

The coming export OPPORTUNITY

Law 20 incentives can turn service exports into another potential big job-creating machine



By Alex Díaz
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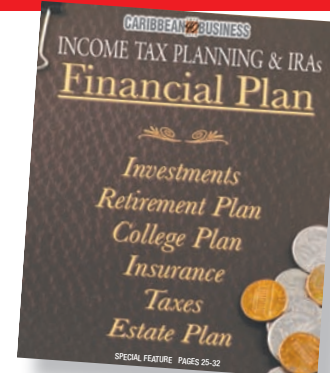
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The new Age of Law 20

Service exporters of the world, take notice. Local service providers, wake up! Puerto Rico is moving quickly to turn Law 20 incentives into the new growth pillar.

BY ALEX DÍAZ
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McKinsey & Co. calls it “the biggest growth opportunity in the history of capitalism,” referring to the meteoric rise of 577 cities around the world, 423 of them (73.3%) in emerging markets, projected to represent fully half—half!—of all global growth between now and 2025.

And here’s the punch line: “Most of the growth in these momentum cities is happening in the purchase of services.” (See related story.)

It’s as if McKinsey had written the study with Puerto Rico’s new potential development focus in mind.

With industrial promotions having dried up in recent years and showing no sign of turning around, thanks to higher costs at home and the emergence of lower labor costs abroad—manufacturing jobs are now well under 10% of total employment in Puerto Rico, and falling—local government has turned decisively to service-export promotions as one of the keys to future growth.

The tectonic shift in public policy began under the previous administration of Gov. Luis Fortuño and his Secretary of Economic Development & Commerce (DDEC by its Spanish initials), José Pérez-Riera, and has continued without missing a beat by the administration of Gov. Alejandro García Padilla and new DDEC Secretary Alberto Bacó Bagué—an unusual and much-applauded example of continuity following a change in government.

The Fortuño & Pérez-Riera team, pursuing one of the cornerstones of the economic development model they put in place—known as the Strategic Model for a New Economy (MENE by its Spanish initials)—took



Law 20 is designed to incentivize “every conceivable service,” said Puerto Rico Economic Development and Commerce Secretary Alberto Bacó Bagué.

their four-year term to enact several laws designed to spur the growth of service exports by local companies and bring in foreign and U.S. mainland-based companies to export their services out of Puerto Rico.

The new team’s mission now is to take those laws and convert Puerto Rico into “the leading service hub in the Americas,” Bacó added, broadening the island’s sphere of influence and replacing manufacturing as the lead industry in local job creation.

Direct manufacturing employment in Puerto Rico peaked at 180,000 in the 1970s, fell off in subsequent years, before rising to 164,000 in 1996. It stands at roughly 80,000 today.

While the art of projecting peak service-hub direct employment in 10 years is highly imperfect, estimates by observers interviewed for this story hover in the range of 100,000, provided the government and private sector work together.

“That’s only the beginning,” affirmed Luis Torres Llompart, partner at accounting firm Kreston TLSR and a leading private-sector voice behind the switch to a service-export strategy. “Remember that services are far more labor intensive than manufacturing.”

“My own estimate is for the creation of 40,000 to 50,000 jobs in the next four to six years,” Bacó said, agreeing “with the 100,000 estimate in 10 years. This is one of the important ways we have to grow the economy.”

LAW 20 AS THE BACKBONE

The service-related incentive laws enacted by the previous administration, were: Law 273 to create an off-shore finance center on the island; Law 98 to create an offshore insurance center; Law 27 for film and creative services; tourism-related laws 74, 113 and 118; Law 83 for green energy; Law 132 for housing; and

most recently Law 20 to incentivize “every other conceivable service,” Bacó said.

Two other laws look to stimulate the move to Puerto Rico of high-net-worth individuals who are also investors. One, the EB-5 law to draw foreign nationals in exchange for a green card, is a federal statute that is now being promoted aggressively at the local level, following the Fortuño administration’s successful lobbying to make Puerto Rico a processing center. The other one, Law 22, provides passive-income incentives for new residents. (See last week’s CB Front Page story.)

Of all, Law 20 serves as the backbone, as it covers virtually every service segment and could therefore lead to the greatest number of jobs.

Individuals who move to the island through EB-5 and Law 22 may sign up for Law 20 incentives if they establish service-export businesses, as they are encouraged to do, Bacó explained. Likewise, banks and insurance companies that come in for Law 273 and Law 98 benefits will also be signed up for Law 20.

