



MANAGING THE RISKS OF DOING BUSINESS IN LATIN AMERICA



MANAGING THE RISKS OF DOING BUSINESS IN LATIN AMERICA.....	1
LIST OF TABLES	2
TABLE OF FIGURES	2
Overview.....	4
Categories and Types of Risks for Doing Business in Latin America	5
Market Entry Risk.....	5
Country Risk.....	6
<i>Political Risk</i>	6
<i>Economic Risk</i>	8
Regulatory Risk	11
Structure Risk.....	12
Direct Tax Risk.....	13
Talent Risk	14
Operational Risk	15
Market Risk.....	15
Funding Risk.....	18
Competition Risk	19
Credit Risk	19
Residual Risk	20
Deal Structure and Documentation Risks	21
Portfolio Service Risk.....	22
Indirect Tax Risk.....	22
Regulatory Operating Risk	23
Legal Collection Risk and Repossession Risk.....	24
End-of-Lease Risk	28
Currency Risk	29
Exit Strategy Risk.....	30
Industry Collapse Risk.....	31
Summary and Conclusions	32

LIST OF TABLES

Table 1: Categories and Types of Business Risks in Latin America.....	5
Table 2: Political Risk Ratings	6
Table 3: Ten Largest Latin American Economies	16
Table 4: Population in Latin America and the Caribbean.....	17
Table 5: Rule of Law Index for USA and Latin America.....	24
Table 6: Court System Efficiency.....	26
Table 7: Cost to Enforce a Contract.....	26
Table 8: Corruption Perceived Index.....	27
Table 9: A Checklist of How to Respond to Specific Types of Risk	33

TABLE OF FIGURES

Figure 1: Moody's Sovereign Credit Ratings of the Largest Latin American Economies.	9
---	---

Figure 2: EMBI+ Index for Largest Latin American Economies, 2002.....	10
Figure 3: Month of Imports per Country	11
Figure 4: Corporate Income Tax Rates in Latin America.....	13
Figure 5: Talent Productivity in Latin America Compared to that of USA and China	14
Figure 6: GDP Analysis and Forecasts for Selected Latin American Countries	15
Figure 7: Domestic Capital Market Potential	18
Figure 8: Residual Risk Forecast Sample	20
Figure 9: Overvalued (left) and Undervalued (right) Currencies in Latin America	30

MANAGING THE RISKS OF DOING BUSINESS IN LATIN AMERICA

By Rafael Castillo-Triana, Esq.¹

Overview

Latin America is commonly perceived as a volatile business environment. It's futile to attempt to challenge this perception, especially since both the historical facts and anecdotal evidence from throughout the nineteenth, twentieth, and beginning of the twenty-first centuries feed this perception. However, the region's turbulent economic past should not preclude future investment there, especially if one gains a thorough understanding of the business risks, and effective ways to mitigate them, of the region.

Substantial returns await those who seek to fully understand the history of investment in Latin America before they attempt to do the same. Clearly, Latin America represents a huge potential for an industry such as equipment leasing and financing. The rich natural resources and hard-working human resources of a population predominantly young and able to emulate the great United States economy and culture have the clear capability to transform new capital investment into wealth and a higher standard of living. In economic terms, Latin America has the potential to grow tenfold just to approach the standard of living of the United States. In economic terms, this growth would result in purchasing power about twice that of the current United States GDP. Moreover, Latin America has a predominantly market-oriented culture (in contrast with many of the emerging giants of the Asia-Pacific Region, such as China), and in many cultural respects, including religion, is very closely aligned with United States values.

A wise business approach toward Latin America would be one that seeks to tap the region's potential while taking a proactive approach toward offsetting the risks and volatility that have historically been associated with it. Some companies have already taken such an approach and are already succeeding. Others remain on the sidelines, missing the region's opportunities because they lack an adequate risk-management approach.

This article will provide a framework for creating a professional risk-management approach toward business investment in Latin America and outline a proactive approach toward being able to tap the enormous potential of the Latin American economy.

¹ Rafael Castillo-Triana is an international attorney with over 22 years of practice in the international leasing arena. A principal of The Alta Group, the leading consulting firm for the equipment leasing and finance industry, Mr. Castillo-Triana authored several publications, including *Legal Aspects of Equipment Leasing in Latin America*, a book published in 2001 by Kluwer Law International.

Categories and Types of Risks for Doing Business in Latin America

RISK CATEGORY	RISK TYPE
MARKET ENTRY RISK	COUNTRY RISK
	REGULATORY RISK
	STRUCTURE RISK
	DIRECT TAX RISK
	TALENT RISK
OPERATIONAL RISK	MARKET RISK
	FUNDING RISK
	COMPETITION RISK
	CREDIT RISK
	RESIDUAL RISK
	DEAL STRUCTURE RISK
	DOCUMENTATION RISK
	PORTFOLIO SERVICE RISK
	INDIRECT TAX RISK
	REGULATORY OP. RISK
	LEGAL COLLECTION RISK
	REPOSSESSION RISK
	END-OF-LEASE RISK
CURRENCY RISK	
EXIT STRATEGY RISK	INDUSTRY COLLAPSE RISK
	COUNTRY RISK

Table 1: Categories and Types of Business Risks in Latin America

Table 1 summarizes the types and categories of risks that need to be assessed when an equipment leasing company, bank, or financial institution plans to do business in Latin America. A brief illustration of each type of risk and a discussion of its mitigative tools will be provided in this article.

Market Entry Risk

Market entry risks are those types of risks that must be assessed at the initial stage when any business intends to enter a particular Latin American market. The following is an illustration and discussion of each type of market entry risk.

Country Risk

Country risk entails two distinct components: political risk and economic risk.

Political risk entails the likelihood that a given country would subject foreign and/or domestic investors to measures that would impair their security in enjoyment of life, freedom, and property. In concrete terms, such political risks are political violence, revolution, and expropriation and its various corollaries, such as government breach of contracts.

Economic risk can be broadly summarized as a series of macroeconomic events that might impair the enjoyment of expected earnings of any investment. Some analysts further segment economic risk into financial factors (those factors leading to inconvertibility of currencies, such as foreign indebtedness or current account deficits and so forth) and economic factors (factors such as government finances, inflation, and other economic factors that may lead to higher and sudden taxation or desperate government-imposed restrictions on foreign investors' or creditors' rights).

Political Risk

A good approach for rating Political risk is performed by the PRC Group, Inc. Table 2 contains a very extensive list of indicators.

Table 2: Political Risk Ratings

COUNTRY	CURRENT RATINGS				COMPOSITE RATINGS				
	Political Financial Economic			Year	Current Forecasts				
	Risk 09/03	Risk 09/03	Risk 09/03	Ago 10/02	Rating 09/03	One Year WC	Five Year BC	WC	BC
Argentina	64.0	29.5	36.5	49.3	65.0	58.5	67.5	60.5	77.0
Bahamas	84.0	37.5	36.0	76.0	78.8	75.0	79.5	70.5	81.0
Bolivia	63.5	37.0	33.0	65.8	66.8	62.5	70.0	63.0	74.5
Brazil	69.0	30.5	33.0	59.5	66.3	51.0	63.0	59.0	76.5
Canada	89.5	42.0	42.0	84.8	86.8	77.5	84.0	72.0	87.5
Chile	77.0	37.5	39.0	76.3	76.8	67.5	76.0	68.5	79.5
Colombia	55.0	39.5	32.5	61.0	63.5	57.5	66.5	53.0	69.5
Costa Rica	74.0	37.0	33.5	74.8	72.3	73.0	77.5	69.0	80.0
Cuba	58.5	28.5	33.5	64.3	60.3	50.5	63.0	45.0	71.0
Dominican Rep.	62.5	29.5	27.5	69.8	59.8	56.0	63.5	55.5	69.5
Ecuador	58.0	34.5	34.0	59.8	63.3	51.0	61.0	52.0	67.0
El Salvador	64.0	39.5	35.5	71.5	69.5	71.5	76.0	67.5	79.0
Guatemala	60.5	40.0	33.5	67.3	67.0	65.3	71.5	60.0	75.5
Guyana	68.0	29.5	27.5	62.0	62.5	59.8	66.0	58.5	69.5
Haiti	45.0	31.5	25.5	54.0	51.0	39.5	52.0	38.5	66.5
Honduras	60.5	36.0	28.0	63.8	62.3	57.5	66.0	56.5	72.0
Jamaica	70.5	36.0	32.5	68.3	69.5	66.5	73.0	65.0	78.0
Mexico	69.0	38.0	37.0	69.8	72.0	66.0	72.8	60.0	77.0
Nicaragua	57.5	25.0	22.0	54.8	52.3	44.5	52.0	43.5	60.0
Panama	72.0	35.0	36.0	71.0	71.5	65.0	74.5	59.0	78.5

Paraguay	57.0	39.0	29.0	60.3	62.5	56.3	65.0	42.5	70.5
Peru	62.5	37.5	36.5	68.3	68.3	59.5	71.3	55.0	72.5
Suriname	65.0	35.5	30.0	62.8	65.3	61.0	67.5	57.5	71.5
Trinidad & Tobago	67.0	45.0	41.0	72.5	76.5	74.0	78.8	71.5	80.5
United States	81.0	33.0	38.0	75.5	76.0	73.0	79.5	72.0	84.0
Uruguay	70.5	30.5	28.0	61.5	64.5	57.0	67.5	58.0	73.5
Venezuela	50.0	42.5	26.5	54.3	59.5	54.5	65.5	51.5	76.0

Source: *International Country Risk Guide*, Volume XXIV, Number 9, September 2003

Published Monthly by The PRS Group, Inc., <http://www.prsgroup.com>.

