Massive $100B+ capital market looms in Puerto Rico

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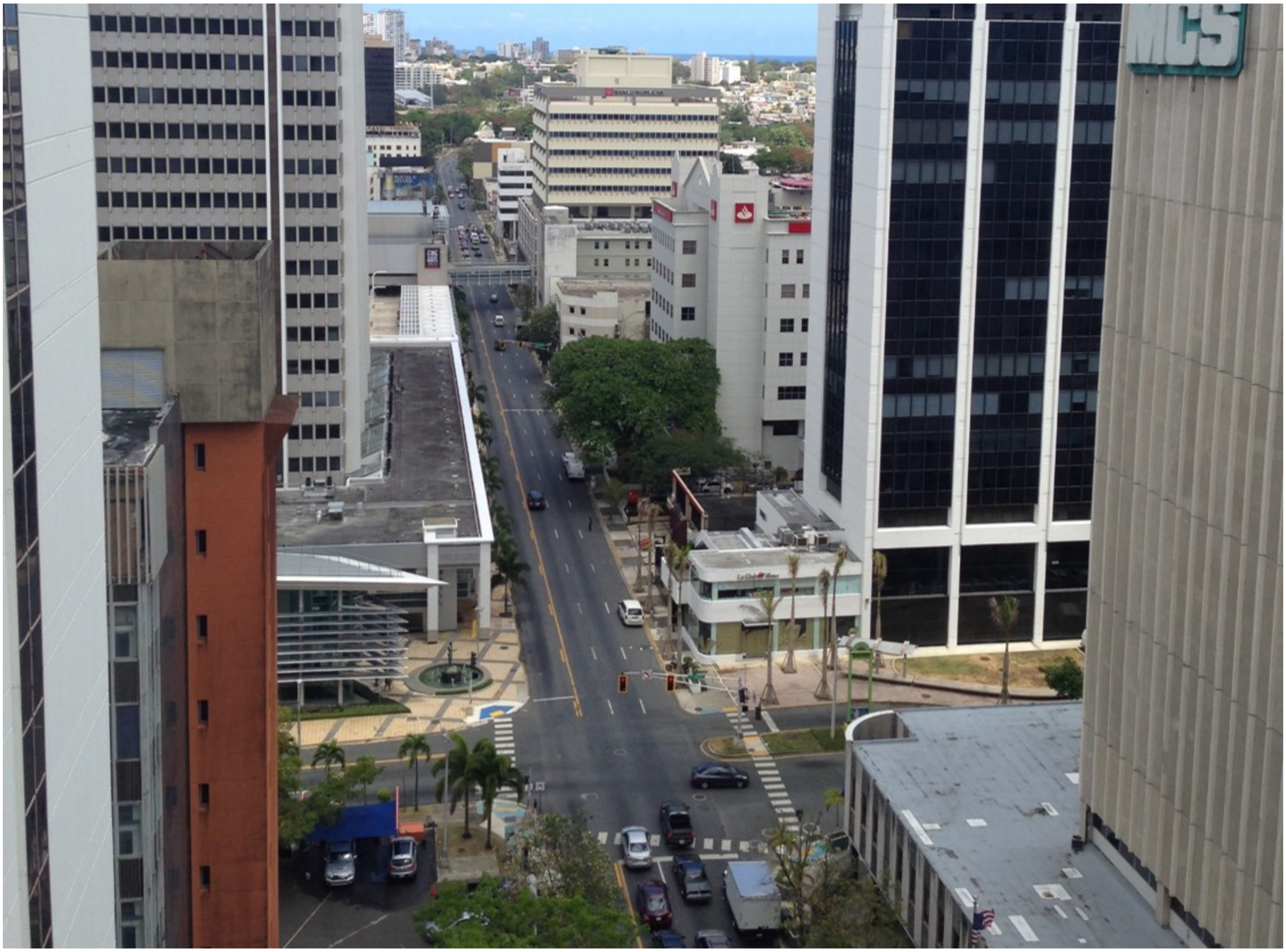

PRBT: The time has come to see Puerto Rico differently. To promote it differently. It can begin at a conference in a few days, where participants will have a chance to adopt a new 20/22 vision, one where capital features as prominently as incentives, where promoting a tsunami of new service companies becomes as urgent as attracting the wave of investors who have already begun arriving on our shores. The change is upon us. Let's make some history.

