

**LEVERAGING THE CAPITAL MARKETS TO INCREASE
FINANCING TO SMALL ENTERPRISES THROUGH FACTORING
PE-M1033**

Summary

Factoring is a form of asset-based finance in which a factoring company (*the factor*) extends credit to companies that produce and sell products (*the sellers*) on the basis of the value of the sellers' accounts receivable, that is, the amounts owed to the sellers by the companies that buy their goods (*the buyers*). Factoring is very well suited to the small enterprise (SE) segment because it enables them to access financing without putting up real guarantees and even if they have short credit histories. Factoring companies make their credit decisions based on the risk of the buyer, not the risk of the seller. This makes factoring especially attractive in those cases where the small company is selling to large or foreign companies that are creditworthier than itself.

As a result of the shortage of low-cost bank financing in Peru, capital markets have come to be viewed as an attractive, albeit still largely untapped, alternative source of funding. In the past, the two main barriers that have prevented small companies from accessing capital markets have been *critical mass* and *risk*. Indeed, the funding needs of small companies are usually too small to be appealing to capital market investors that manage very high volumes. Furthermore, the high transaction costs associated with selecting, analyzing, and supervising small investments make them unappealing. Finally, most capital market participants are too risk averse to invest in SE instruments.

The goal of this project is to increase the availability of financing for Peruvian small enterprises. The specific objective of the project is to pilot an innovative fund that is able to leverage capital markets to offer Peruvian SEs lower cost financing via factoring. If this project is successful, it could result in demonstration effects that would lead to the creation of similar funds throughout LAC.

The proposed fund expects to provide up to US\$90 million in short-term working capital financing per year to small companies (once it has ramped up) at interest rates that are determined based on the riskiness of the underlying buyer company and are hence significantly lower than what the small company could achieve on his own. Furthermore, all the financing made available to the SEs will be provided in domestic currency. In the long run, increasing competition among factoring providers will lead to downward pressure on interest rates. Over time, this pressure will encourage factors to seek higher margins by broadening their target market towards higher-risk companies that were previously excluded. Overall, this dynamic will decrease the interest rates charged to borrowers and increase the access to factoring services to a wider range of small companies.

Value Investments Group Ltd., the administrator of the fund, was established and started operations in 1999 and is an authorized *Sociedad Administradora de Fondos de Inversion* (SAFI) supervised by CONASEV. The SAFI currently manages a US\$30 Million private equity fund (*Fondo de Inversión Stella*) targeted at mid-stage firms.