To understand the ratings, The PRS Group explains that the composite scores, ranging from zero to 100, are then broken into categories from Very Low Risk (80 to 100 points) to Very High Risk (zero to 49.5 points). These are combinations of several factors. Such are:

<u>Political Risk Components</u>	<u>Financial Risk Components</u>	<u>Economic Risk Components</u>
Government Stability	Foreign Debt as a Percentage of GDP	GDP per Head of Population
Socioeconomic Conditions	Foreign Debt Service as a Percentage of XGS	Real Annual GDP Growth
Investment Profile	Current Account as a Percentage of XGS	Annual Inflation Rate
Internal Conflict	Net Liquidity as Months of Import Cover	Budget Balance as a Percentage of GDP
External Conflict	Exchange Rate Stability	Current Account Balance as a Percentage of GDP
Corruption		
Military in Politics		
Religious Tensions		
Law and Order		
Ethnic Tensions		
Democratic Accountability		
Bureaucracy Quality		

WC stands for Worst Case Forecast and BC stands for Best Case Forecast

A prime example of a recent event that illustrates political risk would be the currency devaluation undertaken by Argentina in 2002--the effects of which are still being felt today, more than two years later.

In January 2002, Argentina decided to make an unexpected reversal of its economic policy, particularly in its attitude toward foreign investment. While the country had been suffering from rising unemployment and a persistent and pervasive loss of competitiveness, the path selected was to devalue its currency, completely eliminate the convertibility program, and convert to local currency all contractual obligations that were previously agreed upon.

For those not familiar with such economic measures, this so-called "pesification" consisted of the mandatory conversion of all domestic obligations formerly denominated in foreign currencies (mainly United States dollars) into Argentine pesos at a mandated ratio of 1 to 1, while all costs in obligations payable abroad were maintained to be paid in such foreign currency. Because of the effect of the devaluation, these obligations were made more expensive to those creditors holding rights in domestic contracts denominated in foreign currency under prevailing statute law at the time when such obligations were contracted. This pesification of contractual obligations turned out to be both a breach of government contract and tantamount to expropriation. Many foreign investors, and in particular some large multinational leasing companies, suffered significant losses from Argentina's devaluation and pesification.

Fortunately for some, political risk insurance was available at the World Bank's Multilateral Investment Guaranty Agency (MIGA) and other political risk insurance agencies. For others, it was fortunate that Argentina is a party to several bilateral investment treaties that provide a legal basis for such foreign investors to seek indemnity through international arbitration conducted before the International Center for the Settlement of Investment Disputes (ICSID), a multilateral agency also sponsored by the World Bank. Currently, 29 of the 74 arbitration cases awaiting resolution before the ICSID are pending against Argentina. All international case law precedents² forecast that Argentina will be ordered to compensate foreign investors, including a major US leasing company, for such indirect expropriation.

So far, pesification has been construed as tantamount to, or indirect, expropriation by insurance practitioners and investors and therefore compensated accordingly³. Many lessons can be learned from this experience in Argentina that are valuable for shaping a comprehensive strategy for managing risk in any emerging economy, not just those in Latin America.

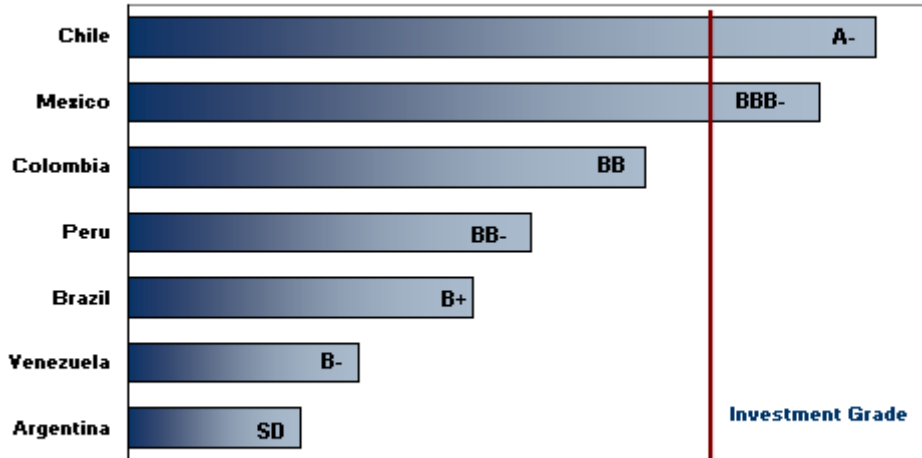
Economic Risk

Credit agencies normally rate country risk, or the risk of doing business in a given country, based upon the ability of that country's government to pay back its foreign obligations.

² The most notable being "Metalclad vs. United Mexican States": Award rendered on August 30, 2000, 40 ILM 36 (2001); 26 Y.B. Com. Arb. 99 (2001); 13 World Trade and Arbitration Materials 47 (2001); 119 I.L.R. 618 (2002); 5 ICSID Rep. 212 (2002); French translation of English and Spanish originals in 129 *Journal du Droit International* 233 (2002) (excerpts). The text of the award is also available online at <http://www.state.gov/documents/organization/3998.pdf>. (...) National Court Decision: Supreme Court of British Columbia, Reasons for Judgement of May 2, 2001, The United Mexican States v. Metalclad Corporation, 2001 BCSC 664; 119 I.L.R. 647 (2002); 5 ICSID Rep. 238 (2002) (...) Supreme Court of British Columbia, Supplementary Reasons for Judgement of October 31, 2001, The United Mexican States v. Metalclad Corporation, 2001 BCSC 1529, and *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States* (Case No. ARB(AF)/00/2) [Award rendered on May 29, 2003](#), available on-line at <http://www.worldbank.org/icsid/cases/award21>. Latest visited September 18, 2004

³ AON reports: "Catering company – Argentina (...) Caught up in Argentina's recent economic woes, a U.S. company's dollar-denominated certificates of deposit were "pesified" (converted to the Argentina currency) and then access to them was severely restricted. Underwriters agreed that this amounted to expropriation by Argentine government." Source: http://www.aon.com/us/busi/risk_management/risk_transfer/trade_credit/political_risk/tools_and_solutions/claims_sampling.jsp. Latest visit September 18, 2004.

Figure 1: Standard and Poor's Sovereign Credit Ratings of the Largest Latin American Economies



Another indicator of country risk is the perception of international capital markets toward specific countries, measured by their EMBI+ Index⁴. Both the Moody's and the EMBI+ ratings focus upon the same parameter: the likelihood for a government to pay back its debts.

The question that potential investors in Latin America need to ask themselves is this: what are the existing links between a financially healthy government and the risks/rewards balance of a foreign investor?

⁴ The Emerging Markets Bond Index Plus (EMBI+) tracks total returns for traded external debt instruments in the emerging markets. The instruments include external-currency-denominated Brady bonds, loans and Eurobonds, as well as U.S. dollar local markets instruments. The EMBI+ expands upon JP Morgan's original Emerging Markets Bond Index, which was introduced in 1992 and covers only Brady bonds.

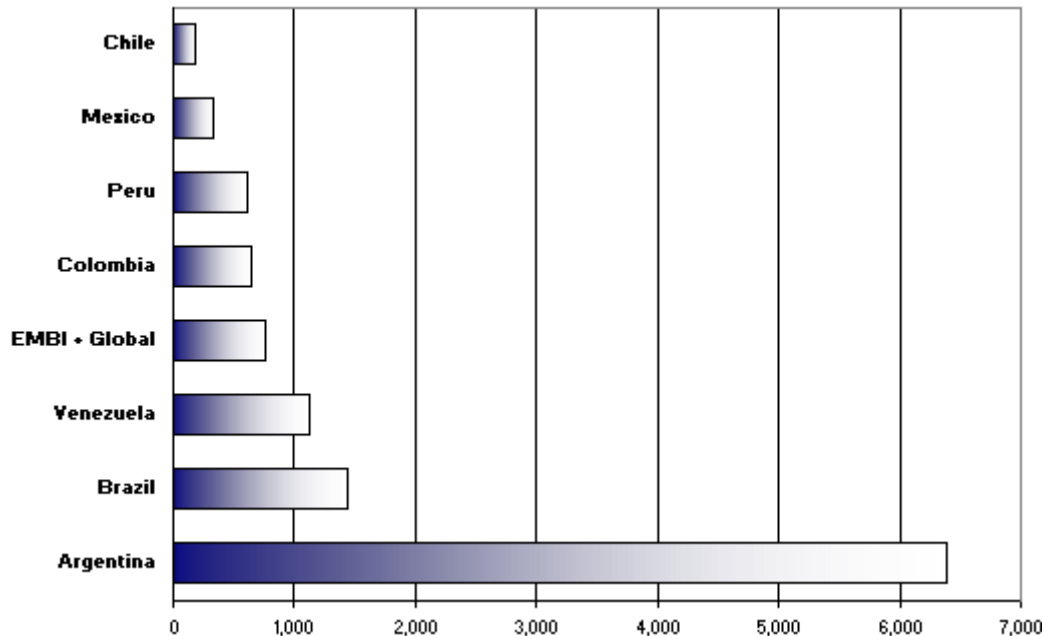


Figure 2: EMBI+ Index for Largest Latin American Economies, 2002.

