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THE INCLUSION OF THE PERFORMANCE SENSITIVE DEBT IN AN EMERGING ECONOMY – COLOMBIA –

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Pregrado en Administración de Empresas
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A mis padres, a quienes les debo todo y viviré siempre para ayudarlos y servirles; por ser siempre esa compañía, apoyo y sabios consejeros durante toda esta etapa. A mis hermanos, por ser personas con las cuales puedo siempre contar y aprender. A mi novia, por estar desde el momento cero de esta etapa, una ayuda incondicional. A todas las personas, amigos y profesores, de los cuales pude aprender todos los días, experiencias y conocimientos.

Ahora es mi turno de devolverle a la vida todo lo que me ha dado.

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EXECUTIVE SUMMARY

The performance sensitive debt is an exotic kind of debt, in which the interest rate is going to be fluctuating based on the financial ratios of the borrowers. The objective of the paper is to analyze an emerging market, as Colombia and the performance sensitive debt, remarking their virtues and disadvantages, to have in a conclusion how viable is in the short, medium and long term the inclusion of the performance sensitive debt.

The first chapter is going to talk about the virtues and how the PSD complements the empty spaces that the traditional loan has in the market. On the next chapter the emerging economy is going to be explained, including topics as national economy overview for later then enter in details about how is the corporate environment and its structure.

The conclusion is going to remark two aspects, what should be the following investigations to understand the concept of performance sensitive debt. If the concept was clearer in the future, its adaptability would be greater in any market and easy to understand for every agent. On the other hand, what should the entrepreneur expect about the inclusion of this kind of contract in the local economy?

INTRODUCTION

When the financial obligation contracts include a pricing grid, the concept of performance or price sensitive debt becomes real. The PSD, is an exotic financial obligation in which the interest rate is floating[1] ; “Performance *pricing is a relatively new provision in bank debt contracts. A traditional bank loan is priced using a fixed spread over a floating benchmark such as LIBOR or prime. Performance pricing explicitly makes the interest charged on a bank loan a function of the borrower’s current credit rating or of their financial ratios such as debt-to-EBITDA, leverage, or interest coverage by having the interest rate in the contract vary directly with changes in measures of financial performance. In so doing, performance pricing expands the importance of accounting information in debt contracts and potentially reduces the contracting costs of private debt*“ (Paul Asquith, 2005)

The performance sensitive debt concept covers up qualitative risks that impact the final cost of a financial debt, such as information asymmetry, that can derive in moral hazard, renegotiations costs, and adverse selection.

Agency problem, information asymmetry, moral hazard, are factors that are implicit in any financial relation, this summarize in the hold up problem. “We argue that PSD is used as a tool to mitigate hold-up problems in long-term lending relationships. Sharpe (1990) and Rajan (1992) show that a cost of relationship lending is the potential for hold-up by the lender. This is because the lender invests in the acquisition of borrower specific private information. The resulting information advantage of the lender makes it difficult for the borrower to switch to another lender who is less well informed due to adverse selection. If the borrower is "locked-in", the bank can exploit the situation by charging higher interest rates or by denying interest rate reductions when the borrower’s performance improves.” (Adam & Streitz)

[1] The term floating, references the interest rate fluctuation, different from the traditional interest rate that it is fixed during the lifetime of the debt contract.

The information asymmetry is a concept that is going to be developed during this paper, remarking how the performance sensitive debt provides different tools to mitigate these qualitative risks.

The performance sensitive debt figure tries to unify the client and the bank more than using the traditional debt contract. This figure will demand a candid and genuine data from the company's financial information. The back office of the commercial banks will do their analysis with the objective to understand, base on the financial statements, the company.

The pricing grid is determined by financial ratios[2], the most suitable ones that will illustrate the operations of the company. The idea of the financial ratios is based on the operation and paying capacity of the company.

In small economies, and small companies, the financial ratios are the main indicators of the risk of a company, if we focus on the commercial bank point of view. In Colombia, the rating agencies are used by law when a company wants to issue bonds or stocks, exclusively; otherwise rating agencies are unnecessary for small, medium and big companies.