Not only is Law 20 broader in the eligible activities it covers, but its incentives are extraordinarily generous.

It reduces the local income tax paid on service-export activity to a flat rate of 4%, and gives a 100% exemption of corporate dividends from those projects, a 100% exemption from property taxes, and 60% reduction in municipal license fees, or *patentes*. Regulation 8313 also extends tax benefits to income from service-export earnings that are re-invested in the local eligible operation, invested in another business on

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the island, or deposited in Puerto Rico financial institutions.

The incentives are available to companies already on the island, as well as new ones coming from outside, the former being a historic departure from the practice of incentivizing only foreign and U.S. mainland-based companies.

"It is a fantastic incentive," added veteran local attorney & CPA Jorge Cañellas, of Fiddler González & Rodríguez, who begins a one-year term as president of the Puerto Rico Chamber of Commerce in June.

"It's not only significant because of the savings it brings companies, but also because it's available to any locally owned firm, so it breaks with the tradition of only incentivizing companies from outside," Cañellas continued. "We're doing everything we can at the chamber to get the word out and will do even more as companies become aware of the opportunity to grow outside the island."

THE SWITCH TO PRIVATE PROMOTERS

Tying the arrival of new investors and service exporters to Law 20 will trigger the other huge innovation introduced by the law.

"It allows us to extend the incentives created by Law 20 to private sector promoters," Bacó explained.

"From its very inception, the law contemplated that in order for Puerto Rico to fulfill its potential of becoming a world-class services hub, the private sector has to be involved in the promotional process more so than ever before," Pérez-Riera stated.

To enable private promoters, the law created the Special Fund for Export Development & Promotion Services, which in turn led to a series of incentives under Regulation 8315 of December 2012.

"It's pretty clear that our department doesn't have the resources to hire a large team of promoters, so we have to rely on incentivizing ones in the private sector," Bacó said.

Reg 8315 offers promoters up to \$1,500 for every job created

and \$0.001 for every \$1 invested in plant, property or equipment.

Law 20 also provides for what has come to be known as the Promoter's Exception—an exception, that is, to the law's nexus rule that prohibits a recipient of incentives to have a nexus, as it were, to other activities on the island. That provision extends the same 4% tax rate offered under the law to the service companies themselves, but only on income derived from the promotional activity during the 12 months prior to a company investing on the island or starting operations here.

Bacó is asking promoters, including leading professional-services firms with affiliates throughout the world, to pitch several of these incentive laws as a package.

"Not just anyone can be or should pretend to be a promoter," cautioned Torres Llompарт, speaking of the profile needed to attract service exporters from beyond the island. "The people we need are highly seasoned and connected. Ideally, they should be current or former executives and CEOs who are highly networked among the companies we're targeting—you know, the folks who can pick up the phone and get an appointment, and who can then get on a plane and deliver a knock-out presentation, people with relationships and credibility."

Reg 8315 enables yet another break from tradition: the creation of an innovative nonprofit organization to complement the government's traditional promotional role.

The group's duties may include the supervision of all private sector promoters, including a registry, a control mechanism to make sure they don't call on the same clients, and marketing materials for all promoters to use.

"This may become the perfect vehicle to obtain a highly specialized, private sector-led entity that may provide the quality of service required if Puerto Rico is to compete with promotional giants like Singapore," Pérez-Riera added. "If we can achieve this in

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An offer you can't turn down

Puerto Rico's enticing Law 20 service-hub incentives offers bigger tax breaks than Law 73*, more eligible activities and a new incentive for private sector promoters

4% flat corporate rate

- On all income derived from service-export activities
- On service-export income reinvested in Puerto Rico or deposited in local banks
- 3% rate when gross income is derived from "strategic services"

100% exemption on dividends

- On the distribution of all earnings and profits

100% exemption on property taxes

- For selected services for first five years
- 90% exemption after the first five years

60% exemption on municipal license fees (*patentes*)

20-year decree

- Provides guarantee and stability
- Renewable for 10 years

ELIGIBLE SERVICES

- Research & development
- Advertising & public relations
- Consulting (economic, environmental, technological, scientific, management, human resources, information technology and others)
- Advice on matters relating to any trade or business
- Professional services (legal, accounting, audit and others)
- Shared-services centers (subcontracted to provide services to many clients outside Puerto Rico)
- Commercial arts & graphic services
- Construction-related (production of drawings, architectural and engineering

services, and project management)

