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New Avenues for the Financing of Small and Medium
Enterprises (SMEs)

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of Brazil

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IOSCO

“Capital Markets and Economic Development:

New Avenues for Financing of Small and Medium Enterprises”

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First of all I would like to thank IOSCO, and particularly Chairman Damodaran, for the kind invitation, and for the opportunity of being here to participate on the discussions about SME financing. The Counsel of Securities Regulators of the Americas – COSRA and the Inter-American Regional Committee of IOSCO, which I had the honor to chair for two years, and are now chaired by my colleague from Argentina, Eduardo Hecker, have been focusing on the SMEs for the last three or four years. Commissioner Campos, from the SEC, has been chairing the task force on SMEs financing, and with his strong support COSRA organized its first SME Forum, in Miami last may, to discuss the SME financing challenges in the region. The event was very successful, and we committed ourselves to repeat it every year. Next September the Autorité des Marchés Financiers of Quebec will host the 2007 SME Forum in Montreal.

During my presentation I would like to raise three points among many others that we have been discussing in COSRA, and which I believe are important to bear in mind when discussing SME financing alternatives. The first is related to the role of securitization. The second is the need of regulating private equity vehicles. And, finally, I will comment on the way regulators could approach small public offerings in order to foster it. I believe Brazil capital markets can also offer a good testimony on some of these subjects.

Securitization can be even more important for SMEs than to larger companies. Normally SMEs have fewer alternative financing possibilities outside the banking system. This can be even worst in the high interest rates scenarios that are so common in emerging markets. Available information about SMEs is often limited or particularly difficult to appraise, a situation that attract bankers, but place investors away. The use of securitization schemes opens the possibility of diluting risks by structuring funds with multi-generated receivables, opening access to investors to this restricted area, and allowing them to share with the SMEs the saved costs of banking spreads. Securitization also allows SMEs to benefit from the better credit rating of some of their clients, including by selling long-term receivables.

Hence, securitization offers a low cost, credible way for the information to be produced and provided to investors. Obviously, some specialization of intermediaries, depositaries and services providers is needed in order to allow such industry to grow. In the business of securitization, the expertise of these players is a key factor, since the receivables must be analyzed, held, received and sometimes recovered, and the cash flow must be preserved and well managed.

Brazilian markets are living a booming period for securitization. Securitization has grown on a steady pace since it was regulated in our country in 2001. From 2004 on, asset backed securities (ABS) and mortgage backed securities (MBS), including securitization funds

(which are the preferred vehicle in our country), corresponded in average to 15% of all the issuances registered before the Commission.

Regulators can play an important role regarding SMEs securitizations schemes. In Brazil we still allow only qualified purchasers to buy shares of receivable funds, and we also have a special discipline for high net worth individuals, who can buy those shares with even less information about the receivables and the companies, as compared to regular securitization transactions. This two-tiered system intends to be an incentive to financial disintermediation to SMEs, and a good solution to investors too. Recently we have split the regulation of securitization funds in order to segregate the less risky products (with higher levels of diversification and higher credit rating) from the others. This separation can also be understood as a first step to allow direct access to retail investors to that kind of products. Nowadays, retail investors only participate indirectly on securitization deals, thorough the stakes they owe on mutual funds. But mutual funds have so far been the major buyers of receivables, with about almost 40% of participation. Direct acquisitions by individuals corresponded to just 1% of the proceeds.

Securitization has been a turning point in terms of cost of capital and of alternative to traditional bank borrowing for many SMEs in Brazil. Besides that, the homework needed to frame a securitization transaction includes more sophisticated operational and financial routines that can pave the way to a future, enduring relationship with the market. In this sense, even recognizing that a vast majority of the SMEs will not become public traded companies, securitization can serve as a first point of contact between SMEs, capital markets and investors needs, and eventually this first contact can develop into a enduring relationship, providing an incentive for SMEs to become publicly listed.

My second point relates to the importance of private equity for SMEs. Private equity is an increasingly important component of a dynamic and efficient capital market, since it offers a compelling business model with significant potential to enhance the efficiency of SMEs both in terms of their operation and their financial structure. Regulating private equities is key for many reasons. But in particular to SMEs financing, regulation of private equity can work as an incentive to attract and engage prospective institutional investors in the same endeavor.

