillar of the private pension system in the US. The term 401(k) refers to a section in the US tax code that permits employed persons to pay a certain share of their gross wages or salaries (in 2000 the maximum amount was USD 10.500 p.a.) into a private pension fund of their choice.

As a rule, the funds start to pay when a participant has reached the age of 60, and the sums paid out are taxable. In hardship cases, participants are permitted to tap their balances at an prior to maturity. Furthermore, participants are entitled to borrow, at their own discretion, a share of the capital they have saved.

In 1998 34.6 % of US households had a 401(k) account with an average balance of USD 57.220. The average participant pays 6.7% of his gross wage or salary into this private pension plan. As a rule, employers also participate in the plan, though their contribution (2-5 %) is distinctly lower than it is in conventional pension plans. The volume of the 410(k) Plan has grown constantly since its inception in 1981, increasing from USD 41.5 million in 1986 to a figure of USD 142.6 million in 1990, USD 486 million in 1996, and USD 1.2 billion in 2000.

Source: Gesichertes Leben, [www.gesichertesleben.de/archiv/rente/791971302133923840.html], (accessed on: 21 May 2002); 401k.com, [www.401k.com/401k/pfp/rp/fringe.htm], (accessed on: 21May 2002); and IG Metall(2001), p. 12

195 Cf. Repetto (2001), pp. 227 - 232.

would appear to be well suited to administer a fund of this type. COFIDE has recently reviewed various instruments suited to promoting the venture-capital market and is now convinced of the advantages involved in fully financing and administering such a fund patterned on semi-governmental agencies e.g. from Germany (KfW) and the US (SBA). To boost the instrument's effectiveness and to signal its intentions, a higher-level fund should be entitled to assume investment obligations totaling up to 33 % of another fund's total assets. However, COFIDE's authority to establish a fund on its own responsibility is limited, and it is at present unlikely the MEF itself will provide the financial resources required. Here, multi- and bilateral financial cooperation institutions could provide an important contribution by making available certain shares of the resources needed to establish a higher-level fund.

— Clear-cut regulations on the **investment rights of public institutions** that could act as investors could provide a further impulse toward diversifying the investor landscape in Peru. A revision of the country's investment regulations is anticipated in the near future. At present public institutions are required to invest 70 % of their assets in deposits offering the highest possible interest rate determined by a call for bids. There are no concrete regulations covering the use of the remaining 30 %. When the regulations are revised, it would be desirable to provide for the possibility of public institutions to invest in venture-capital funds. Even though conservative investment strategies are appropriate for public institutions, which often lack sufficient expertise in investment management, this approach could generate more interest in new forms of investment. By hiring specialized fund managers and introducing a more complex form of portfolio analysis geared to examining the papers available in the investment market, public institutions could begin to play a more active role in the capital market.

Development of Human Capital

As far as the low number of fund managers available in the Peruvian market is concerned, greater investor demand for higher-risk and higher-yield investment opportunities is the best means to ensure the development of the human capital needed to strengthen capital investment companies. Aside from this, joint efforts undertaken by government decision-makers and bi- and multilateral development cooperation can contribute to popularizing the concept of venture capital and providing the relevant actors with the know-how they need. Other promising approaches include seminars, practice-oriented visits abroad, and other communication-related instruments like the setup of an Internet platform that facilitates contacts between investors and capital-seeking businesspeople. One good example of concrete support for the training of fund managers is offered by the Chilean development bank CORFO, which funds advanced training seminars for fund employees in the US or invites experts to the country to conduct advanced training measures. The IADBcommitments to Peru include a training component for the financial sector that could be utilized for this purpose.

Startup Initiatives and Improvement of the Administration of Peruvian Companies

Looking at the last-named obstacle, limited exit options, there exists as far as IPOs are concerned a possibility to reduce the transaction costs which are connected with the access to the stock exchange. However, creation of a new segment of the stock exchange for trade in papers of young or smaller companies appears unrealistic, at least at present.