By Alex Díaz. Puerto Rico Business Today. April 19, 2014.

No one, it is safe to say, saw this coming. Scant few, in fact, see it even now, more than a year after the government of Puerto Rico began its aggressive promotion of Law 22.

It does feel, however, as if the island's bright new dawn will come into clear view when the sun rises following the April 24-25 Investment Summit in San Juan and Rio Grande, a first-of-its-kind activity designed, precisely, to promote Law 22 and its partner incentive package, Law 20 – the former for individual investors and the latter for companies moving to the island.

Or maybe not. The numbers are so big that perhaps incredulity will prevail even after the anticipated audience of 200 investors and entrepreneurs, folks considering making the move themselves, receive the Puerto Rico pitch that got their hosts and speakers to bring their businesses and families to Puerto Rico and who are now calling this U.S. territory home.

But as finance guys always say, numbers are numbers, even when they're as big as these. According to the latest count obtained this week by Puerto Rico Business Today during an exclusive interview of Economic Development & Commerce Secretary Alberto Bacó Bagué, there are now 236 Law 22 investors in Puerto Rico.

Just ten, he revealed, "intend to invest about $10 billion among them – an average of $1 billion each – in 24 months," or better said, in their first two years on the island. Some of these Big 10 – including the two now iconic cases, John Paulson and Nicholas Prouty – are already well into their first 24 months. Others are just getting started.

So if 10 out of 236, or roughly 4%, are good for $10 billion – alone a fantastic amount of money for a recession economy of 3.6 million people in desperate need of capital – where exactly is this going? (By the way, we'd love to hear what you have to say about this money trail. If you think we are overstating it or – alas! – falling short, please speak your mind in the comment section below or drop us a note at adiaz@businesspr.today .)

Bacó was not clear how much the other 226 investors are likely to pump into the local economy in the same two-year time frame. "I'm seeing something like the 80-20 rule playing out, with 80% of them investing $2 million to $5 million and about 20% going much higher, up to the $500 million range."

During a recent meeting of the Puerto Rico Manufacturers Association, one leading banker lauded that "these investors are coming to our office with amounts we've never seen – $300 million, $500 million, one with $750 million. And lately, I've been seeing 5-10 of them every month."

So for the sake of this article, is it reasonable to draw a curve that places the average for these 226 investors – not counting the Big 10 – at, say, $40 million to $50 million each? We think so, and that adds another $10 billion to Puerto Rico's new Law 22 capital market.

That merits repeating. Law 22 has created a brand new capital market on the island of roughly $20 billion, money that is just now starting to make its way through the local economy and financial system. We'll dig deeper into the full implications of this mind-blowing game-changer in an upcoming story. For now, consider something else.

Try $175 billion – for starters!

Having 236 investors already here "is way beyond our greatest expectations going in," said Bacó. "Our initial projection called for about 500 investors to move to the island by the end of this four-year term," between 2013 and the end of 2016.

The number is now 236, and it's only been a little over one year, so what's the 2016 expectation update? "Two thousand is probably a fair number. And if we fall short of that, I don't see it staying below 1,500."

That's because, he added, "we're seeing how when one investor decides to make the move, they persuade others, usually more than one, so the number compounds." Yes, Bacó is a banker, and compounding happens when interest adds to principal to generate a higher curve of earnings across time.

If the April 24-25 event is any indication, Bacó might still be underestimating the number. He originally expected 100 attendees. As of this interview, 150 investors had registered, and "we can only fit 200 in the room." Can you move to a bigger room? "No. We'll just have to do another event." And then another, we suspect. And another. And then let's see how many investors end up moving to the island.