- Centralized management services (headquarters operation or regional office)
- Electronic data-processing center
- Development of computer programs (software, cloud and others)
- Telecommunications (voice, data and others)
- Call centers
- Storage & distribution centers (equal to the logistics and commercial-trade service under Law 73 for the movement of goods)
- Educational & training services
- Hospitals & laboratories
- Investment banking & other financial services
- Any other service at the discretion of the Economic Development & Commerce Department

The incentives and eligible activities apply to any company established in Puerto Rico, whether it is an existing Puerto Rico business or an international company based outside the island. Private sector promoters may receive the same tax incentives, but only on net income derived within the 12-month period prior to the establishment of the promoted new business (meaning either the start of construction of the facilities, commencement of operations, or executing a contract to acquire or lease facilities in Puerto Rico). Promoters also receive up to \$1,500 for every job created and \$0.001 for every \$1.00 invested in property, plant or equipment.

*Law 73 is the Puerto Rico Industrial Incentives Act of 2008, originally designed to attract manufacturing companies and later amended to cover services as well. Law 20, a spin-off of the services component, added eligible services and enhanced the incentives.

Sources: The Puerto Rico Economic Development & Commerce Department and San Juan accounting/auditing firm Kreston TLSR.

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a bipartisan way with a long-term view, we will have achieved something truly special.”

ADVANCED SERVICES

Promoter incentives apply to those getting business from outside the island. For those focusing instead on getting local service companies to export, one analyst would point them to those firms offering what he describes as advanced services.

Economist Joaquín Villamil, chairman of Estudios Técnicos, authored a 2009 study that identified five large categories of service firms on the island: infrastructure and construction, information technology, business services, professional services and quality-of-life services. When Law 20 was later enacted, it included these and others as eligible to receive the tax benefits.

“We did the study to evaluate the potential for local companies in the new Cafta market,” Villamil said, in reference to the U.S.-Central America Free Trade Agreement. “As it turned out, service providers in Puerto Rico are far more advanced than their competitors in the region, and the same is true when we look at other countries in Latin America.”

It was the same premise that led to a highly successful initiative last year by an alliance of local and New York executives and government agencies—including the White House and high-level federal and New York state government executives—to create partnerships among service companies in Puerto Rico and their counterparts in New York to penetrate the Hispanic market. (See CB Front Page, April 12, 2012.)

A unique three-day summit (March 29-31, 2012) held in New York City, initiated by then-Economic Development Secretary Pérez-Riera, brought together 84 executives from 45 Puerto Rico firms with dozens of minority suppliers from the States to bid on procurement contracts with many New York State agencies. The goal was for local companies to bring their extensive expertise to the table and collaborate with stateside counterparts that enjoy local connections and market knowledge, but have less experience and capital for large projects.

As do most states of the union, New York must set aside a percentage of



Local authorities know that very little of this export volume (chart) is from local companies, but they have little clue how much of that is in services. “It’s not even counted in official figures,” said economist Joaquín Villamil.

its contracts—20% in this case—for minority- and women-owned enterprises.

“We have a clear competitive advantage over minority incumbents in the States and over companies in Central and South America,” Villamil said. The region is home to 40 of the 423 emerging-market momentum cities identified by McKinsey & Co. “The only thing standing between those markets and our companies is [the latter’s] will to grow.”

‘THINK BIG’

By becoming the leading service hub in the region, Puerto Rico would become, in effect, the Singapore of the Americas, a reference to the island-nation the size of the greater San Juan area that has grown into the leading service hub in Southeast Asia.

“Panama and Costa Rica are moving in this direction as well,” Bacó said. Yes, added Villamil, but “Puerto Rico has far greater potential, particularly because we’re part of the U.S., and that gives us a significant edge.”

The economist pointed to Singapore

as a more suitable model. “They’re way ahead of us, to be sure, and the market around Singapore is far bigger, but their strength lies in the synergies and linkages we can also create in Puerto Rico over time.”

During a recent visit to the Asian city-state, CARIBBEAN BUSINESS saw the service-export model firsthand (see Front Page, Sept. 20, 2012).