As regards the possibility of buybacks, the potential investors interviewed expressed doubts as to whether the companies concerned had the **critical mass** needed. Many Peruvian companies, it was noted, have been unable to meet growth expectations and lacked the **administrative structure** required for a venture-capital investment. Here, political decision-makers have three principle options for action:

— First, the state could directly promote start-up initiatives, e.g. by fostering and supporting incubators or business development or start-up centers. One point of departure here would be the country's 70 universities, though care should be taken to select universities that offer high-quality and practice-oriented courses of study.

— Second, SME administration and management can be provided support through business development services. Here, support programs are already being conducted by German and bilateral donors.

— Third, seminars tailored to the needs of interested businesspeople that can at the same time facilitate contacts between suppliers and demanders of capital.

7.2 Promotion of Leasing as a Financing Instrument for SMEs

The present study's findings on the Peruvian leasing market lead to the following central conclusions:

— Leasing is an effective instrument that permits SMEs in developing countries to procure medium- to long-term resources for their investments.

— In Peru leasing is already widely disseminated among medium-sized companies, though the instrument is not yet widely used by smaller companies.

— Some of the advantages widely attributed to leasing for SMEs were not confirmed for Peru.

Proceeding from these findings, the present study recommends the following approaches to increasing the use made by SMEs of the instrument of leasing and better adapting the "product" to the needs of SMEs.

Greater Dissemination of Leasing Among SMEs – the Quantitative Aspect

Promising approaches to further disseminating leasing among SMEs should focus on the government and DC levels as well as on the market actors themselves.

The basic condition of any sustainable SME support policy is reliable information on the group targeted by the policy as well as on its significance and regional distribution. In Peru, however, there is no viable, unified **database** available **on SMEs**. A valid definition of the segment formulated at the government, ministerial, level would contribute to clarifying the picture. Furthermore, the relevant government actors could undertake more, and more targeted, efforts than they have in the past to collect and statistically evaluate relevant data. The financial intermediaries of the SBS could be called upon to meet their obligation to break down their portfolio in terms of customer size. As far as leasing is concerned, this would make it possible to come up with reliable data on the SME orientation of individual providers, and this in turn could serve as a basis for defining concrete support measures, e.g. measures aimed at facilitating refinancing.

What is called for to alleviate the current uncertainty among the actors interviewed as regards the present **legal framework** and its tax implications is an analysis of the burdens of individual companies and the allocative effects of the new depreciation regulations. In general, international experiences have shown that tax incentives substantially boost the willingness of leasing operators to expand their operations to include SMEs. It should at the same time be noted that such incentives do not necessarily mean a reduction of tax revenues, since they for the most part lead to a disproportionate increase in the absolute values of transactions. To create an environment that is conducive to leasing and poses no additional uncertainties for market actors, Peru should therefore implement a legal framework that provides for adequate tax benefits, applies equally for all leasing operators, and is set to remain in force for a longer period of time. The present tax framework should be reviewed with this in mind.

Leasing operators are forced to rely on adequate **refinancing mechanisms**, and these are limited in Peru. It can thus be said that the issue of refinancing constitutes a serious constraining factor for independent leasing operators and a high barrier to the market entry of new providers. This is also indicated by the low number of providers in general and the low number of independent providers in particular encountered in the Peruvian market. As the present study has shown, independent leasing operators tend to be more SME-oriented than bank-affiliated providers. Against this background, the government side or the donor side could create alternative means of refinancing with appropriate security arrangements. This would facilitate the market entry of additional independent leasing operators and enable bank-affiliated providers already active in the market to expand their operations. And this in turn would entail positive effects on the intensity of competition in the Peruvian leasing market and at the same time broaden the scope of leasing for SMEs.

In their **promotion of leasing institutions**, bi- and multilateral financial cooperation organizations should focus on medium-size leasing operators. The reason why this appears appropriate is that this category of leasing operators is large enough to be able to operate cost-effectively, without being hampered by the typical bank structures that restrict flexibility and close customer relations. Another issue closely bound up with refinancing is a framework that permits and promotes the formation of **strategic alliances** with foreign manufacturers and financial institutions. Above and beyond a broadened refinancing potential, this approach may also entail a transfer of knowledge, for instance concerning novel or innovative decision-making mechanisms in the leasing business. Finally, deficits in accounting and company management in the SME segment constitute an obstacle to an expansion of leasing to include small companies. By instituting and promoting **business development services** (BDS), government agencies could contribute to closing this formalization gap.

