Expanding the audience

Recent tax changes have made investment into Brazilian private equity infrastructure funds more appealing to domestic participants, but shouldn't Brazil also be creating incentives to attract foreign investors?

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Brazil is in need of several infrastructure projects, both related and unrelated to the 2014 World Cup and the Olympics in 2016 – airports, seaports, railroads, highways, energy, and arenas to name a few. Funding of these several required projects is subject to whether or not there are enough incentives for players other than BNDES (Brazilian Development Bank) and other public sources to get involved.

Absent to regulatory changes, big-ticket projects are likely to continue to depend heavily on financing from BNDES and other public-sector sources. The primary reason for this is that BNDES offers long-term loans and does it at subsidised interest rates, whereas, given Brazil's recent history of super high inflation, long-term financing from private sector banks is pretty scarce and the benchmark lending rate in Brazil is 11.75%.

Conversely, it is evidently important for the Brazilian industry to be able to access different sources of financing. Natural and interesting alternatives for financing infrastructure projects would be capital markets and foreign institutional investors; however, these are not seen frequently.

Specific capital markets regulation was put in place in 2007 creating the Fundos de Investimento em Participações em Infra-Estrutura, or FIP-IE. The FIP-IE is a slight variation of the ordinary private equity fund (FIP) – the main difference being that it must only invest in special purpose corporations that explore infrastructure projects. Other regulatory provisions, however, made the FIP-IE a not-so-flexible vehicle, such as the ordinary FIP.

Among these provisions was the ability to invest only in energy, transportation, water and sewage, and irrigation sectors, and a mandatory minimum of ten investors, none of which with more than 20% of the fund. On the pro side, the government approved income tax exemption for individuals investing in an FIP-IE, and a 15% taxation of capital gains (as opposed to a 34% ordinary rate) applicable to investments made by legal entities. Notwithstanding, less than five FIP-IE have been registered – an indication to the government that more needs to be done.

To help boost long-term investments in the infrastructure sector, in December 2010 the government enacted Provisional Measure No. 517/2010, with certain important regulatory and tax incentives. The potential portfolio of the FIP-IE was expanded to include investments in other sectors declared (or to be declared from time to time) as priority by the government. Also, the minimum number of investors in a FIP-IE dropped to five, provided none should have more than 40% of the fund. However, the most important piece of the Provisional Measure was its tax front.

Income from publicly traded securities issued by non-financial corporations and that met certain criteria established in the regulations – which are mostly related to a long-term rationale (for example minimum average term of four years; absence of mandatory put option; call option prohibited in the first two years) – became subject to zero-rate withholding income tax when paid to foreign investors (except those domiciled in countries in which income is not taxed or is taxed at less than 20%).

> "FOREIGN INVESTORS ARE LIKELY TO HAVE MORE APPETITE FOR INFRASTRUCTURE PROJECTS"

But we should ask again whether there are enough incentives for other players to finance infrastructure projects in Brazil. While not disregarding the importance of all benefits that have already been approved, an important one seems to us left behind: extending to foreign investors in FIP-IE the current tax benefits applicable to foreign investors in the ordinary FIPs.

Given the size of the infrastructure projects, their complexity and longer terms of maturity, and the risk profile associated to them, foreign institutional investors are likely to have more appetite for these vehicles than the Brazilian individuals and entities benefited by the recent tax changes.