Based on the information and verdict of the back office team, the clients company will have an internal rating. Base on this, the commercial bank offers a debt contract the more suitable as possible to generate income that covers the risk taken and to be the least harmful for the company.

Once the debt contract is celebrated the performance of the client doesn't matter for the bank, the key point is that the company is capable of paying the interest expenses and the

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[2] There are going to be specific financial ratios taken into account for the pricing grid of the interest rate. These ratios are going to be developed in the chapter about the virtues and characteristics of the performance sensitive debt.

capital lend. This model is the one that have been in the business environment, we can tell globally, since always, paying a fixed interest rate based on the capital that the bank gave to the company. This type of debt works, is easy to understand by the businessmen and business owners.

The performance sensitive is created with the objective to complement the financing options in the market; the figure by itself is a brand new model that is only known in countries with a well-developed economic and finance knowledge, United states, England, between others countries; economies that had develop a financial sector strong enough to be always searching for new instruments to generate a growth in the economy.

The performance sensitive debt is an example of the innovation in finance that these economies can produce to swell the options for companies to find capital resources.
The PSD[3] concept compliments the traditional way of debt financing, taking into account the financial ratios of the borrowers to determine the floating interest rate. The financial cost[4] is going to fluctuate through the time based on the performance on the borrower. This figure-given by the financial ratios performances- has a real perspectives of the borrower, because is not an interest rate given a priori –traditional method- that it will include all the risk of the expected performance and decisions of the borrower. This interest rate is going to follow the operation closely, relatively, rewarding the good decisions and punishing the bad ones.

There are two types of interest performance sensitive debt:

“PSD contracts can be defined in different ways. Purely interest increasing contracts are contracts where the pricing grid in the PSD contract only allows for interest rate increases if the borrower’s performance deteriorates but not for interest rate reductions if the

[3] Performance sensitive debt.
[4] Financial cost, is what is known as financial expenses in the income statement.

borrower's performance improves. Similarly, interest decreasing contracts are contracts where interest expenses fall if the borrower's performance improves but do not rise if the borrower's performance deteriorates. Combinations of both types are also possible." (Adam & Streitz)

The idea that concludes these two types of performance sensitive debt is that banks must understand in what business stage is the client passing through. Also shows that performance sensitive debt makes commercial banks back office team to understand more the financial information of the client, knowing what's the most suitable future of the company is after the capital inflow.

The objective of the paper is to couple an emerging economy and its financial sector with the performance sensitive debt figure. The context and economic environment is different on the literature developed of this topic, the performance sensitive debt.[5]

[5] The following final dissertation, is going to be developing the critic concepts during the paper, with the objective to expose them in a context in which the reader can feel more conformable and relate better the concept and its inherence of the topic.

CHAPTER 1. THE VIRTUES OF THE INCLUSION OF THE PERFORMANCE SENSITIVE DEBT CONTRACT IN THE FINANCING MARKET

Based on the literature, the pricing grid in debt contracts, reinvents the way companies are related to their financial debts. Is not going to be a frozen interest rate during the lifetime of the contract. The results of previous investigation tells us how having an interest floating with the operational ratios challenge-to-improve indicators oft he the companies.

1.1 Pricing grid

The traditional debt contracts, can be easily replaced by the debt contracts with pricing grid, "In a traditional bank loan, borrowers whose credit quality improves can obtain a lower rate on their loans only if they are willing to incur refinancing costs: they must exercise or threaten to exercise their option to prepay the loan without penalty to obtain a lower rate. Also in a traditional bank loan a lender does not receive a higher rate on the loan for small deteriorations in a borrower's credit quality. The lender can increase the rate charged on a loan only if a firm violates the covenants in the loan agreement causing an actual or technical default. While these covenant violations allow the bank to call the loan immediately, more typically they lead to a re-contracting of terms (e.g., additional collateral) and an increase in the effective interest rate." (Asquith, 2005)

The economy fluctuates, and so their agents. Can be taken into account that the traditional debt contracts have a two-parts interest rates, one that has a macroeconomic indicator – that will fluctuate with the economy- and the other one includes fix points. The idea is that the indicator absorbs the schocks from the enviorment and the fix point is the spread that the bank will have as an income.