Looking at the relevant market actors, we find that the risk associated with SMEs constitutes an obstacle to any expansion of leasing to include SMEs. One way to address this increased risk would be to work for closer and more open **cooperation** between leasing operators and their clients. From the perspective of providers, close customer relations not only give rise to customer loyalty, they also are conducive to obtaining better information on the circumstances of client companies. And this can render **risk analysis** more transparent than it has been in the past. At present companies see risk analysis, particularly that conducted by banks, as a kind of black box, which makes it as good as impossible for them to comprehend certain decisions with which they are faced. Open cooperation in advance of decisions and, if worse comes to worse, a reasoned, "constructive" rejection may provide customers with a chance to eliminate their weak points, and this in turn can contribute to company formalization. More transparent decision-making mechanisms should be accompanied by a greater range of **advisory and support services** provided by leasing operators. This can help customers to improve their financial management and make their accounting more transparent.

Adjustment of Leasing to the Needs of SMEs – the Qualitative Aspect

The present study's findings indicate that the leasing agreements offered in Peru lack, or are deficient in, certain elements which are commonly regarded as typical of leasing. We are thinking here in particular of three elements of leasing contracts that run counter to the needs of SMEs:

- Leasing operators often demand guarantees and a deposit.
- Decisions on contracts take insufficient consideration of the cash flows of potential clients.
- Access to leasing is often too slow and lacks sufficient flexibility.

Development of the markets for used goods.

One reason cited by the leasing operators interviewed for their need to demand additional guarantees and deposits is the insufficient size and specialization of the Peruvian market for used goods. This factor is due on the one hand to the size of the Peruvian economy on the whole and on the other hand to the weakness of the economy in recent years. There is little that can be done to alter this picture or to counter the major loss of a value to which goods are subject once they have been purchased. Both government and market actors can, however, take certain measures to alleviate this effect.

The **government side** can work to reduce information asymmetries and improve the flow of information in used-goods markets. These markets are generally highly intransparent. In Germany, for instance, creation of a fair for used machinery has substantially increased market transparency.[196] Furthermore, Internet platforms can be used to bring supply and demand more into line. In recent years the Internet has become an indispensable marketplace for used goods – though the quality and user friendliness of supplier websites often leave much to be desired. A competition on the design of a central Internet platform could help to reduce such deficits.

For their part, **market participants** should give more thought to the option of used goods. This can work to the benefit of both sides: the lower risk of depreciation in the years following the purchase of a good can compensate a leasing operator for the additional costs he incurs in assessing the quality of a good and make it possible for the lessee to cut his procurement costs. Moreover, it may prove advantageous for a leasing operator to retire from the strict role of financier and assume a more active role in sales negotiations between manufacturer and lessee. Thanks to his market power, the leasing operator is in a position either to obtain a more favorable price or to induce a manufacturer to agree to a repurchase guarantee for a given period of time.

196 Cf. Fleig (2000), p. 274.

Consideration of the Factor of Cash Flow in Decisions on Leasing Contracts

As far as decisions on leasing contracts are concerned, there is little of the often-touted future-oriented character of leasing to be seen in Peru. Whether and to what extent leasing operators can be induced to show more flexibility toward their customers in this regard depends in large measure on competitive pressures in the market, but also on the information provided by clients on the potentials and chances offered by leasing. The latter could, for instance, be addressed in workshops conducted by the chambers of commerce for interested businesspeople.

Simplification and Acceleration of Access

As an instrument, leasing is relatively easy to manage and entails lower risk than other financing instruments. However, the present study was unable to confirm the expectation that, at least for standard goods, decision procedures would be briefer than they are for bank loans. Furthermore, and in keeping with Peru's centralist structure, leasing services are largely concentrated in Lima.