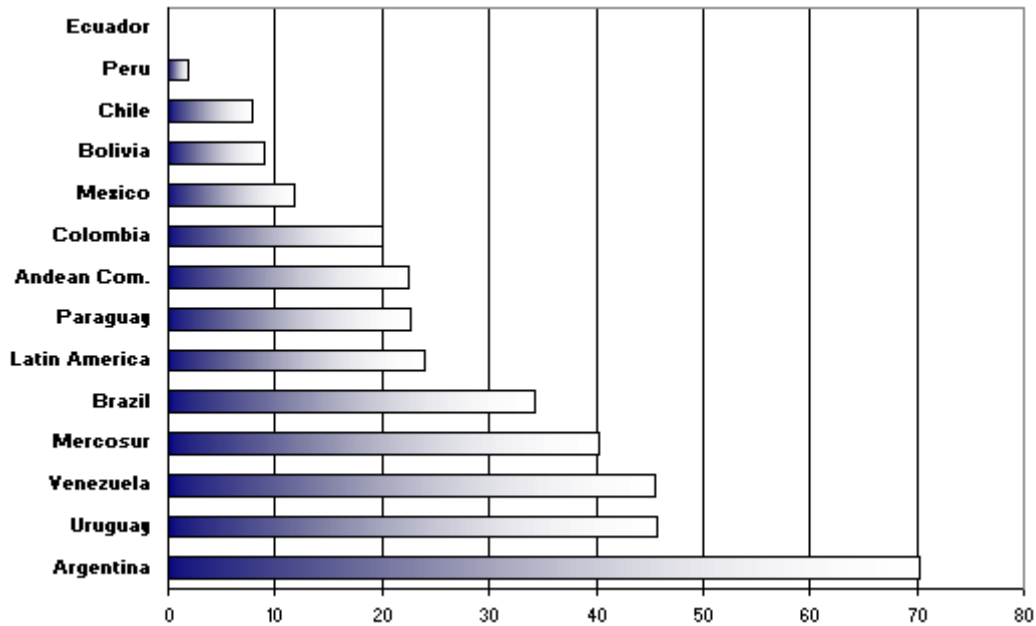
First and foremost, a government facing financial difficulties would most likely increase taxation, with the effect of either reducing profit margins to investors or affecting the disposable income of purchasers. Such increased taxes might also increase the cost of products and services so that the revenues of an investor might be depressed.

Second, a government with difficulties may intend to fund itself with newly issued money, thereby furthering inflation and generating the same effect of depressing revenue, income, and margins.

Third, a government in financial trouble may opt to expropriate privately owned assets at various levels to generate immediate revenues.

Recent events in Venezuela are illustrative of these tendencies. A populist government with political instability and a lack of acceptance between the domestic business community and local leadership decided to impose restrictions on foreign exchange transactions. Consequently, many multinational corporations have suffered the virtual inconvertibility of the Venezuelan currency (Bolivar) due to bureaucratic restrictions. Venezuela created in early 2003 a government currency board, called CADIVI, that regulates inflows and outflows of currencies. Currently, Venezuela has over US \$21 billion in international reserves and a total foreign debt of US \$34.4 billion. The country exports over US \$25 billion per year. Therefore, the Venezuelan problem is not an economic or financial problem; instead, it is just a political problem.

Figure 3 shows how these bureaucratic restrictions are not financially or economically motivated but politically motivated.



Note: Months of imports.

Sources: National statistical institutes, central banks, and calculations by LatinFocus.

Figure 3: Month of Imports per Country

How can leasing companies cope with country risk? The answer depends upon the leasing company's individual strategic plan. By analyzing the trends of the country risk environment, leasing companies can improve their risk/reward balance.

Leasing companies are particularly vulnerable to tax changes. A change in tax policy that eliminates any incentive for capital investment is a significant detriment for leasing companies. Therefore, leasing companies and their industry associations must remain continually alert on local economic policy.

In addition, all political events similar to those described in Venezuela and others such as inherent political violence must be addressed by leasing companies as an essential component of the environment that determines their strategic plan.

The leasing industry has been shrinking dramatically in Venezuela (although its decline has some other precedent causes) and in Argentina up to the end of 2003. It is expected that 2004 will show an increase in the Argentine leasing industry.

Regulatory Risk

When considering a market entry plan, leasing companies must identify their regulatory risk, which can be determined by answers to the following four questions:

- ✓ Will the leasing industry be subject to licensing requirements--i.e., are there barriers to entry into the market?

- ✓ Will the leasing industry be subject to reporting obligations that may increase operational expenses?
- ✓ Will the leasing industry be subject to mandatory ratios and measures, such as mandatory low-yield investments, which reduce profitability?
- ✓ Will the leasing industry be subject to regulations that impose red tape but do not add value to the business?

An appropriate analysis of the answers to these questions must seek, first, to identify the current regulations; second, to define the general trends related to such regulations; and, third, to determine whether the regulations imposed actually serve to add value instead of simply depressing the industry⁵.

A typical example of good regulations for the leasing industry can be found in Brazil and Mexico. Both the Central Bank of Brazil and the National Banking Commission of Mexico have developed educated human resources and good systems that make the regulated market more transparent, competitive, and efficient. Peru also has a strong system of good regulation.

Regulations that have prevented the growth of markets are found in Venezuela, Colombia, and Ecuador, although Colombia is currently making progress in reforming its regulatory climate.

Lack of or scarce regulation can be found in Argentina, Chile, Central America, and the Caribbean. These countries or regions face the strong prospect that global regulatory initiatives, such as the adoption of the Basel II Accord, to regulate financial markets might lead to strict regulations on leasing companies established in these countries because of the absence of any local or country-specific regulations to provide guidance.

Structure Risk

The chosen structure of a leasing company in a given market also has a significant impact on the risk/reward balance. Large corporations need first to address whether they can afford to open a permanent establishment in a given country rather than just maintain a cross-border presence.

Many factors must be weighed in making this decision, most notably the existence of any current barriers to cross-border business (such as tax issues) and a long-term strategy whereby the given captive or leasing company would seek to capitalize on the knowledge and existing learning curve of partners through joint ventures in a given domestic market. Such a joint venture permits participation in the target domestic market without creating a permanent establishment in a country, thereby enabling the investor to gain the consolidated tax and accounting effects of permanent establishment without entailing the risks and expense of a permanent presence.

⁵ For a detailed analysis of regulations, see “Legal Aspects of Equipment Leasing in Latin America” by the same author. Available at www.amazon.com

When the given company elects to make a permanent establishment in a given country, then the type of juridical organization chosen would also influence the risk/reward balance.

Again, in Argentina, from the end of the nineteenth century through the beginning of the twentieth, large banks such as Citibank (today Citigroup) and the Bank of Boston elected to open branches in the country instead of creating a domestic legal entity wholly controlled by the parent companies. With the devaluation crisis of 2002, such banks realized that all claims by depositors would not stop in Argentina, since clearly the parent companies were direct obligors and responsible vis-à-vis their depositors and creditors. Therefore, the exit strategies of Citigroup and BankBoston (Fleet) could not be implemented as quickly and effectively as the exit strategy applied by the Scotiabank from Argentina, where the legal structure employed was that of an Argentine incorporated bank.

Direct Tax Risk

Every financial projection is focused on after-tax profits, and the structure and impact of direct taxes in the target market are certainly drivers of such final profits. Generally, the most important direct tax is the income tax, but it is not the only one. Increasingly, the imposition of taxes on gross revenues by state or provincial or city authorities, or all of them together, is certainly affecting the pricing of leases and therefore their viability as an affordable financing tool.

	1998	1999	2000	2001	2002
Antigua and Barbuda	40	40	40	40	40
Barbados	40	40	40	38	38
Argentina	33	35	35	35	35
Colombia	35	35	35	35	35
Mexico	34	35	35	35	35
Trinidad and Tobago	35	35	35	35	35
United States	35	35	35	35	35
Venezuela, RB	..	34	34	34	34
Jamaica	33	33	33	33	33
Guatemala	30	28	31	31	31
Costa Rica	30	30	30	30	30
Paraguay	30	30	30	30	30
Uruguay	30	30	30	30	30
Peru	30	30	30	27	27
El Salvador	25	25	25
Bolivia	25	25	25	25	25
Dominican Republic	25	25	25	25	25
Ecuador	25	..	25	25	25
Nicaragua	30	..	25	25	25
Puerto Rico	20	20	20	20	20
Chile	15	15	15	16	16
Honduras	15	15	15
Brazil	15	15	15	15	15
Bahamas, The	..	0	0	0	0
Bermuda	..	0	0	0	0
Cayman Islands	..	0	0	0	0

Source: World Development Indicators database

Figure 4: Corporate Income Tax Rates in Latin America

Every business or strategic plan must acknowledge the trends of direct taxation at the different levels of government in the specific country and attempt to anticipate, as much as possible, the effect that such an increase in taxes would have on its business.