The inclusion of the pricing grid, will be the base of the virtues that the performance sensitive offers in the market. The innovation of the performance debt takes advantages of the actual empty spaces that the traditional debt has.

1.2 The Performance Sensitive Debt and the agency problem

To understand the most important virtue, or at least the most popular in the theory papers, we must talk about the agency problem.

“A conflict of interest inherent in any relationship where one party is expected to act in another's best interests. The problem is that the agent who is supposed to make the decisions that would best serve the principal is naturally motivated by self-interest, and the agent's own best interests may differ from the principal's best interests. The agency problem is also known as the "principal–agent problem."
(Investopedia, 2015)

The agency problem will lead us to two specific concepts, the moral hazard and the adverse selection. In finance and economics, these two concepts are the main qualitative problems of the agents in an economy once they have any commercial, corporate relation.

1.2.1 Adverse Selection

“Adverse selection occurs when buyers have better information than sellers and so the highest cost consumers end up buying a particular product.” (Economics Help, 2015)

The adverse selection doesn't focus on a specific activity, but what the concept is telling is that one party knows more about "x" and it will use it to obtain a quantitative advantage over the other party.

In banking, the client (borrower) knows more about its operation and organizational structure than the bank (that focus on the numbers). That advantage will use it to gain a quantitative advantage.

The commercial bank to ensure the money that is lending to the client is going to have premium rate covering the implicit risk of the company.

1.2.2 The moral hazard

The risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles. (Investopedia, 2015)

This scenario taken into practice is quite difficult due to the quantity of information banks ask to proceed to the analysis. Most of them will be confronted, internal financial information (audited) and the information given to the fiscal authorities. Even though the concepts exist and companies know how to trick their numbers (internal and fiscal ones) to take economic advantages.

The moral hazard can be mitigated with covenants to the borrower operational and financial decisions. The concept is going to be develop later in this paper.

These concepts will generate an inefficient debt contract. The contract is going to be charge with risk premium (implicit costs). The performance sensitive is going to confront the financial information with the performance of the company, avoiding empty spaces in time (lack of control) and the bank will have a better optic of their borrower. On the other side, the financial costs will not be as high -compared to a traditional debt contract- or at least the interest rate will be the most suitable to each party, the bank through the

interest rate is going to cover the risk and the client company will use those sources at a comfortable rate.

The idea of the performance sensitive debt, is that the client must be a transparent source of information, must take into account that the bank will have few sources -if the company is publicly traded-and that factor increases the risk.

With the bank knowing all the information of the company, the performance sensitive will be structured to be the most suitable to the clients operations and future plans. If the information given is not transparent at all the changes in the rates are not going to be efficient, as it should.

1.3 Covenants in debt contracts

The traditional debt contracts lacks of control, compared to the performance sensitive debt. One aspect that is included in this contracts, are the covenants.

"A promise in an indenture, or any other formal debt agreement, that certain activities will or will not be carried out. Covenants in finance most often relate to terms in a financial contracting, such as loan documation stating the limits at which the borrower can further lend or other such stipulations. Covenants are put in place by lenders to protect themselves from borrowers defaulting on their obligations due to financial actions detrimental to themselves or the business." (Investopedia, 2015)

The covenants once they are achieved will punished the financial cost of the debt. This concept covers the banks against the agency problems. For example, if the capital was ask for working capital it shouldn't go for capital expenditure. If the company goes against what is stipulated in the covenants there is going to be an increased in the interest rate.

The concept is leaving an empty space that goes with a question, what happens when the company is using the sources as it should and also is having an excellence performance. Why is there a method to punish but none to congratulate?

Even though the concept was created to cover the risk taken by the financial institution and to work as a measure to understand the situation of their clients, if the company is not following the covenants, the risk of default is going to increase; the objective of the covenants is to show what the company should not do to have a healthy financial situation, avoiding to much risk investing or harming their cash flow.