Both leasing operators and their clients can contribute to accelerating the decision-making process. A **leasing client** interested in having his leasing application processed promptly should be prepared to present a punctual, viable, and reliable documentation on his company and his planned project. For their part, **leasing operators** interested in focusing their business more on SMEs can facilitate access regionally by improving their presence in the regions and giving their regional branch offices more competence to decide on leasing contracts. Moreover, bank-affiliated leasing operators are only likely to accelerate the procedure if leasing contracts are not processed like bank loans in a central risk-assessment department but instead decided on a decentral basis in regional branch offices. The efforts already undertaken by some leasing operators to standardize and simplify leasing contracts as a means of both speeding up procedures and reducing costs should be further pursued.

To conclude, the present study's goal was to work out and present a conceptual contribution on the assessment and promotion of alternative instruments of investment financing for SMEs. The study's aim was in particular to examine whether and under what conditions leasing and venture capital are, or can in fact become, effective means of financing for the target group, SMEs. In general, the two instruments turn out to be well suited to financing the investment of SMEs. It is becoming evident that in the medium term venture capital will reach only a limited number of SMEs, though the instrument can provide important impulses that help SMEs to exploit their comparative advantages and thus to master the ongoing process of structural change. Leasing, on the other hand, is better suited for use as a broadly effective financing instrument that can serve to supply SMEs with the long-term financial resources they need and reach even the smaller companies of the target group.

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Appendix

Appendix 1: Possible obstacles to the Development of the Venture-Capital Market in Peru. Response possibilities: “highly relevant”, “relevant”, problem of “low relevance”

Possible obstacles to the Development of the Venture-Capital Market in Peru. Response possibilities: “highly relevant”, “relevant”, problem of “low relevance”	
1	Limited fungibility of fund shares
2	Limited exit options
3	Legal framework
4	Tax legislation
5	Lack of experienced fund managers
6	Lack of investors
7	Lack of transparency on the part of entrepreneurs as far as external capital and control are concerned
8	Lack of company transparency
9	Lack of enterprises with potential

Appendix 2: List of interviews conducted in Peru

Experts (15)

18-02-02	CONASEV	Carlos Castro, Rodny Rivera
21-02-02	PROCAPITALES	Daniel Cordova
21-02-02	Ministerio de Agricultura	Gycs M. Gordon
22-02-02	Equitas Partners	Omar E. Goyenechea, Isabel Elías
26-02-02	SNI, Comité de Industria de laConfección	Fernando Carrasco
26-02-02	SNI, Comité de Industria de Textil	Martín Reaño
27-02-02	GTZ	Uwe Kleinebrahm, Martha Cruz
05-03-02	APOYO	Lizardo Miranda, Miguel Angel Zapatero
07-03-02	Inform@ccion	Fernando Cillóniz
11-03-02	Enfoca	Enrique Solano
14-03-02	FOMIN	Fernando Lucano
19-04-02	SEAF	José Garcia
23-04-02	VIP	David Ambrosiani
25-04-02	Estudio Rodrigo, Elías y Asociados	Dr. Juan José Cárdenas

Potential Investors in Venture Capital (15)

28-02-02	AFP Integra	Gabriel Villalobos
28-02-02	AFP Horizonte	Pablo Moreyra Almenara
01-03-02	CAF	Jorge Gartner
01-03-02	EsSalud	Katherine Bartra
04-03-02	FMO	Efrain Salas
04-03-02	Wiese Aetna	Julio Romaní Vadillo
06-03-02	AFP Profuturo	Guillermo Garrido Lecca
08-03-02	AFP Unión Vida	Mariano Avarez
08-03-02	Credifondo	Christian Laub Benavides
12-03-02	Fondo Mivivienda	Marilú Gonzales
20-03-02	Interseguros	Guillermo Kocnim
05-04-02	Pacífico Vida	Katherina Bringas
05-04-02	ONP	Alberto Medina
18-04-02	COFIDE	Claudio Higa
22-04-02	Wiese Sudameris Fondos	Martin Palmer

Leasing operators (11)