In countries where the law permits tax stability agreements (Such as Chile, Peru, and, until some years ago, Colombia), it is highly advisable to inspect the terms and conditions of such agreements and, if possible, enter into them. This would provide a framework of security and partial amelioration of direct tax risk.

Talent Risk

No business or strategic plan can be executed if there is no human talent—in terms of management, sales, and administration—that can turn business purposes and objectives into realities.

In many emerging markets such as those found in Latin America, talent is scarce and, once found, must often be extensively trained and motivated. Therefore, effective business or strategic plans must provide a comprehensive approach to how and where to recruit and train such local management. An incentive-based compensation plan must be created that has compensation as one, but not the only, motivational factor for newly hired talent. In Latin American countries, a friendly environment generally overshadows better paid but hostile working environments. Such is the prevailing culture.

COUNTRY	Labor Cost per Worker (USD p.a.)Avg 1995-99	Value Added per Worker (USD p.a.)Avg 1995-99	PRODUCTIVITY (VALUE ADDED/LABOR COST)
Colombia	2,507	17,061	6.805345034
Chile	5,822	32,977	5.664204741
Venezuela	4,667	24,867	5.328262267
Argentina	7,338	37,480	5.107658763
Dominican Republic	1,806	8,603	4.763565891
Uruguay	3,738	16,028	4.287854468
China	729	2,885	3.957475995
Mexico	7,607	25,931	3.408833969
USA	28,907	81,353	2.814301034
Panama	6,351	17,320	2.727129586
Ecuador	3,738	9,747	2.607544141
Costa Rica	2,829	7,184	2.53941322

Source: FitchRatings Sovereign Data Comparator- March 2004

Figure 5: Talent Productivity in Latin America Compared to that of USA and China

Figure 4 illustrates the productivity of workers in selected Latin American countries (note that no data were available for Brazil) compared to that of workers in China and the

United States. The productivity numbers of Latin American workers are, however, outstanding, and in a global perspective show that the region has a deep and rich pool of talent.

When assessing talent risk for a particular country, it is critical to become familiar with domestic labor laws and labor uses, including conducting detailed analyses of statute law, jurisprudence (case law), and prevailing practices.

Operational Risk

Market Risk

A business case or strategic plan must assess, as accurately as possible, the potential market for leasing. Many indicators for market risk can be used, such as the GDP, population, equipment imports, and overall level of investment within a given country.

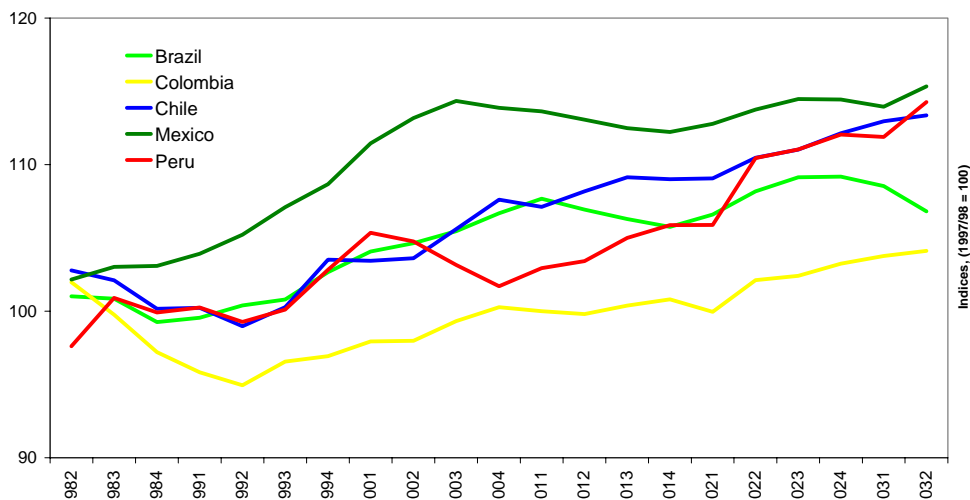


Figure 6: GDP Analysis and Forecasts for Selected Latin American Countries

Demographic data provide interesting indicators about market potential. With all other factors being equal, population and GDP must keep the same ranking while the corresponding economy grows at a pace consistent with an improving standard of living. A market with a large population certainly shows great potential.

Table 3 lists the latest statistical data of Gross Domestic Product in Latin America. It must be noted that this table differs from the ranking that was prevailing in 2000. Brazil used to be the largest Latin American economy and the 8th world largest. Some changes have come into such rankings, taken Mexico to the leading position, though some other countries such as China and Spain have entered into the list of the world ten largest economies.

As far as Latin America is concerned, Table 3 indicates an interesting ranking in terms of actual size of the economy, market share and potential for growth.

Table 3: Ten Largest Latin American Economies

Countries	GDP	%
Mexico	\$ 637,205,282,816.00	38%
Brazil	\$ 452,387,078,144.00	27%
Argentina	\$ 102,191,431,680.00	6%
Venezuela, RB	\$ 94,339,735,552.00	6%
Colombia	\$ 82,194,358,272.00	5%
Puerto Rico	\$ 67,897,098,240.00	4%
Chile	\$ 64,153,722,880.00	4%
Peru	\$ 56,901,464,064.00	3%
Ecuador	\$ 24,347,000,832.00	1%
Guatemala	\$ 23,251,742,720.00	1%

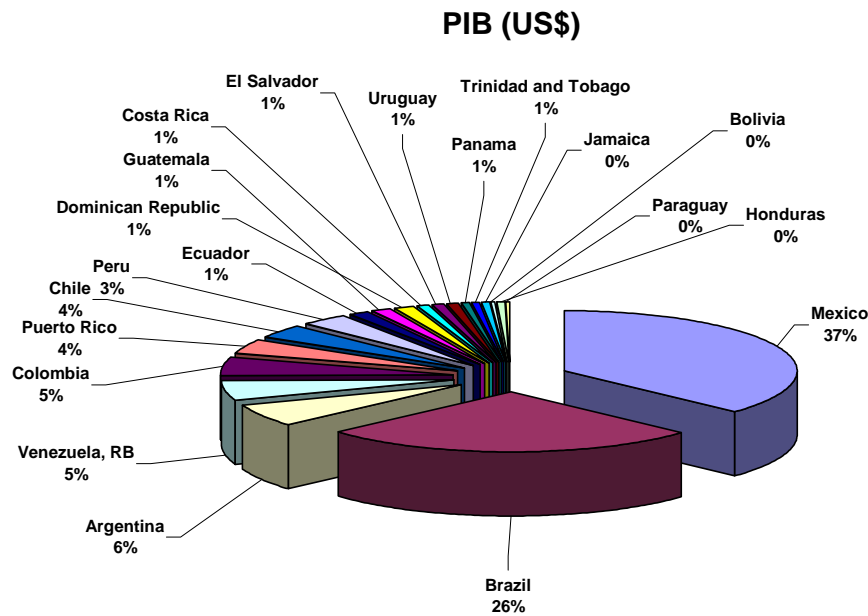


Table 4: Population in Latin America and the Caribbean

Countries	2002	
Latin America & Caribbean	526,747,712	%
Brazil	174,485,408	33%
Mexico	100,921,480	19%
Colombia	43,744,848	8%
Argentina	37,928,280	7%
Peru	26,749,000	5%
Venezuela, RB	25,093,370	5%
Chile	15,578,820	3%
Ecuador	13,112,100	2%
Guatemala	11,991,950	2%
Bolivia	8,697,080	2%
Dominican Republic	8,634,690	2%
Haiti	8,286,490	2%
Honduras	6,755,060	1%
El Salvador	6,523,910	1%
Paraguay	5,510,000	1%
Nicaragua	5,334,930	1%
Costa Rica	3,941,750	1%
Puerto Rico	3,868,870	1%
Uruguay	3,380,990	1%
Panama	2,940,410	1%
Jamaica	2,612,930	0%
Trinidad and Tobago	1,318,300	0%
Guyana	771,970	0%
Bahamas, The	313,990	0%
Barbados	269,380	0%
Belize	253,330	0%
Netherlands Antilles	220,000	0%
St. Lucia	158,520	0%
St. Vincent and the Grenadines	116,720	0%
Grenada	101,710	0%
Aruba	90,000	0%
Dominica	71,800	0%
Antigua and Barbuda	68,890	0%
Bermuda	60,000	0%
St. Kitts and Nevis	45,980	0%
Cayman Islands	35,000	0%

Source: World Development Indicators database

extending their presence into other markets--namely, the five largest Latin American markets. Colombia, Peru, and Chile have the largest growth potential in terms of expanding their GDP to more accurately reflect the size of their population.