But let's stick to the projection of 2,000 by the end of 2016, shall we? Here's the big question: Is it safe to expect that the 4% billion-dollar investment level will hold steady – which would mean 80 investors averaging $1 billion each – as well as the $40 million to $50 million average for each of the other 1,920 investors?

Did you do the math? That amounts to a massive $166.4 billion capital market in Puerto Rico created by Law 22. Puerto Rico hasn't seen that kind of capital since the construction heyday of the 1950s and 60s, when the bulk of the island's infrastructure, schools, industrial parks, airports, hospitals and housing developments were built.

The huge difference today is that the bulk of this new Law 22 capital is looking for business and entrepreneurial opportunities. Oh, sure, there remain some infrastructure and mega-strategic developments to fund across the island. But they are frankly not that numerous, and it's fairly clear that this generation of investors is far more interested in companies and deals that will take Puerto Rico to the next level – into the stratosphere, in fact, where only the likes of Singapore and Dubai are found. In the U.S. context, Law 22 investors are comparing Puerto Rico to such sun-belt cities as Miami, Dallas and Phoenix during their pinnacle boom years.

In the case of Puerto Rico, Law 22 seems likely to compress the island's own zenith into an even more accelerated time frame. The two-year deployment timing mentioned by Bacó has this money making its way through the local economy between last year and 2018, or in just six years. And that's not counting the investors who will continue to come past 2016.

Memories of Section 936

But wait, it gets better, because that number only covers Law 22. Much of that capital will initially fund the investors' own Law 20 businesses, or companies they bring down or create once here to do business with clients in the U.S., Latin America and elsewhere.

Then there are the Law 20 companies founded or brought to the island by investors who choose not to move here themselves under Law 22. The total number of Law 20 companies in Puerto Rico is now up to 213, according to Bacó, who couldn't specify how many of those are owned by Law 22 investors living on the island and how many are operated by non-resident, non-Law 22 corporations.

And here's the fine point of it. Law 20 grants a fantastic 4% corporate tax, but earnings repatriated to the states by parent companies or investors based in the U.S. must pay the much higher IRS rate. "If you live in Puerto Rico and send money to the U.S., that does not apply," explained Bacó. "So we're finding that a growing number of Law 20 companies based in the U.S. are opting to retain their earnings here on the island, and that's starting to create an impact similar to [Section] 936 funds."

An impact similar to 936 funds. For those of you unfamiliar with the magnitude of those words, Section 936 – previously Section 931 – was the part of the IRS Code that allowed U.S. companies, used overwhelmingly by manufacturers at the time, to operate in Puerto Rico at significantly-below U.S. tax rates. It's the main reason Puerto Rico became a manufacturing powerhouse, though today it remains a powerhouse mainly on the strength of being as U.S. territory and boasting a magnificent talent pool.

A 1976 Puerto Rico law provided an incentive, commonly called the tollgate tax, for 936 companies to retain their earnings on the island. Profits repatriated prior to a certain date was subject to a local tax. At their peak in the early 90s, 936 funds, as they were called, mushroomed to some $20 billion – capital used by banks to lend and otherwise keep the local economy humming.

So speak of retained earnings before repatriation, and you are likely to raise quite a few eyebrows on the island, because Section 936 – and the funds that came with it – was at one point the end-all and be-all of the island's economic development strategy. The hope for the future. The promise of bigger things to come. Until the promise crashed upon the phase out of 936 and the complete exit of the funds between 1996 and 2005.

Calls for a new model have since been heard from every corner. Many have been proposed. None ever managed much traction. When Bacó's predecessor, José Ramón Pérez Riera, began articulating a new Singapore-style service-economy vision, few paid much attention, not even in his own government. When he finally bulldozed the enactment of 20 and 22 in 2012 to enable the vision, the consensus among business and government leaders alike was that the new laws would amount to a rather marginal contribution. A yawn. No big deal. The focus remained fixated on the long-running combination of manufacturing and tourism, particularly given that a different party won the election and was widely expected to follow the awful local tradition of throwing out sound ideas from the previous tribe when yours takes over.

