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The Brazilian factoring industry and receivable investment funds: a successful partnership

Ronald Herscovici, Eduardo J Herszkowicz and Carlos Augusto Junqueira

Souza Cescon Avedissian Barrieu e Flesch Advogados

The factoring industry provides important incentives in Brazil for the production and sale of goods and services, especially among micro, small and medium-sized companies. In recent years many of these companies have suffered due to the lack of available bank financing, as well as the strict conditions and obligations imposed by financial institutions when they do provide credit. As a result, such companies have come to rely on factors as their primary source of financing, continually assigning all or a portion of their receivables as a means to fund their operations.

Factors compete with banks in discounting receivables by relying on their lack of formality and a speedier credit analysis process, offering discount rates higher than those offered by traditional banking institutions in exchange for availability and simplicity.

There are approximately 2,000 factors in operation in Brazil. The *Associação Nacional das Sociedades de Fomento Mercantil* (ANFAC - the national association of factors) has approximately 730 affiliates, which provide services to around 120,000 businesses and manage a portfolio of approximately R60 billion (roughly \$30 billion) in receivables. Although such numbers may seem impressive on their own, they also reveal the great potential for growth in this market, especially considering that there are currently around 5 million micro, small and medium-sized businesses in operation in Brazil (according to government sources).

According to ANFAC, the factoring industry grew from a portfolio of R42 billion in 2004 to R52 billion in 2005 and approximately R59 billion in 2006 - an average growth rate of more than 18 per cent a year. ANFAC further states that the average discount rate currently offered by factors is 4 per cent a month.

Table 1: Market for factoring companies

#	Sector	Share
1st	Metallurgical industry	26%
2nd	Other industries	18%
3rd	Commercial companies	17.5%
4th	Services	14%
5th	Textiles and clothing	8.5%
6th	Chemical sector	6%
7th	Sugar and ethanol	4.5%
8th	Printing	4%
9th	Transportation	1.5%
	Total	100%

Table 1 shows the market for factoring companies in Brazil in the first half of 2006 (figures from an ANFAC survey).

Characteristics of the factoring business

Federal Law 9249, enacted on December 26 1995, defines 'factoring' as "the activity of cumulatively and continuously providing credit and market-related services, credit management, risk selection, management of accounts payable and accounts receivable, as well as the acquisition of receivables originated from the sale of goods and services".

Despite the broad range of services included in this definition, the vast majority of factors are almost entirely devoted to the selection and purchase of receivables. In this type of transaction the factor negotiates and purchases receivables from its customers at a discount (considered to be the fee charged by the factor for the rendering of its services) against assignment and delivery by the customer of the proper credit documentation.

Another typical transaction is the advancing of funds by the factor to a customer for the acquisition of raw materials and services used by the customer in its production lines, ultimately leading to the creation of a

receivable. After having sold the goods or services, the customer assigns the receivable resulting from such sale to the factor as payment for the advance of funds at a discount. In this kind of transaction, the factor generally monitors the customer's activities very closely and usually requires a substantial amount of control over its inventory and production lines.

Despite their importance to the economy, factoring activities still lack specific laws and regulations in Brazil, resulting in uncertainty for factors and the market. For instance, it is generally understood that factors may not obtain debt financing or issue debt instruments in order to fund their activities. It is alleged that in doing so, factors would be acting as financial institutions without the proper authorisation from the Central Bank. However, there is no law or regulation supporting this understanding.

Furthermore, the Brazilian courts generally hold that factors are not allowed to demand any kind of guarantee or security from their customers to secure payment of the receivables. Following this understanding, factors must rely solely on their capacity to collect the receivable from the debtor in order to be paid. The courts have stated that only this action justifies the high discount rates charged

by factors to customers. They have further stated that the demand of a guarantee or collateral would turn such a transaction into a pure discount of receivables (as opposed to a purchase of receivables), which can only be performed by a financial institution. In a pure factoring transaction, the seller of the receivable is liable only for the existence and proper documentation of the credit.

Regarding taxes, factors are subject to:

- the social integration programme contribution and the social security contribution, which are social welfare contributions levied on net revenues at the rates of 7.6 per cent and 1.65 per cent respectively; and
- the income tax and social contribution on profits, which are levied on the company's net income at the rates of 25 per cent and 9 per cent respectively.

According to Law 9430/96, factoring companies must calculate and pay income tax pursuant to the actual income regime. The purchase of receivables is further subject to financial transaction tax and a social contribution on the transfer of funds at 1.5 per cent and 0.38 per cent respectively.