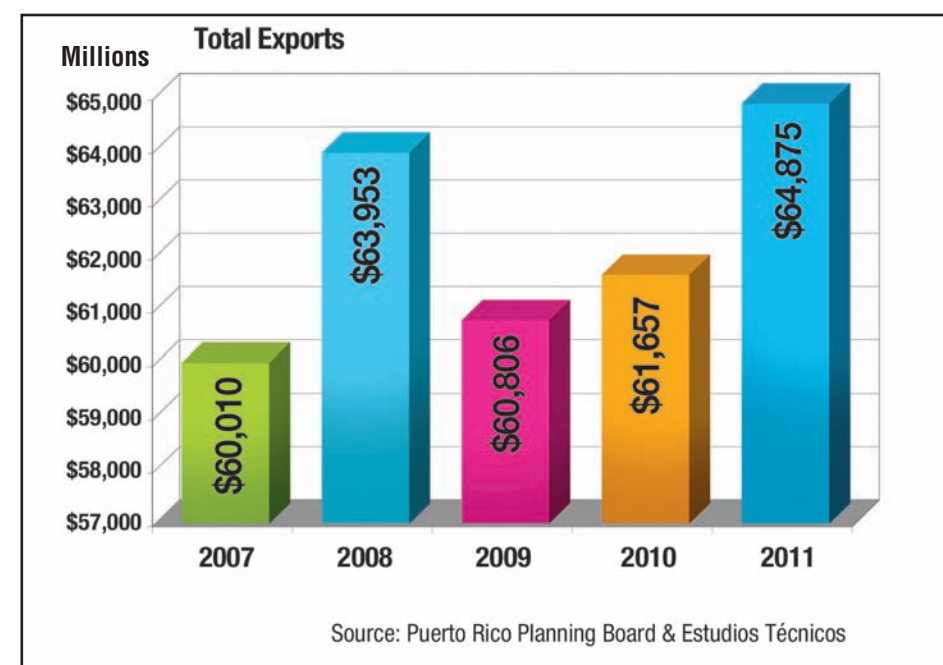
An alliance of government and private-sector leaders huddled in the late 1990s and decided to take Singapore’s already important service hub to the next level. The government expanded the number of promotional offices to 59 and went all out, pitching Singapore to any company and market that would listen.

The speedy results speak for them-

company anywhere in Latin America or the U.S. mainland,” Pérez-Riera said.

As Puerto Rico attracts service firms from outside and local ones flex their muscles, the island could create a critical mass of companies interconnected among themselves, with tentacles reaching into every resource a company may need to do business in the region. Companies will know to call on Puerto Rico for any of these services.

When told that Puerto Rico had recently enacted laws very similar to theirs, one Singaporean banker sat back and said, simply, “So go! All you have to do is promote the heck out of [them], as we did here. It’s not very complicated. You will see results rather quickly. We benefited



selves. Bank assets in the country’s offshore finance center jumped from \$270 billion in 2000 to \$688 billion last year. Exports by multinationals with hubs in Singapore, mostly service-related, surged from \$320 billion to \$800 billion in the same period. Singapore began the 2000’s boom with 3.5 million people and ended the decade with 5.3 million, a stunning employment hike of 1.8 million—mostly workers and executives who moved to the island—an estimated 500,000 in the same service-export segments Law 20 is now targeting for Puerto Rico.

What Singapore and other such hubs around the world have done is create a “high density of complementary services in a single jurisdiction,” to offer, as it were, “a one-stop shop for any service needed by any

from the growth in the Asian countries surrounding us, but you have many and vast countries in Latin America that are growing nicely, and the U.S. [mainland] and Canada, which will strengthen their recovery soon. So you can’t go wrong.”

“The first thing you must do is allow yourselves to think big,” said Tan Choon, deputy managing director of the Singapore Economic Development Board.

THE MONEY TRAIL

The new government in Puerto Rico may have gotten out of the gate with a big fiscal mess that hinders Singaporean-level accomplishments, but Bacó is pressing ahead on the development side with some

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big thinking of his own, focused on the joint promotion of these service-export laws already on the books, mostly from the previous administration.

One of Bacó's first challenges was dealing with the government's existing export-promotion structure. In Puerto Rico, the task of promoting exports has traditionally been in the hands of the Puerto Rico Commerce & Export Co. (CCE by its Spanish initials), one of the three principal agencies under Bacó's DDEC, the other two being the Puerto Rico Industrial Development Co. (Pridco, in charge of manufacturing) and the Tourism Co.