1.4 Renegotiation

The traditional debt contracts, often reached a stage of renegotiation, in which the parts must readjust important aspects of it. The topic that we are focus on is the interest rate (financial expenses).

"The result of an agreement between a borrower and a lender to modify a loan by taking a loan that a customer was having difficulty paying and turning it into a loan that the customer can pay. The loan may be modified by lowering the interest rate, changing it from an adjustable-rate loan to a fixed-rate loan, lengthening the repayment period or forbearing principal. " (Investopedia, 2015)

For the development of the renegotiation concept, we are going to quote the results of the investigation done by Roberts and Sufi, Renegotiation of financial contracts: Evidence from private credit agreements. The objective of putting the renegotiation concept in the context is to know how frequent they are and how do they traduced to explicit cost for each part creating once again an inefficient contracts.

"Our analysis of what triggers renegotiation reveals that the accrual of new information concerning credit quality and outside options is a strong predictor of the incidence and outcomes of renegotiation. For example, we find that increases in borrowers' assets and decreases in their financial leverage increase the incidence of renegotiation, and, more specifically, increase the probability of receiving additional credit and lower interest rates. Likewise, decreases in the cost of equity capital, a competing source of funds, increases the probability of renegotiations that lead to lower interest rates and more credit for borrowers. These results highlight how changes in credit quality and outside options can generate surplus under the initial terms of the contract and lead to renegotiation. Further, they illustrate how the manner in which these changes occur shifts the relative bargaining powers of the borrower and lender, enabling each party to extract a relatively larger or smaller fraction of the surplus from the renegotiations. " (Roberts & Sufi, 2009)

Must be taken into account that, the objective is to show the virtues of the performance sensitive debt. When we are talking about performance, we are focusing on the interest rate. Is for the bank and for the borrowers company to be competitive, minimizing costs and expenses and maximizing income. To maintain the competitiveness, on the bank side, they must understand their client daily basis. In the analysis done a priori, the analysis team is going to develop a complete image of how the company may perform in the future once they have the capital source. But is natural of any economy that some enterprises can reach high levels of productivity, leading to a healthier financial state, the company will search for other capital source cheaper with the objective to reduce their financial expenses. On the other side, enterprises can fail following their plan for any external/internal reason, and that will follow to a higher risk of default.

"These findings suggest an alternative rationale for contingencies in the original contract, as opposed to staving off costly renegotiation. Specifically, contingencies can influence the outcome of ex post renegotiation by allocating bargaining power to either the borrower or lender in different states of the world (Aghion, Dewatripont, and Rey, 1994; Harris and

Raviv, 1995). For example, an ex post reduction in cash flow leads to a situation in which the borrower is better off under the initial terms of the contract and, therefore, has little incentive to restructure the contract in a manner reflect- ing the ex post deterioration in credit quality. However, the presence of the pricing grid shifts the relative bargaining power to the lender by increasing the interest rate in accord with the deterioration in credit quality. In fact, pricing grids can subject borrowers to a doubling of interest rate spreads as their credit quality deteriorates. Consequently, pricing grids can incentivize borrowers to renegotiate with lenders following a decline in credit quality because these contingencies implicitly allocate bargaining power in a state contingent manner. Coupled with the frequency with which renegotiation occurs, our results suggest that an important objective of a bank loan is the contractual allocation of bargaining power." (Roberts & Sufi, 2009)

What the inclusion of the performance sensitive debt will lead to, is to have a flexible relation between lender and borrower, knowing that the macroeconomic and microeconomic context is not stable for anyone. The final idea is to avoid cost that can be avoidable and to improve the risk management by the bank, on the other side, for the company to have a loan that follows its performance, reducing the chances of having to search a new loan with better rate or to renegotiate every time the situation is not the desire one.