26-02-02	Credi Leasing	Teobaldo Llosa
26-02-02	Citi Leasing	José Antonio Iturriaga
27-02-02	Banco Sudamericano	Adolfo Torres
28-02-02	Wiese Leasing	Javier Ducassi, Gonzalo Tamayo

28-02-02	BBVA Banco Continental	Rafael de Vivero Delgado
01-03-02	Banco Santander Central Hispano	Carlos Cano
01-03-02	Leasing Total	David A. Nuñez
05-03-02	Latino Leasing	Carlos Krüger
06-03-02	Interbank	Claudio Thiermann, Víctor Vinatea
07-03-02	América Leasing	Mario Ventura
12-03-02	Banco Financiero	Oscar Albán Velasco

Companies in the Textile and Clothing Sector (31)

07-03-02	MODIPSA	Víctor Duenas
07-03-02	Corporación Calex	Farid Issa, Patricia Portalanca
07-03-02	Creaciones Anahi	Orestes Romero Toledo
08-03-02	Samitex	Carlos Valdivia
08-03-02	Creaciones Mariana	Francisco Fernandini
11-03-02	Confecciones Aaron S.A.	Rosa Días de Arce
11-03-02	Filasur	Nicolás Abuseda
12-03-02	Inversiones Comindustria S.A.	Geri Ciabatti
12-03-02	Textil Oceano	Jorge Villacorta
13-03-02	Textiles del Sur	Nicolá Sansour
13-03-02	Romosa	Pablo Lupis
14-03-02	Textil Koral	Juan Morán Peralta
14-03-02	Cotton Knit	Sandro Rujo
14-03-02	Perú Pima	Daniel Varón, Ilona Bialikamien
15-03-02	Fijesa	Elie Scialom
18-03-02	El AYNI	José SimonZubieta
19-02-03	Texfina	Oscar Seattone
19-02-03	Hilandería Andina	Francisco Obludyner
19-02-03	Alpacryl	José Luis Vigo
20-03-02	Marga S.R.L.	Marcia López de Romaña
21-03-02	Confecciones Mogli	José Mosquera
21-03-02	Inversiones Alma Viva	Jaime Murga
22-03-02	Cantex S.A.	José Luis Peroni
25-03-02	Perypel (Arequipa)	Rosario Flors
25-03-02	Qori Exports (Arequipa)	Luis Alvarez, Leonor Becerra de Alvarez
25-03-02	Raymi Reru (Arequipa)	Nelson Mallea
26-03-02	Europa Textil (Areqipa)	Oscar Davila
26-03-02	Grupp (Arequipa)	Carlos Grupp
27-03-02	Fibras Peruanas (Arequipa)	Edilberto Munoz Prado
01-04-02	Artesania Illary (Cuzco)	Hector Uribalda
01-04-02	Mayela (Cuzco)	José Luis Dominguez

Companies in Agroindustry (17)

11-03-02	Nuevo Horizonte	Federico Vacari
13-03-02	TAMBO INCA	Miguel Angel Popolizo
14-03-02	Fundo de Mango	Carlos Correa
15-03-02	Athos S.A.	Jorge Checa
15-03-02	Duna Corporación	Bruno Carlini
15-03-02	Agrocasa	Juan Arrieta
18-03-02	Fundo San Hipólito	Luis Alayza
18-03-02	Agrícola Copacabana	César Peschiera
19-03-02	Inagro Sur	Adolfo Valle
25-03-02	El Bosque (Arequipa)	Peter Pollandt
26-03-02	AgroInca PPX (Arequipa)	Alvaro Delgado
26-03-02	MC&M Agronegocios (Arequipa)	Sandra del Carpio Benavente
27-03-02	Alimentos Procesados S.A. (Areqiuipa)	Leonidas Zavala Lazo
01-04-02	Agroindustrias Andinas SRL (Cuzco)	Jose Luis Aguirre Navarro
01-04-02	Asociación Agrotrade (Cuzco)	Gustavo San Roman, Marco Olivares Palisa
01-04-02	Kuski (Cuzco)	Andrés Llosa
01-04-02	Misky (Cuzco)	Patricia Kross

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