The CCE also covers the growth of small businesses on the island, which is why it became the lead agency for the administration's Jobs Now Act incentive program.

But as reported in CARIBBEAN BUSINESS on the March 7 Front Page, the agency has been plagued by inefficiencies and a small budget that has hindered its export promotion over the years. Pridco, meanwhile, had never focused on anything other than attracting exporters from overseas, and then mainly manufacturers.

That equation seems to be changing. The previous administration placed Law 20-driven export promotion in Pridco's hands in part because of its experience with tax-exemption decrees, and Bacó has followed the lead, which makes sense considering it is essentially the same thing Pridco has always done, but focused on services instead of manufacturing.

But the DDEC hasn't granted Law 20 the promotion funding historically enjoyed by manufacturing. "That is all under analysis," Bacó said.

For the time being, he said, Law 20 will rely on the special export fund mentioned earlier, which is starting out with a \$10 million purse that will come from collections on the 4% tax imposed by the legislation, plus an undisclosed chunk siphoned from the other agencies, and monies reassigned from the DDEC's administrative budget.

The fund will not only pay for the private-promoters incentives, but may also be used by the DDEC to cover expenses and incentives related to promoting service exports

in other ways.

"At some point, though, we have to return to the big-time advertising and marketing we used to do to promote manufacturing in the 1960s and 1970s in such global magazines as The Economist, Businessweek, Fortune and Forbes," Bacó said. "That's the high profile we must have to bring in even more service exporters than the team of private promoters would be able to do on their own."

164 OFFICES

Fortunately for Bacó, Puerto Rico can call on a certain friend to boost this economic-development strategy.

The federal Commerce Department's Commercial Service office exists to help companies in every state and territory—which by definition are U.S. companies—export their goods and services everywhere

any service exporter can use, some for a fee, most for free. Singapore may have 59 offices, but "through us, Puerto Rico has 164 offices in 80 countries," Burgos said, including every country in Latin America and the Caribbean, except Cuba and Venezuela.

"Our presence here, given that Puerto Rico is part of the U.S., should be sold as a plus to companies comparing Puerto Rico with Panama or any other country," he added.

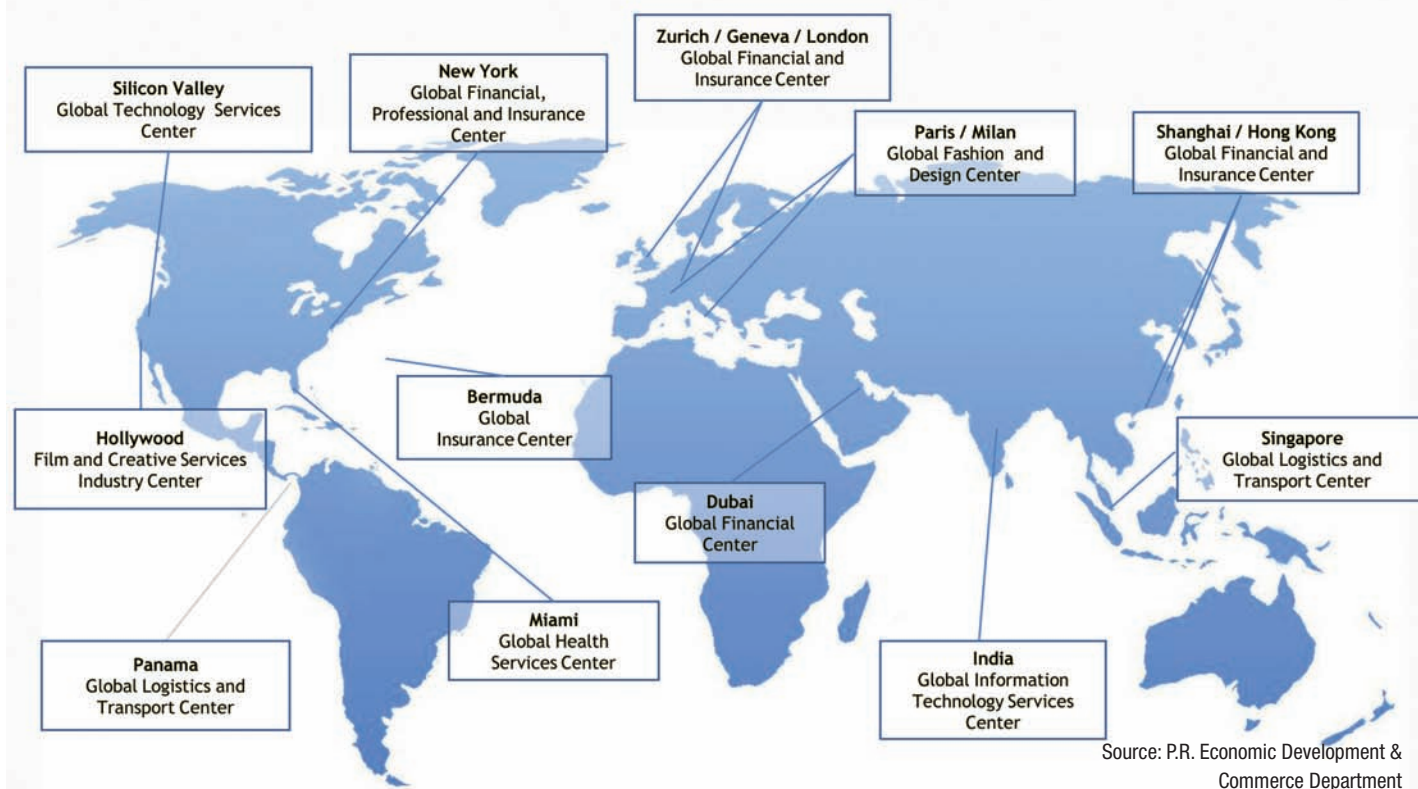
"We use them often and have found their services and resources extremely valuable and efficient," said Torres Llompart, whose firm recently established a partnership with Washington, D.C.-based Manchester Trade Ltd. precisely to help local companies export.