Receivable investment funds and factoring business

Receivable investment funds (*fundos de investimentos em direitos creditórios* or (FIDCs)) were created in November 2001 by Resolution 2,907 of the Brazilian Monetary Council and further regulated in December 2001 by Instruction 56 of the Brazilian Securities Commission.

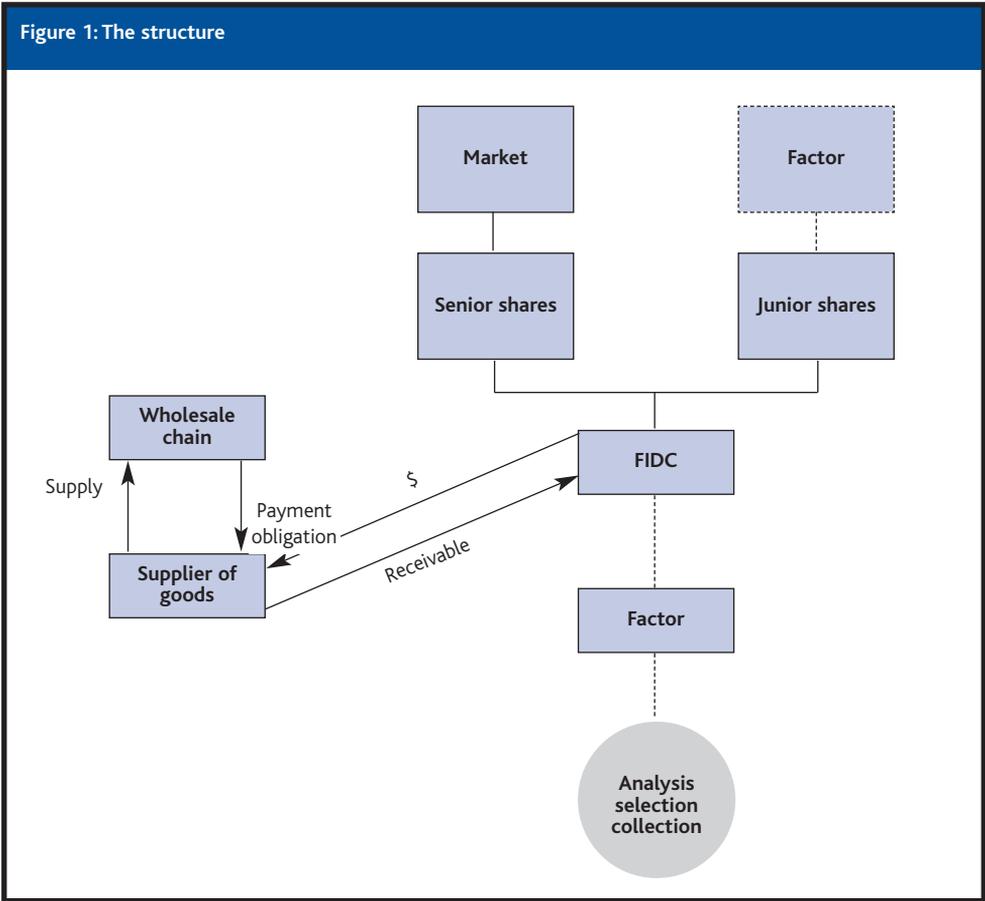
FIDCs are mutual investment funds that apply the majority of their financial resources (at least 50 per cent of their net assets) in receivables of almost any kind or nature (the definition of 'receivables' given by Instruction 356 is extremely broad).

Since their creation, FIDCs have caused a revolution in the factoring industry in Brazil. Attracted by the operational and tax advantages offered by this new securitisation vehicle, many major factors have structured their own FIDCs and have carried out activities through them. The structure adopted by these factors is as follows:

- Instead of buying receivables, the factors have become intermediaries, pitching to customers and ensuring a constant flow of receivables to the FIDC. In this structure, however, the factor remains responsible for the credit and documentary analysis of the receivables, making a pre-selection of those that can be purchased by the fund. The factors also remain in charge of the collection of receivables that are not paid at maturity.
- After analysing each receivable, the factor sends to the FIDC trustee (which must be a financial institution) a list of those that can be purchased by the fund. The fund trustee works directly with the originators of the receivables and performs all acts necessary to formalise the purchase and sale of the receivables on behalf of the fund.
- The FIDC raises money to fund its operations through the sale of senior and junior shares, as follows:
 - The senior shares have a pre-determined amortisation schedule and an interest-rate goal, both fixed in either the fund regulations or a supplement to the regulations, which makes them similar to a debt security. Senior shares are generally issued and distributed in a public offering to qualified investors (according to Brazilian Securities Commission regulations, only qualified investors can purchase shares of an FIDC).
 - The junior shares have no amortisation schedule and no predetermined interest-rate goal, and can be amortised only after full payment of the senior shares or in very specific situations allowed under the fund regulations. Junior shares are generally held by the factor or a related company.