Panel A: Loan outcomes						
Loan outcome	Fraction of low loans	Merge or acq.	Go private	Loan duration (days)	Stated maturity (days)	Loan duration/ stated maturity
Renegotiated	0.645	0.020	0.000	538	1,367	0.436
Matured	0.208	0.024	0.000	506	506	1.000
Right censored outcomes						
Disappeared	0.095	0.589	0.021	453	1,463	0.324
End of sample	0.052	0.000	0.000	784	1,747	0.459
Loans	1,000	1,000	1,000	1,000	1,000	1,000

Panel B: Loan outcomes by maturity				
	Stated maturity bin (years)			
	<1	1–3	3–5	>5
Renegotiated	0.268	0.727	0.941	0.983
Matured	0.732	0.273	0.059	0.017
Loans	194	172	255	232

Table 1: Loan outcomes.

“The sample consists of 1,000 private credit agreements between financial institutions (lenders) and publicly traded non-financial U.S. companies (borrowers) during the period 1996–2005. The table presents the distribution of loans over the four mutually exclusive eventual loan outcomes: Renegotiation, Mature (no renegotiation), Disappear from the sample, End of sample. The last two categories correspond to censored outcomes where the borrower disappears from the EDGAR database (most often due to an acquisition) or the loan is still active at the end of the first quarter of 2007. The columns ‘‘Merge or acq.’’ and ‘‘Go private’’ present the fraction of firms that experience one of these two events, conditional on the loan outcome. The panel also presents the duration of the loan, defined as the number of days from the loan origination to the eventual loan outcome. For example, 64.5% of the loans in our sample were renegotiated. Of these loans, 2% of the borrowers merged or were acquired, none went private, and the average time until the renegotiation is 538 days, though the average stated maturity of these loans is 1367 days. Further, renegotiations occurred, on average, after 43.6% of the stated time to maturity had elapsed. “ (Roberts & Sufi, 2009)

As we can see, the data is taken from companies of the United States. As our paper tries to develop the challenges of the emerging countries to include the concept of performance sensitive, this table can illustrate how more or less, can the national economy (Colombia) would be once their economy pass from emerging to a more stable one.
The table shows us how common renegotiation is, and we must understand that the renegotiation generates costs for both parts, being a product of the inefficient understanding of the borrower situation done by the bank. Is a common situation that renegotiation happens base on the table due to lack of control in the traditional debt contract, that is what the performance sensitive debt tries to do, covering empty spaces of control and knowledge of the client, to be efficient for both parts.

What is the client pursuing in a renegotiation? We must give importance to the contracts in which the parts are renegotiating the interest rate or spread. Because this is the factor taken into account in a PSD.

Panel A: Changes in absolute value of contract terms due to renegotiation					
Variable	Obs	Mean	SD	Min	Max
|Change in maturity (days)|	296	766	528	0	2,093
|Change in amount ($Mil)|	301	193	548	0	8,400
|Change in spread (bps)|	301	64	78	0	575

Panel B: Likelihood and timing of renegotiation outcomes conditional on renegotiation		
	Likelihood of outcome	Loan duration/stated maturity
Renegotiation outcomes		
Amount increase	0.560	0.416
Amount decrease	0.291	0.446
Spread increase	0.293	0.460
Spread decrease	0.259	0.486
Maturity increase	0.569	0.521
Maturity decrease	0.119	0.346
Switch lead arranger	0.114	0.528
Mutually exclusive outcomes		
Borrower favorable	0.284	0.455
Amount increase, not favorable	0.336	0.392
Amount increase, spread increased	0.161	0.426
Amount increase, spread change ambiguous	0.175	0.360
Amount decrease, not unfavorable	0.181	0.423
Amount decrease, spread decreased	0.048	0.493
Amount decreased, spread change ambiguous	0.079	0.408
Fraction of deal amount prepaid	0.012	0.341
Deal terminated	0.042	0.396
Borrower unfavorable	0.152	0.496
Only maturity increased	0.045	0.499
Only maturity decreased	0.002	0.177
Firm-quarter obs	645	645

Table 2: Renegotiation summary statistics.