Tables 3 and 4 show such market potential for Latin America and the Caribbean.

A strategic planner may correlate population with GDP and assess the potential market in individual countries. For the equipment leasing business, an additional factor that needs to be assessed is the capital expenditure of the economy.

It must be noted, however, that other factors contribute to determining whether or not strong market potential can be achieved, such as the availability of natural resources, the strength of infrastructure, the quality and extent of education, and the reliability of the social safety net.

In examining various Latin American markets, some interesting features emerge. For example, while Brazil and Mexico combined have 52% of the Latin American population, they generate 65% of the region's entire GDP today. A simplistic approach would suggest that Brazil and Mexico should be the natural strategic markets for doing business in Latin America. However, empirical evidence has shown that such a limited approach is wrong because large markets that attract intensive investment soon reach a saturation point, and intense competition then cuts into profits while driving marketing costs up. For instance, GE Capital has not developed a real Latin American presence, although its strategy is confined to the two aforementioned countries. Other players such as Caterpillar Financial or CIT have proven more successful by

But in any event, markets can also shrink, and all other factors considered may impose barriers to the generation of new business.

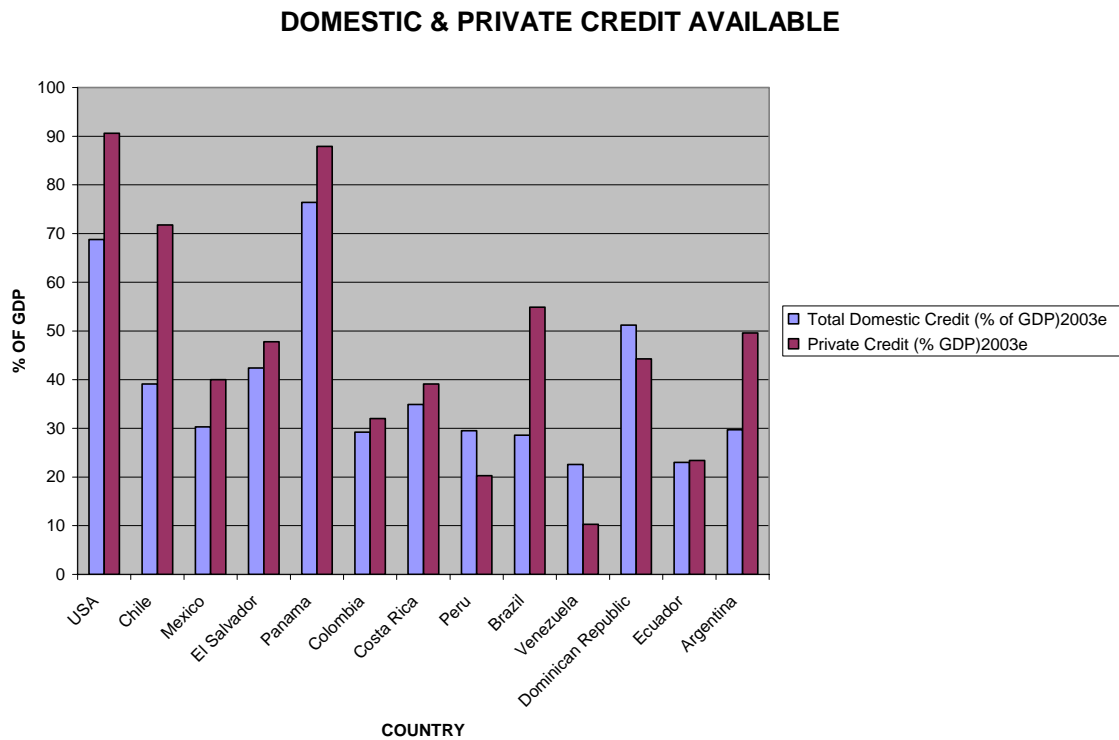
Funding Risk

A key to success in equipment leasing is access to competitively priced funding.

Large multinationals, especially companies with access to large capital markets, may potentially have large capital resources available and at very competitive, low costs. However, cross-border funding faces regulatory barriers—generally, exchange barriers—and the previously described exchange risk factor can be a major deterrent to such international funding unless an affordable and competitive hedge structure is in place.

Availability of local, domestic capital resource markets is one of the factors that potential lessors in Latin America need to assess. For example, after the Brazilian devaluation of 1999, leasing companies there switched their funding strategy from United States dollar-denominated borrowings to Brazilian Reais-denominated papers. Even though the interest rate gap is so wide (the prevailing Central Bank/SELIC rate is currently 16% p.a., while the United States Federal Funds rate is 1.25% p.a.), most leasing companies and leasing customers preferred dealing in Reais. Potential investors in Latin America must ascertain how large the domestic capital market is and how sustainable a funding strategy would be if it were either domestically based or internationally based.

Figure 7: Domestic Capital Market Potential



Source: Fitch Ratings Sovereign Data Comparator, March 2004; chart from The Alta Group.

Figure 5 shows the potential of the domestic capital markets to provide funding for leasing companies. It can be seen that Panama, Chile, Brazil, and Argentina have the best potential to raise funds in their domestic markets for funding leasing transactions.

All other countries bear a higher domestic funding risk, and investors in these countries must therefore rely more upon cross-border funding than upon domestic financing.

Competition Risk

Once a company has dealt with building a legal structure, hiring competent management, completing a marketing strategy, and obtaining reliably available financial resources, it would be tremendously disappointing to learn that its sales people cannot originate enough transactions because their market is too competitive. Leasing companies must continually perform analyses of their competitive climate. Lessors must know who their competitors are, what their product offerings are, and how their own pricing, service, and products compare with those of their competitors. This diligence is absolutely critical to the lessor's viability.

Generally, the larger and more mature an industry is, the tougher the competitive environment is for that industry. At certain stages of maturity, it is no longer viable for lessors to allow their lease offerings to become a commodity and thereby end up trapped by the need to lower prices and margins, or worse, be obliged to close deals with unacceptable credit risks. Continuous analysis of the competitive climate is certainly an imperative to mitigate competitive risks.

Credit Risk

Credit risk is the core risk undertaken by every equipment lessor. It is a generalized perception that credit risk analysis must assess the famous three "Cs" of credit scoring: *character*, *capacity*, and *collateral*.

Unfortunately, most of the business environments in Latin America are still deficient in their ability to provide available information to assess credit-worthiness and make a credit judgment. The credit information systems in most Latin American countries are improving, but a large gap still exists between the quality and accuracy of credit-scoring information available in Latin America and that available in the United States. Progress is being made, however. Brazil, Mexico, Argentina, Colombia, and Peru are adapting state-of-the-art credit information technology. Moreover, credit bureaus are in operation in these countries, and the regulations as well as their enforcement are leading to steady but increasing improvement of credit information.

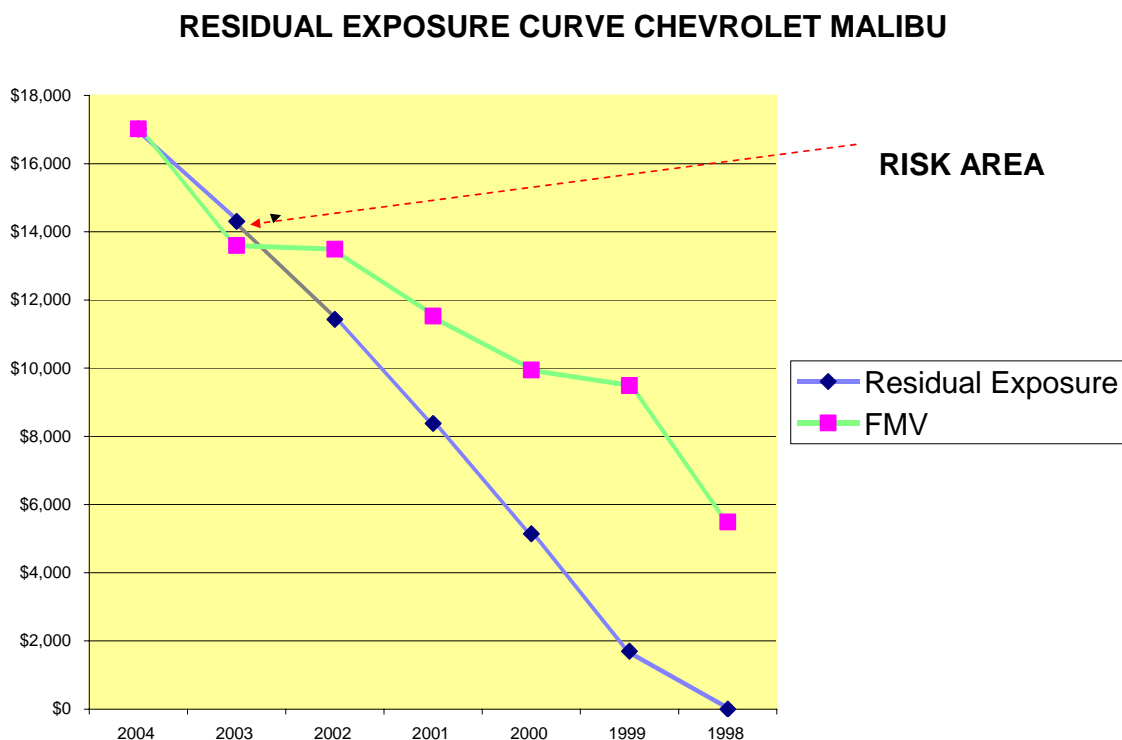
The bottom line is that credit risk must be examined very closely in Latin America; the good news is that the credit scoring infrastructure and information databases are becoming increasingly available.