Bacó, however, decided to break with tradition. "I make it a point every chance I get to recognize the previous administration's role and the vision they had in enacting these laws," he told Business Today.

For him, the epiphany came at a December 2012 meeting with Governor-elect Alejandro García Padilla and Law 20/22 investor Pavan Agarwal.

Agarwal, who will speak at an April 24 panel of early adopters, made the case to the new García Padilla and Bacó team. His Sun West Mortgage was one of the first Law 20 companies on the island,

and he and his family soon followed, moving to Puerto Rico to take advantage of Law 22.

“We decided right then and there to make this the heart of our strategy going forward,” Bacó said.

Don’t be such a doubter

And not just 20 and 22. The previous administration enacted two other incentives, Law 273 to enhance Puerto Rico’s offshore banking regime and Law 98 to create an offshore insurance center, and Bacó put together a promotion program to pitch the four laws in sync.

There are others – mainly Law 74 for tourism and Law 27 for film and creative services – but the Secretary is lumping those services under Law 20 for simplicity’s sake, leaving it to the accountants to work out which law best serves which company. That probably explains why so many of the current crop of investors stem from financial services. As the news spreads of the broader reach of this incentive toolkit, look for all kinds of service enterprises to make the move, as well.

Following that fateful meeting, Bacó got on with the task, and the rest is history in the making. So much so that the sheer volume now contemplated by the combination of Law 22 capital and Law 20 retained earnings appears likely to dwarf the capital ever invested and retained by 936 companies.

Still, even Bacó admits to some pause when approaching these new numbers. When we add Law 20’s retained earnings (again, companies with non-resident owner-investors) to the $166.4 billion Law 22 figure, how much do you think that will amount to by 2018? We think $10 billion is a fair estimate for the retained earnings, so let’s round off the total at $175 billion.

If your reaction to this number is something along the lines of, “Nah, it can’t be that high,” you’re certainly not alone. Bacó himself was not willing to go there, at least not as of the day of this interview. “Only time will tell.” Of course it will.

Which begs the question, then, that each of us MUST answer: What number would you be more comfortable with? $130 billion? $80 billion? The headline of this article says $100 billion, but only because we didn’t want readers to react to a $175 billion headline and not even read the piece, instinctively assuming the number to be far too outlandish. No one with whom we spoke following the Bacó interview was willing to go there, either.

That alone is extremely interesting. The numbers are there. We just went over them. To assume the total will be lower than $175B, you would have to either think the number of investors will be lower than 2,000, or that they will invest less than the projected average, or that they’ll invest whatever they will invest along a longer time span. And again, we mustn’t forget that investors and companies will keep coming past 2016. The number, behold, will grow even larger.

A tsunami of companies in search of capital — oh, yeah, and incentives

The main question we encountered when discussing these scenarios with various sources, and which led to much of the disbelief, is worth inserting right about now, and it is: Where will all this money go? What, exactly, will it be invested in?

The top banker at the PRMA meeting lamented, with a facial expression and body language of a man profoundly concerned, that he's turning investors away, unable to help them find enough of the high-caliber investments they're looking for. "Are we bound to lose all that capital for lack of a deal flow?" he pondered.

Bacó is feeling his pain. "It's true. Puerto Rico does not have enough deals." He posits a two-phase theory to explain how it will all work out in the end, as the capital begins its journey through the island, and it is a theory we think leads right to a third phase that would solve the riddle by securing more than enough deals.

In the first phase, "investors were focused mostly on picking up distressed properties," Bacó said, "including those held by banks, and that seems to be petering out" – that is, Law 22 investors have now largely acquired the distressed properties they're interested in, at least the investors already here.

"We're seeing the start of the second phase now, and that's where investors begin launching their own businesses and ventures and taking advantage of Law 20 incentives."