To be sure, Burgos is the first to admit that, while helpful, the Commercial Service's offices can't of-



The U.S. Commercial Service helps any exporter with offices in Puerto Rico with such services as market intelligence, contacting prospects, setting up appointments, office and chauffeur service on site, trade missions and events, logistics, financing, licensing, regulations, legal and accounting matters, navigating U.S. free-trade deals (which include Puerto Rico), and more.

Puerto Rico is set to become another Global Service Hub



except the U.S. itself.

"Our mission is very clear," said José Burgos, the Commercial Service's director in San Juan. "We help any company established in Puerto Rico export its products, including companies with headquarters in foreign countries setting up an operation here."

That is no small matter. The U.S. Commercial Service offers an impressive menu of resources that

fer everything Puerto Rico's or any state's own offices are able to do.

The CCE only has export-promotion offices in Costa Rica and the Dominican Republic, with plans to open at least two others: one in Brazil and another in either Peru or Colombia, said agency Executive Director Francisco Chévere. "We're evaluating those locations and others, and will make an announcement in the coming weeks."

MASTERING NEW TRADE DYNAMICS

No matter which office they use, companies setting up in Puerto Rico to export their services would be well advised to seek out all the help they can to navigate the recent and still ongoing transformation in the trading of goods and services.

"There has been a quiet revolution

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in trade and export in recent years,” Villamil said, “and now that we’re moving aggressively to turn this into one of Puerto Rico’s new development pillars, we would be well advised to master these trends.”

Starting with e-commerce, or the conduct of trade via the Internet. “If you don’t have a robust web presence,” added Burgos, “don’t even bother getting into exports.”

Digital trade has become ubiquitous. Not only can a company sell its products and services to any market on the planet, but of equal importance, it can now purchase from anywhere as well.

To sell, there is digital marketing, which begins with the right online design and merchandising, and extends to advertising, search programming and social-media management to build the relationships so vital in the services field. Interested in penetrating Brazil or Quebec? Design a version of your website in each language, Portuguese and French, respectively, and adjust the merchandising and sales pitch to respond to the needs of those consumers.

To buy, you may either install one of the many digital supply-chain-management programs available in the market or subscribe to a cloud service offered by the likes of Salesforce, IBM and Oracle, which facilitate purchasing from all countries, currencies and languages.

“Internet trade has been so fine-tuned that any company can do it now, no matter the size or service offered,” Villamil said. “The beauty of selling services online is you can do it from anywhere—your office, home, hotel or coffee shop. Law 20 requires that your homebase be Puerto Rico, but you’re selling an intangible produced by your mind, so you can deliver it wherever you happen to be. And it can be done 24/7 any day of the year. The Internet never sleeps.”