Residual Risk

Lessors are confronted by residual risks not only at the end of the lease but throughout the complete term of the financing. An inherent probability always exists in every lease that the lessor may be forced to repossess the leased equipment at any time. This repossession could be necessitated by almost any reason whatsoever, and the repossession could range from voluntary repossession to forceful recovery of equipment.

Figure 7 contains an illustration of a residual risk curve. The curve shown illustrates the amount of unrecovered investment by the lessor under the lease arising from collecting stipulated rentals (“Residual Exposure”) compared to the fair market value of the equipment over the entire lease term (“Fair Market Value”).

Figure 8: Residual Risk Forecast Sample



Source: Kelly Blue Book and calculations of The Alta Group

A more sophisticated residual risk curve must add to the residual risk exposure concept the costs of repossession in cash and time (these costs would include legal fees and the time required for repossession, refurbishment, and going to market). Therefore, the most

valuable tool for effective residual risk management is certainly an in-depth, up-to-date information source about secondary markets.

Unfortunately, in emerging markets such as Latin America, there are fewer and less robust secondary-market information sources than in more mature markets, such as those in the United States. However, secondary-market information is available, and certainly the lessor who is able to consistently access such information and use it to create more accurate residual risk estimates will be the winner. Residual risk projections must also consider the rapid changes in technology and how these changes influence the secondary markets for any given equipment.

The good news in emerging markets such as Latin America is that second and third layers of customers exist for used equipment. For instance, there is still a growing market for fax machines in some rural areas of Latin America, while the stand-alone fax machine has almost become obsolete in the first world.

Deal Structure and Documentation Risks

Lessors face a combined set of risks in deal structuring and documentation.

First, a well-engineered deal structure and clear documentation provide reassurance to the lessor that he or she has entered into a sound and profitable deal and, secondly, may also be competitive tools because they can help differentiate the value proposition of a given lessor from that of his or her competitors. Therefore, sound structures and documentation are optimal if they achieve the dual purpose of enforceability and differentiation from the competition. (Note that the latter purpose of market differentiation may only be temporarily beneficial, until the competition learns of the advantage and emulates the successful deal structure).

In Latin America, several factors drive deal structure and documentation. Of course, the most obvious and immediate advice is to retain good legal counsel, but the following are some additional factors that influence deal structuring and documentation:

1. The existence or absence of a domestic *ad hoc* regulation for equipment leasing;
2. The existence or absence, as well as the familiarity, of the domestic courts with equipment leasing as opposed to traditional rental agreements or the hire purchase or conditional sales agreements;
3. The existence or absence of a strong domestic leasing association that defends the interests of the leasing industry and serves as an advocate and communication conduit to the government, congress, and courts (and even to the press); and
4. The existence or absence, as well as the prevailing attitude, of government regulators to the financial markets and, in particular, the equipment leasing industry.

In countries such as Brazil and Mexico, all these factors exist. However, innovation in the equipment leasing industry in these countries (and, therefore, any innovative lease

structures) should ideally be pre-approved by government regulators prior to launching it because lack of awareness of any new structure and its rationale might be misinterpreted by regulators and result in undesirable outcomes and losses by the lessor.

It is interesting to note that Chile, which does not have the any *ad hoc* legislation for leasing transactions, has still developed and produced a very consistent body of jurisprudence that reflects an understanding of the real nature of the leasing business and favors the enforceability of equipment leasing arrangements.

Other countries, such as Colombia, Peru, Costa Rica, and Guatemala, have some of these structures in place and are at present improving them, but they are not yet strong enough to be consistently reliable.

Portfolio Service Risk

It is very clear that a well-documented transaction with an acceptable credit risk and appropriate coverage of residual and other risks is still not adequate to generate sufficient revenue for the lessor to sustain his or her business. Having an adequate portfolio service infrastructure and organization to bill, collect, liquidate, and receive payments is essential for the success of any lessor.

A portfolio may lose its value if portfolio servicing declines. Recently, a securitized portfolio in Brazil experienced some temporary increase in delinquency, mostly attributable to a temporary crisis in portfolio servicing and notwithstanding the fact that the credit rating of the lessee was still investment grade.

To weigh portfolio service risk, one must make a comprehensive assessment of the following factors:

1. Human resources: hiring good talent and providing adequate motivation and ample training;
2. Sound internal procedures;
3. Good information technology and systems;
4. A strong domestic banking infrastructure and banking relationship in place; and
5. The existence or absence of domestic dedicated portfolio management firms to handle eventual personnel and outsourcing needs.

Indirect Tax Risk

Not only in emerging markets but in markets all over the world, governments are relying increasingly on indirect taxes rather than on direct taxes as the core source for generating public monies.

A newly-enacted indirect tax may affect the pricing structure of an established lease. It is worthwhile to note that in all Latin American jurisdictions, tax law is considered public interest law, and, therefore, its application to existing deals is effective whenever the law is enacted, without regard to whether or not such deals were executed prior to the new law's enactment. Such emerging indirect taxes are virtually unavoidable.

Therefore, lessors must try to anticipate the tendency of their jurisdictions to create or increase such indirect taxes and should assess whether or not such tax structures may affect their expected profit margins in some or all of their leases. A simplistic approach to cover such risk would be the insertion of a typical tax indemnity clause in the master or boilerplate lease agreements. However, such an approach is not always effective and sometimes is not even enforceable. In certain jurisdictions, Brazil or Mexico, for instance, consumer protection laws enable lessees (who are, by extension, protected by consumer protection laws) to dismiss such a tax indemnity clause on the grounds that the courts should have deemed such clauses as not written, if there is the appearance of an unfair deal in detriment to the lessee, and that the courts should attribute, by default, to the "abuse of the dominant bargaining position of the Lessor."

A typical example of such indirect taxation is the so-called "PIS/COFINS Tax" in Brazil, which has undergone several changes over the past 18 months in terms of rates and taxable events.

A comprehensive program to assess the potential for such indirect taxation would be a wise undertaking by any lessor interested in transactions in Latin America. Pricing and documentation may provide responses to the actual indirect taxation risk detected or accurately forecasted and could provide adequate coverage in terms such that neither competition risk nor documentation risk are increased. Overall, this would protect the lessor's profitability.

Regulatory Operating Risk

As mentioned previously, the existence of regulations in the domestic equipment leasing industry could be either a blessing or a curse. If regulators understand the leasing industry, they can stimulate its orderly development for the general welfare of their country's economy. This understanding and proactive approach by regulators represents an ideal scenario, and in some countries, like Brazil, Mexico, and, increasingly, Colombia and Peru, the regulatory situation is improving.

Argentina and Chile do not have such regulatory operating risks at present because most of the lessors may be incorporated without any regulatory intervention, except for banks' controlled lessors.

On the other hand, if regulators are not well educated about the real economic and social benefits of the equipment leasing industry, being subject to them would be detrimental.

The following regulatory factors significantly affect the normal operation of a leasing company:

1. *Expensive and useless reporting obligations.* In some countries, lessors are required to complete regular documentation reports (which could be required at any interval ranging from daily to annually) that are often not well suited to the actual legal, economic, and financial structure of the lessor;
2. *Inadequate auditing procedures.* In countries where regulators are unfamiliar with leasing, auditing by them tends to analogize the internal structure and control of leasing transactions to those applicable to bank loans. While sometimes leases and loans share commonalities, they often have enormous differences;
3. *Limitation on the scope of business offerings and deals structures.* Regulators may not understand the rationale of some transaction structures, and for that reason alone they may forbid it. A typical example is Colombia, where for many years securitization of leases was forbidden by the Superintendency of Banks;
4. *Order or disorder in non-performing players from the market.* The lack of understanding about the leasing industry by regulators may create disorder exits from the market and overall market turmoil that may impair the confidence and trust that the local players, such as vendors, funding sources, and lessees, may have in the lessors overall and, in particular, the good players.

There are a variety of approaches to covering such regulatory risks. The first and easiest is to simply avoid entering into any markets where the industry is regulated, or focus only on selected markets with highly educated regulatory environments. An alternative approach is to actively support the local leasing association in providing good education to the regulators. A third approach that is applicable in any setting is to always deal in an intelligent and strategic manner with any regulators.

Legal Collection Risk and Repossession Risk

When, in spite of good portfolio servicing, well-structured and documented deals fail, it is often because of a lack of enforceability of laws. Enforceability often determines the likelihood of compulsory collections and/or prompt equipment repossessions and disposals.