On April 24-25, we will surely discover which of those businesses are already operating, making it happen, creating jobs, exporting their services and envisioning brave new paths for Puerto Rico to take.

The original plan behind Law 20, in fact, was to get existing, successful companies to move at least part of their service and back-end operations to the island and create countless jobs exporting their services abroad. So far, the government's focus has been on attracting Law 22 investors. As phase two kicks in, look for some big players to discover Puerto Rico and do as so many leading manufacturers did from the 1950s to the 90s.

But everyone seems to be overlooking a third path this can surely take, and indeed must take for Puerto Rico to hold on to all that capital: the attraction to Puerto Rico of smaller companies and start-ups, not just to gain from 20/22/273/98/74/27 incentives, but perhaps more so to gain access to the vast new capital market beginning to pile up on the island – where our new investor-residents expand their role to one of financiers and sources of capital for businesses and ventures launched by others.

And that, dear friends, is what we envision as the defining crown jewel of Puerto Rico's new economic development model.

We have hundreds of investors, soon to number in the thousands, who will be driving around Condado, Dorado, Rio Mar and Palmas del Mar, looking – actively looking – for places to put their money right here in Puerto Rico. And whether it's $175 billion or $100 billion or whatever the number ends up being, it will be astronomical by the island's recent standards, certainly akin to the recent stories of Singapore, Dubai and the major new hubs of global commerce and finance we have seen emerge with great envy, and even some nostalgia, since that was us in the 1960s, before we screwed it up and lost our step.

Well, it looks like we have regained the swagger. Puerto Rico is ready to claim its place as THE center of commerce and finance in the Caribbean, and one of the very few in all of the Americas.

The key to the third phase – to continue Bacó's theory, though we should perhaps think of this as a single holistic process, second phase and third phase happening simultaneously – is to target companies using Law 20/22 capital as a central reason why, instead of focusing only on the incentives, and then turn their arrival on our shores into a veritable tsunami.

When Singapore decided to do exactly this in the 2000s – the three phases as one – they attracted tens of thousands of companies. The island's GDP, $75 billion in 2000 – comparably that of Puerto Rico's today – skyrocketed to more than $200 billion ten years later. Per-capita income went from $23,000 in 2000 – a bit higher than Puerto Rico today – to more than $50,000 and a place in the world's top five by 2010.

And they did it with a strategy eerily similar, not to say identical, to Puerto Rico's new service-driven, multi-industry strategy. Offshore finance, tourism and export services led the way in Singapore starting in 2000, after being a manufacturing and logistics powerhouse in the decades before.

Internationalized destiny

Sounds familiar? It should. The results will no doubt look familiar, as well. It will take a really fast pivot on everyone's part, since firms must step up quickly and provide the intermediary services needed to promote the island overseas and match the companies coming in with the investors looking for them. The latter, in turn, need financial concerns with the right fund products to channel their capital to the right businesses and mega-projects.

"So far, we've been the main intermediary and matchmaker," Bacó said. "But as the number of investors and companies grows, we'll need private players to step up and take it from there."

From there is now. Today. Two hundred and thirty six people and 213 companies is already too many for Bacó's small staff to handle, and they haven't even gotten into promoting the capital to attract companies. In tech, if you want capital, you go to Silicon Valley, and then set up your company there and feed off the ecosystem. Let's have Puerto Rico do the same thing, but not just for technology companies. For ANY kind of service company.

Then our banker friend won't have to lament turning anyone away. The capital will flow not just for the local deals that are available, but for thousands of new ones that join the tsunami and become local, selling their services to the region and the world – many of them forming a wave of new Puerto Rican multinationals.

"We've been calling ourselves a bridge to the Americas for a while but never really lived up to the hype," Bacó said. "That's because we didn't have the right tools to attract these companies and investors and truly internationalize our economy. But now we do. Now we can really turn Puerto Rico into a true service and knowledge-based economy. That's our new development model."

And – who can doubt it now? – our new destiny.