Another recent export trend is the growth of multicompany networks in a single supply chain. “The dominant model in the economy used to be vertical integration, where a company insisted on having under its own roof the many divisions it needed to deliver its product,” the economist continued.

“Today, there is far more

Trade in services has grown in importance in the world economy



outsourcing, and that has created complicated linkages across countries and regions that a company must know how to navigate if it wants to play the game. The challenge for a company, and for a government trying to help its companies export, is to identify those networks and supply chains and insert itself.”

That takes what Villamil calls strategic global intelligence, a skill set he hasn’t found in any local government agency. “That’s something that will have to be provided by someone in Puerto Rico if our companies are to succeed in exporting services in the region.” If not the government, can academia fill that void? “Sure, that would be a great alternative.”

‘HISTORIC OPPORTUNITY’

One tool that would help is the World Trade Center (WTC), a non-profit networking association of exporters with 300 offices in 90 countries, according to its website.

The Puerto Rico WTC was originally shepherded by the CCE, with its own building planned for the Convention Center District, but lack of funds, attention and members led to the demise of the whole idea.

“Nothing happened,” said Torres

Llompert. “But hey, now that we’re moving on exports with these new laws, maybe it’s time to revisit the initiative and get it going.”

Multinational companies, as it happens, come with sizeable export teams that master Villamil’s trade trends and know how to deploy the vast resources available, like the U.S. Commercial Service, to penetrate McKinsey’s growth-mo cities and take advantage of “the greatest growth opportunity in the history of capitalism.”

Local service firms don’t have that luxury. Lacking their own internal experts, they must rely instead, particularly during this early learning-curve stage, on external resources or on hiring a trade team.

Such local universities as Turabo, InterAmerican, the University of Puerto Rico, and Católica, Burgos said, have “sound export programs, but most of those students end up doing something else or moving to the States because companies aren’t hiring. So, the local talent is there. Hopefully, as the new laws create the need, the talent will find its way to the exporters, be they locally owned companies or outside firms with a need to hire local talent.”

Local managers, he added, “aren’t good at following up. It’s extremely frustrating. They go to these trade missions, tell CCE they will sell millions of dollars, which CCE then publishes as if the sales had already happened, and then they fail to follow up and the sales never materialize. They need to be taken by the hand through the entire process. That’s what we try to do with the companies we work with directly, but that’s only a few dozen companies. If Puerto Rico is to truly become a thriving service-export hub that helps local companies grow tremendously in these foreign markets, they will have to stop making excuses and get with the program.”

Otherwise, as happened with manufacturing, the bulk of the growth will be in the hands of U.S. mainland-based and foreign firms.

“That’s not necessarily a bad thing,” Burgos concluded. “But these laws, especially Law 20, give us the historic opportunity to spread the wealth, so we should do everything we can to make that happen.” ■

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McKinsey & Co.: To export, target growth-momentum cities

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That's growth-mo, as in growth momentum, the phrase coined by global consulting firm McKinsey & Co. to refer to the 600 cities responsible for most global growth between now and 2025, a short 12 years from now.

Of these, the firm identified 577 with a population of less than 10 million people—called midleweight cities, as opposed to megacities with more than 10 million—that combined will generate about *half* of all global growth.

The key metric that distinguishes these middleweight cities from the rest is an unusually rapid leap in per-capita income, and McKinsey advises companies to export their goods and services in *those* cities, where firms can get the biggest bang for the buck.

"They represent two-thirds of a company's revenue growth," said the consultancy in its 2012 study "Urban world: mapping the economic power of cities."

That's where consumers and businesses start using their newfound purchasing power to buy goods and services, and establish long-term brand loyalties and relationships. By contrast, "only 4% of revenue growth comes through gaining share in existing or mature markets," because consumers there are already locked in to preferred brands.

So here's a trick question: Would you rather use Puerto Rico's Law 20 to export your services to cities responsible for 66% of your revenue growth or those generating 4% of your growth?

McKinsey also advises governments to focus on growth-mo cities when helping their companies grow overseas.

"They need to move away from networks of embassies designed around the world as it was in the 20th century, to identifying which cities are likely to shape the 21st."

The map shows the 40 growth-mo cities identified by McKinsey in Latin America, 20 of which are in Brazil. Some are well known. Most are newcomers to the global export scene. ■