The necessary legal path to enforcing leasing transactions has three milestones: (i) the rule of law; (ii) the efficiency of the legal system; and (iii) a corruption-free environment.

Table 5: Rule of Law Index for USA and Latin America

Country	Est.
US	1.70
CAYMAN ISLANDS	1.55
BARBADOS	1.43
CHILE	1.30
BERMUDA	1.28
MARTINIQUE	1.28
PUERTO RICO	1.15
FRENCH GUIANA	1.02
COSTA RICA	0.67
DOMINICA	0.67
ST. VINCENT AND THE GRENADINES	0.66
URUGUAY	0.56
TRINIDAD AND TOBAGO	0.34
ST. KITTS AND NEVIS	0.33
ST. LUCIA	0.33
GRENADA	0.28
BELIZE	0.05
PANAMA	0.00
MEXICO	-0.22
BRAZIL	-0.30
JAMAICA	-0.38
DOMINICAN REPUBLIC	-0.43
GUYANA	-0.43
PERU	-0.44
EL SALVADOR	-0.46
ECUADOR	-0.60
BOLIVIA	-0.60
NICARAGUA	-0.63
ARGENTINA	-0.73
COLOMBIA	-0.75
HONDURAS	-0.79
GUATEMALA	-0.84
CUBA	-0.94
VENEZUELA	-1.04
PARAGUAY	-1.12
HAITI	-1.76

The rule of law concept refers to the willingness of the players in a certain country or economy to honor their commitments, whether by freely consenting or by the imposition of statute law.

The World Bank has developed a measurement system of the strength of the rule of law⁶ in various countries. According to this system, the highest rule of law index score is 2.5, and the lowest is -2.5.

Table 5 ranks these index scores, listing the United States and the Latin American and Caribbean countries. This table is an extract of a rating of 186 countries. For illustration purposes, The United States ranks 20th, below countries such as Monaco, Switzerland, Denmark, and Canada; the worst index score is that of Somalia (-2.05).

Understanding the effectiveness of the rule of law in a given market will help lessors directly gauge the overall likelihood of prompt payments and voluntary repossessions there. Therefore, such factors must be considered in shaping a risk-management strategy.

The second factor to be considered is the efficiency of the court systems in the target country. If negotiations fail for any reason, including poor rule of law, then going to court to litigate the dispute must be an effective alternative. But in reality, such litigation in court is rarely an efficient alternative for the pursuit of lessors' rights.

The World Bank and *Lex Mundi* undertook a study to measure the efficiency of judicial systems in 109 countries⁷. Several indicators emerged from this study. Table 6 shows the average prevailing times that are taken in each country to enforce a contract. The table includes some relevant Latin American countries and, for comparative purposes, the United States of America.

⁶ Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi (2003). "Governance Matters III: Governance Indicators for 1996-2002," World Bank Policy Research Department Working Paper.

⁷ Courts: The Lex Mundi Project, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer; April 2002, Working Paper 8890; <http://www.nber.org/papers/w8890>; National Bureau of Economic Research, 1050 Massachusetts Avenue, Cambridge, MA 02138.

Table 6: Court System Efficiency

Time to enforce a contract (days)	2002	2003
Nicaragua	65	125
Paraguay	..	188
Chile	200	200
Jamaica	202	202
Honduras	225	225
El Salvador	..	240
Argentina	300	300
Mexico	283	325
Ecuador	333	332
Uruguay	360	360
Venezuela, RB	360	360
Puerto Rico	..	365
United States	270	365
Costa Rica	370	370
Brazil	180	380
Peru	441	441
Bolivia	464	464
Dominican Republic	215	495
Colombia	527	527
Guatemala	1,460	1,460

Based upon such data, a lessor can assess the time involved in enforcing a leasing document. In order to determine the costs, the World Bank also undertook a contract-enforcement cost analysis, which is presented in Table 7:

Table 7: Cost to Enforce a Contract

Cost to Enforce a Contract (% of GNI per capita)		
	2002	2003
United States	0	0
Brazil	2	2
Bolivia	2	5
Colombia	6	6
El Salvador	..	7
Honduras	7	7
Argentina	9	9
Mexico	10	10
Ecuador	11	11
Uruguay	14	14
Chile	15	15
Nicaragua	18	18
Guatemala	20	20
Puerto Rico	..	21
Costa Rica	23	23
Peru	30	30
Paraguay	..	34
Jamaica	42	42
Venezuela, RB	47	47
Dominican Republic	441	441

By assessing the combination of time and cost involved in litigation for a given market, some strategic decisions may be made to ensure adequate risk management in this area.

When lessors succeed in their litigation strategies, they may face another obstacle to enforcing their rights: the corruption of the government and/or the judiciary.

Table 8: Corruption Perceived Index

	Country	CPI 2002
Rank		score
16	USA	7.7
17	Chile	7.5
32	Uruguay	5.1
35	Trinidad & Tobago	4.9
40	Costa Rica	4.5
45	Brazil	4
47	Jamaica	4
48	Peru	4
57	Colombia	3.6
58	Mexico	3.6
59	China	3.5
60	Dominican Rep.	3.5
63	El Salvador	3.4
67	Panama	3
70	Argentina	2.8
72	Honduras	2.7
82	Guatemala	2.5
83	Nicaragua	2.5
84	Venezuela	2.5
89	Bolivia	2.2
91	Ecuador	2.2
92	Haiti	2.2

Source: Transparency International

Table 8 contains a ranking of markets and their “perceived corruption score” for some selected Latin American countries compared to those of the United States and China. The higher the score, the lower the perceived corruption of the government in that particular country.

An interesting and unique feature of leasing enforceability is the prevailing recognition of the preferential rights of lessors vis-à-vis secured and unsecured lenders. Bankruptcy courts and liquidators have systematically accepted the preferential range of lessors’ rights in bankruptcy proceedings. In practical terms, both in the cases of finance leases and operating leases, lessor rights to collect rentals under an automatic stay are treated as operational expenses of the reorganization. In such cases, they then shall be paid with preference, or, in cases where the leased assets are not essential for the continuation of

the business, friendly repossessions ordered by the bankruptcy courts tend to be the solution. This has been extensively documented in Mexico, Brazil, Chile, Colombia, and other jurisdictions⁸.

End-of-Lease Risk

The equipment leasing industries in Brazil, Mexico, Chile, Colombia, Peru, and Argentina are evolving from the pure finance, or capital-lease-based, model, which normally is supported by tax incentives, to a more mature operating lease environment.

In a prevailing finance lease model, end-of-lease risk is not an issue because normally lessees tend to purchase for a nominal or very low value the equipment at the end of the lease.

However, in an operating lease model, end-of-lease options create many potential alternatives and, therefore, imply several risks to be considered by the lessor:

1. *Return of the equipment.* In such an option, the lessor faces, *inter alia*, the following risks:
 - a. Equipment in poor condition, below fair wear-and-tear standards;
 - b. Obsolescence of the equipment;
 - c. Need to refurbish the equipment; and
 - d. Other logistical conditions
2. *Extension of the lease for a longer period.* In such an option, the lessor faces an extension of its exposure to the lessee's credit risk;
3. *Purchase of the equipment for its fair market value.* Here the lessor's associated risks consist of any taxes applicable on the sale, and, of course, the credit risk of the final purchaser;
4. *Refusal by lessee to exercise any of the above options, and therefore withholding of the equipment.* In most jurisdictions, if the contract does not provide otherwise, the lessee may have a statutory right to keep possession of the equipment, alleging that there are obligations due by the lessor by any reason associated to the same.

The best protection in these cases will always be a very well drafted contractual provision. However, in some cases, even a good contractual provision may be challenged in court by the lessee. In such cases, screening the character of the lessee is one of the major preventive measures that helps ensure sound risk management.

⁸ For more detailed information about court precedents in the most active countries, we encourage reading "Legal Aspects of Equipment Leasing in Latin America" by this paper's author. See note 5 above.

Currency Risk

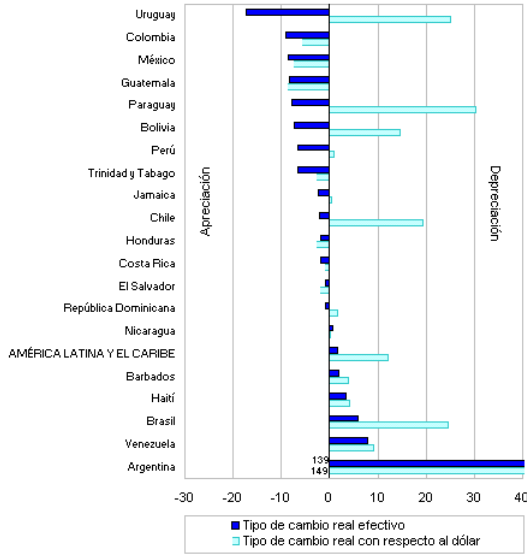
Lessors and equipment finance lenders face currency risks, not only in their overall portfolio recoveries, in collecting any receivables out of the stream, or in rentals that have been denominated in local currency, but also when liquidating any transaction that requires a conversion of all the local-currency proceeds into hard currency (such as United States dollars, Euros, or any other hard currency).