Figure 1 shows this structure.

The junior shares serve as collateral for the payment of the fund's obligations to the senior shareholders. Any default in the portfolio of receivables held by the fund has a direct impact on the value of the junior shares, but will impact on the senior shares only if and to



the extent that the cushion provided by the junior shares has been fully used. However, all income of the fund after payment of the expenses and the obligations to senior shareholders is allocated to the junior shareholders.

Advantages of an FIDC structure

The FIDC offers the following advantages compared to the traditional factoring structure:

- Regulation by the commission - unlike factoring, which lacks appropriate regulations, FIDCs are fully regulated and monitored by the Brazilian Securities

Commission. All aspects of FIDCs - including their organisation, the issuance and amortisation (or redemption) of shares, subordination between senior and junior shares, the rights and obligations of the trustee, shareholders’ meetings and auditing and reporting requirements - are governed by commission regulations, providing investors with a greater amount of protection.

- Payment guarantee – in contrast to factors, FIDCs can require from the assignor of the receivable any kind of payment guarantee that is deemed appropriate (eg, recourse against the assignor, a third-party guarantee or collateral).

- Liquidity - shares of an FIDC can be listed for trading on the stock exchange or over-the-counter markets. Although at present there is not a very liquid market for FIDC shares, liquidity is expected to increase as more investors become attracted to this kind of investment. However, only 'qualified investors' (as defined in commission regulations) can purchase and sell the shares of an FIDC.
- Access to investors - due to the greater protection to investors afforded by commission governance and regulations, it is easier for an FIDC to raise capital to fund its operations than it is for a traditional factoring business. Furthermore, FIDCs can make use of the subordination structure set forth in the regulations (ie, senior and junior shares) to provide additional protection to investors.
- Tax aspects - as a tax-neutral entity, an FIDC is far more advantageous from a tax standpoint than a traditional factoring company. FIDCs pay no taxes. The shareholders of an FIDC, on the other hand, are subject to withholding income tax at a rate of between 15 per cent and 22.5 per cent in the case of Brazilian entities or individuals, or 15 per cent in the case of foreign investors not resident in tax-haven jurisdictions, in any case upon amortisation or redemption of their shares, and only to the extent that the amount amortised or redeemed exceeds the subscription price of the shares.

Foreign investment in the factoring industry

Foreign investors have been investing in shares of FIDCs for some time. However, it was only recently that these investors discovered that they can obtain good returns in the factoring industry with a reasonable amount of protection by using the FIDC structure.

There are two main ways for a foreign investor to participate in this market. First, it can purchase shares of an FIDC directly in Brazil through the portfolio investment regime, established by Resolution 2,689 of the Brazilian Monetary Council. Under this alternative, the investor

must remit funds to Brazil through an appropriate channel (the 2,689 account) and convert them to reais to purchase the shares of the FIDC on the stock exchange or over-the-counter market. The investor must also employ a local representative, which must be a financial institution, to act on its behalf before the commission, the Brazilian Central Bank and the tax authorities. This alternative can be rather expensive and sometimes prohibitive, depending on the size of the investment.

The second option is for a foreign investor to invest in an FIDC through credit-linked notes. Under this alternative, the foreign investor hires a financial institution to purchase the shares of the FIDC in Brazil and issue the credit-linked notes to the investor abroad. The returns of the credit-linked notes are directly linked to the returns provided by the underlying shares of the FIDC. The financial institution generally incurs no credit or exchange-rate risk associated with the investment. Depending on the amount of the investment, this option is much less costly than the alternative of settling a 2,689 account in Brazil.

Conclusion

FIDCs have been responsible for a major transformation in the factoring industry in Brazil. Whereas many major factors have structured or are about to structure their own FIDC vehicles, the smaller factors are trying to join forces to set up funds jointly. This move is expected to formalise the factoring industry, which until now has always worked with a certain degree of informality.

The industry is also expected to consolidate quickly, as the smaller factors cannot support the costs and expenses associated with the organisation and maintenance of an FIDC and, as a result, will be unable to access all the advantages offered by the FIDC structure. This is expected to provide a crucial competitive advantage among industry players.

Foreign investors are increasingly expected to participate in the market, taking advantage of the protection and investment opportunities offered by the FIDC structure.