In Brazil, due to transparency requirements, pension funds can only invest in closely held companies or private equity funds by means of closed-end funds registered at the CVM (FIPs). This requirement contributed to the significant growth in the capital flowing into private equity funds. During 2004, Private Equity Funds registered at the CVM (FIPs) raised almost US\$ 650 millions, a figure that grew to about US\$ 1 billion in 2005, and almost to US\$ 4 billion in 2006. In 2006 private equity funds roughly represented 20% of the amount raised in the same period by means of stock offerings (primary and secondary). This percentage has so far remained the same in 2007: to date we have US\$ 2,7 billion dollars in private equity as compared to almost US\$ 13 billions in stock offerings (again, primary and secondary, and including the ones under examination at CVM).

Of course these growing numbers are also a result of the good stories that have been experienced by the first movers in the recent IPO cycle in Brazil. Private equity stakes that were sold in the IPOs that recently took place in Brazil corresponded to about 40% of the IPOs proceeds and this percentage could be even higher if we consider the private equity stakes involved in block trades and follow-one offerings.

Having rules does not mean, however, that we should not scale our regulations according to the flexibility needed for private equity schemes to operate. In Brazil, the regulation of private equity funds requires only better disclosure, independent auditing and some governance requirements, including a commitment, by the invested companies, to list themselves in the special corporate governance segment of the São Paulo Stock Exchange, when and if they go public. Preserving freedom to structure investment and divestment schemes is also a key factor when regulating private equity and SMEs.

My last comment touches on the way regulation should approach SMEs public offerings. Almost every country and market in the world try to identify publicly-traded SMEs. One of the most used criteria is the market capitalization. Here in India, for example, the Bombay Stock Exchange has launched in 2005 the [BSE Mid-Cap index](#) and the [BSE Small-Cap index](#) to track the performance of companies with relatively small market capitalization.

In Brazil we have been using a similar methodology, taking market capitalization as a measure to define what would be a “smaller public company”, and labeling as “microcaps” companies ranked at the bottom 1% of total market capitalization, and as “smallcaps” those representing the next lowest 5% of total market capitalization.

According to this method, as of March 2006, , micro and small caps represented each 52% and 22% of our listed companies, or 74% of the total. Updating the numbers to April 2007, we have an increase in the total number of small plus micro caps, that now account for 79% of our listed companies. . However, we had an impressive leap on the number of small caps, which was followed by a proportional decrease in the percentage of microcaps. In 2007, small caps accounted for 67% of Brazilian market capitalization – against 52% in 2006 – and microcaps represented 12% – as compared to 22% in 2006. When looking into the list of small and microcaps to find out the explanation for such change, is easy to learn that that a large part of the companies that went public in the Brazil during the last three years are now assembled as either small or microcaps. About 1/3 of the IPOed companies could be categorized as smallcaps according with this classification, whereas around 6% could be regarded as microcaps.

It is interesting to note that the IPOed companies that increased those small and microcaps figures adhered to corporate governance requirements that are stricter than those of the main market, while the usual pattern for access markets is less stringent corporate governance rules. I don't intend to take a position on the wider debate about the structure and quality of listed markets, and the rights of participants in them. As a matter of fact, we need to recognize that countries have different regulatory frameworks, laws, political and economic structures, and also that the best way of financing SMEs varies by country and region. However, in the particular Brazilian experience, a stricter corporate governance matrix was not necessarily burdensome and harmful to SMEs. Therefore, a sound regime of protection and respect for investors' rights cannot be discarded as a means of attracting capital.

Nevertheless, I believe we should leave enough room for flexibility as to the regulation of public offerings of SMEs, assuming, of course, that we are talking also about small amounts, proportional to the small size of the issuer. In those cases, it is fair to say that the potential of risk to the markets will be also small and occasionally worthwhile. Also, I guess that it is more important regulating investors than issuers. Regulators traditionally accomplish their goal of investor protection through the registration and direct regulatory control of issuers, intermediaries, and self-regulatory organizations in the securities markets. In the case of SMEs, perhaps we should instead regulate investors, for instance imposing higher financial requirements for the subscription of SME's securities that we allow to give less information

to the market. Large, deep-pocketed investors are well-equipped to negotiate directly with firms, to contract for desired protections and to obtain information directly from SMEs. Therefore, less mandatory regulation of public offerings may be desired.

I should end by now with a final remark. Even having said a lot about regulation, I am not stating that regulation is the main factor for the development of SMEs. To be frank, the more I stay in the government, the more I become an assured liberal. But I think that specially in emerging markets it is a mistake not to give the right importance to a well designed regulation, that is able to incentive SMEs access to markets while promoting efficiency and investor protection.

Thank you for your kind attention.