In a global environment, where the international monetary system tends to eliminate or at least condemn to failure any artificial, government-imposed exchange rate, the general tendency is for exchange rates to float. The insurmountable forces of free exchange among markets, including legal or illegal white or black markets, creates both a risk and an opportunity regarding currency exchange. Floating exchange rates necessitate steps by lessors to reduce any currency risks associated with their portfolios.

From time to time, the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) records and analyzes the purchasing power parity of Latin American currencies vis-à-vis their prevailing exchange rates. Such data bring good indicators and warning signs about whether or not a given national currency is overvalued or undervalued (which means, in the case of overvaluation, a significant risk of devaluation, and vice versa in the case of undervaluation). Such indicators should lead lessors to hedge the exchange rate variations, using the available derivative instruments⁹. The latest information published by ECLAC corresponds to FY 2002 and is shown in Figure 9:

⁹ All Latin American countries have banks offering forwards and sometimes swap agreements. Brazil and Mexico have more sophisticated derivatives markets because each one of them has a derivatives exchange. The remaining Latin American countries use public debt instruments denominated in US dollars or Euros, but one must warn that sovereign risk should also be evaluated using such hedging instruments.

Gráfico I.14
AMÉRICA LATINA Y EL CARIBE: TIPOS DE CAMBIO REAL EFECTIVO Y BILATERAL
 (Variación entre el cuarto trimestre de 2000 y el segundo trimestre de 2002)



Fuente: CEPAL, sobre la base de cifras oficiales.
 a/ Un aumento significa una devaluación real.

Figure 9: Overvalued (left) and Undervalued (right) Currencies in Latin America

Exit Strategy Risk

A sound business plan must foresee an exit strategy for that business. As stated in the series of studies published by the Equipment Leasing and Finance Foundation, “The Perfect Storms” and “Forecasting Quality,”¹⁰ the central purpose of any leasing business

¹⁰ The Equipment Leasing and Finance Foundation, in 2000, commissioned The Alta Group to examine why an unusually large number of companies had exited the industry in a short period of time. The purpose of this study, aptly titled “The Perfect Storms,” was to determine why, although most companies are successful, a few failed in a very short timeframe.

The Perfect Storms study consisted of ten companies (the target companies) that had exited the industry, either voluntarily or involuntarily, during the period from 1998 through 2000. These companies represented a broad cross-section of the equipment leasing industry and were active in several different markets. Specifically, the foundation sought to determine whether this exodus was a series of isolated events or an indication of a failing industry. More importantly, the foundation wanted to know whether there were any signals or indicators of these eventual problems. The conclusion reached in this study was that highly questionable decisions were made that, when combined with external factors, created disastrous results for the companies involved. Furthermore, there were signals and trends presaging these results.

In a second stage of research, the foundation asked The Alta Group to identify key measures and useful indicators helpful in successfully managing an equipment leasing and finance business. Lessors can use forecasting quality to evaluate their own financial health, that of possible acquisition targets, and continue to make good business decisions. Further information can be found in www.LeaseFoundation.org.

is to create, add, and capture value. An exit strategy for a leasing business is designed to facilitate this capture of value at a certain stage of time.

A typical exit strategy could be to sell the company to a third party, or to organize a successful Initial Public Offering (IPO) to distribute ownership of the company in the open capital markets.

In our risk categorization (see Table 1), we have identified two major risk sub-categories in connection with an exit strategy—namely, country risk, which was already addressed, and an industry collapse risk, which is described below.

Industry Collapse Risk

Between 1969 and 1996, Venezuela had a healthy and growing equipment leasing industry. Investment in capital equipment was flowing and competition was intense, developing a highly sophisticated and well-funded leasing system.

What happened then? Financial turmoil that affected some of the major Venezuelan banks led to government intervention, change of legislation, enactment of the universal banking model, and the indiscriminate application of all Basel Accord rules to all financial institutions. Talent migrated to other activities and priorities, and the equipment leasing industry collapsed in Venezuela. Today, it is hard to find independent leasing companies operating in Venezuela and even more difficult to find equipment leasing portfolios among Venezuelan universal banks.

The analytical methodologies described in “The Perfect Storms” study can and certainly were applied in such a context¹¹. The conclusions of the study for Latin America were the same and identified the following four factors:

- ✓ Poor or untested business models;
- ✓ Management issues;
- ✓ Poor controls; and
- ✓ Uncontrolled and indiscriminate growth.

But in addition to the above, when the Equipment Leasing Association is weakened in a particular market, the leasing industry tends to collapse because it lacks the appropriate advocate to safeguard its interests--not only toward the government but also toward the market and the public.

¹¹ In 2002, The Alta Group Latin American Region conducted a seminar in which research entitled “*Mares Tormentosos en América Latina*” was presented. A PowerPoint presentation of this research is available for download at www.thealtagrouplar.com.

Summary and Conclusions

Every human activity has inherent risks. As the current advertising message of one insurance company states, “The worst risk is not taking a risk.”

Companies that succeed do not hide from risk. They define their risks and prepare for them, making themselves less vulnerable to such risks than any of their competitors. While Latin America presents many attractive features as a region to conduct business, events associated with the risk categories and types discussed previously are often magnified by the press and by all those who may have ended up a party to one of those events because they failed to do their homework.

The risk categorization included in this paper as Table 1 is a good tool to use in assessing the risks of transacting business in Latin America. Such a list does not pretend to be complete, and new or evolving risk factors might not be included on it. Table 9 serves as a good check-list for conducting a preliminary risk assessment.

While globalization is unavoidable, the Western Hemisphere holds much promise just in better integration of its economies. A new frontier is open for pioneers exploring markets south of the Rio Grande River.

As Thomas McNamara, then chairman of the Council of the Americas, declared in 2001 in Buenos Aires during the Summit of the Trade Ministers of the Free Trade Area of the Americas, the United States of America was the first free trade area of the Americas that gathered 50 States, each with different business environments. Well, the challenge for today’s business leaders is to embrace the 34 additional “states” that comprise Latin America by increasing business with these markets for the mutual benefit of the creation of wealth and welfare in our hemisphere.

The widespread panic among some today about the threats of foreigners producing products at lower costs reflects a short-sighted vision that could lead America to disaster. A vision that seeks ways to leverage the diversity and unique attributes of Latin American economies by combining them with technology, research, and good management has the potential to build a strong and united Western Hemisphere. This is a vision that makes sense and will be sustainable in the long run.

Table 9: A Checklist of How to Respond to Specific Types of Risk

RISK CATEGORY	RISK TYPE	SUGGESTED APPROACH/ PREVENTION OR COUNTERMEASURE
MARKET ENTRY RISK	COUNTRY RISK	Simulation analysis/ political risk insurance/check for international investors' protection treaties
	REGULATORY RISK	Review regulations/assess quality of government entities/retain competent counsel
	STRUCTURE RISK	Undertake comparative analysis/choose the right structure for your interests
	DIRECT TAX RISK	Analyze government finances/prepare a long-term strategy
	TALENT RISK	Evaluate quality of local talent/develop comprehensive training programs/coach and motivate
OPERATIONAL RISK	MARKET RISK	Assess purchasing power/identify the potential of your niche/ identify how to exploit the population-GDP gap
	FUNDING RISK	Assess domestic financial markets and barriers for cross-border funding/develop a long-term funding strategy
	COMPETITION RISK	Maintain continuous competitive analysis on your peers in the business
	CREDIT RISK	Develop an approach combining sound risk-acceptance criteria with a deep understanding of the particulars of the domestic economy
	RESIDUAL RISK	Develop a permanent collateral curve and complete an accurate database/continually inspect leased assets and keep track of secondary markets tendencies
	DEAL STRUCTURE RISK	Build a project team between your business development and sales people and competent counsel/schedule permanent interaction
	DOCUMENTATION RISK	Rely upon competent and experienced counsel, and establish control procedures and levels of authority for documentation risks.
	PORTFOLIO SERVICE RISK	Keep a motivated and diligent team/continue analyzing offerings of outsourcing and cluster services (such as bank collection services) available in the marketplace
	INDIRECT TAX RISK	Build a competent team to track tendencies and trends/keep a sound pricing policy and have bullet-proof documentation, with red flags for changes
	REGULATORY OP. RISK	Analyze competency of regulators/cooperate with the industry association in building training programs for regulators/be proactive;
	LEGAL COLLECTION RISK	Develop a delinquency management strategy with competent personnel and counsel
	REPOSSESSION RISK	Combine permanent asset tracking and inspections with delinquency management strategy
	END-OF-LEASE RISK	Anticipate likelihood of events, and analyze in advance probability of such risks/combine this strategy with asset tracking and delinquency management;
EXIT STRATEGY RISK	INDUSTRY COLLAPSE RISK	Support a strong domestic industry association/make prevailing standards of good management practice/regularly execute a "Perfect Storms" analysis
	COUNTRY RISK	Track the host country macroeconomic and political evolution/combine independent reports with your assessments, and challenge them with competent consultants/build a "shelter" strategy accordingly.