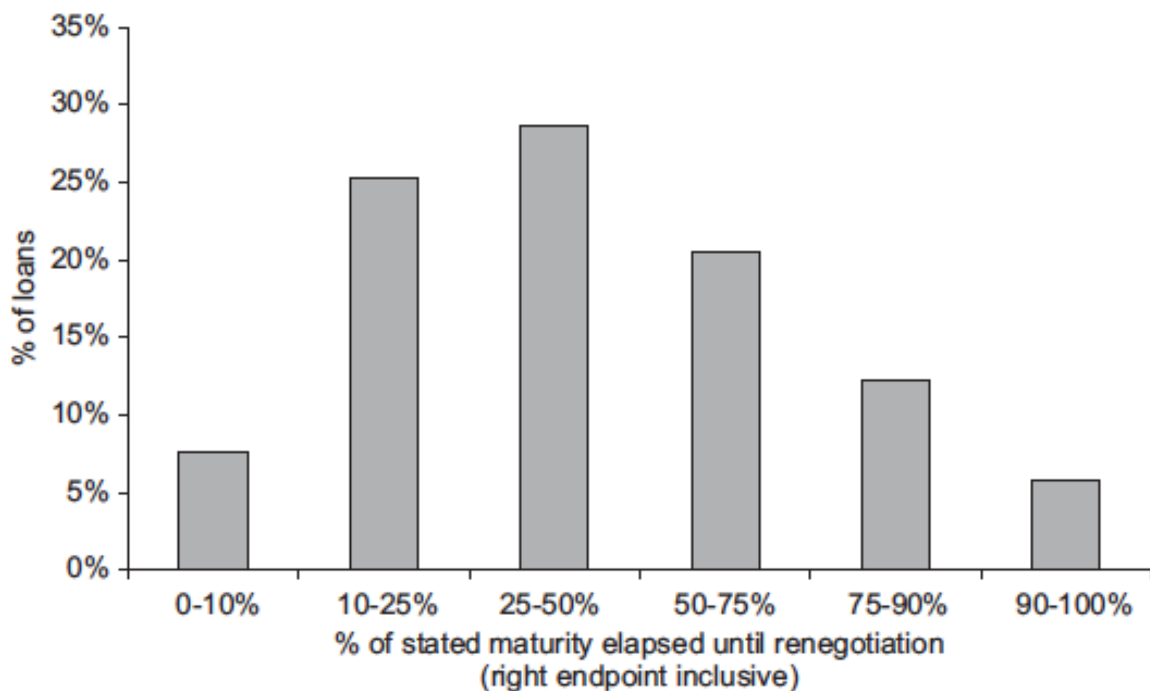
"The sample consists of 1,000 private credit agreements between financial institutions (lenders) and publicly traded non-financial U.S. companies (borrowers) during the period 1996–2005. Panel A presents summary statistics for the absolute value of the change experienced by each contract term in a renegotiation. (Note that not all contract terms are modified in a renegotiation.) Panel B presents the distribution of loans over renegotiation outcomes, conditional on a renegotiation occurring, and the fraction of the stated maturity that has elapsed until renegotiation. Borrower favorable outcomes occur when the amount of the loan is increased and the spread decreased. Borrower unfavorable outcomes occur when the amount of the loan is decreased and the spread increased." (Roberts & Sufi, 2009)

Interest spreads are either increased or decreased in just over 55% of the renegotiations. Interestingly, only 11% of renegotiations result in a change of lender (or lead arranger), a

figure that declines to 8.5% when we also consider loans that mature. The fact that we rarely witness borrowers leave existing lenders before the maturity of the loan suggests that ex ante relationship- specific investments are an important component of corporate lending environments.

The tables, ranks the interest rate modification in 55% of the sample studied. This means that every 1 out of 2 contracts (in a renegotiation stage) will modified the interest rate agreed in the first moment.

And now, when to renegotiation process takes place in the life of the loan contract, this will tell us, the importance of it in the operation of the borrowers company. Understanding when is happening; we could establish the dates when the performance sensitive could readjust the interest rate.



Graphic 1: “When does renegotiation occur in the life of a loan?

The sample consists of 1,000 private credit agreements between financial institutions (lenders) and publicly traded non-financial U.S. companies (borrowers) during the period 1996–2005. We exclude 148 loans that are either still active at the end of the sample (first quarter of 2007) or that correspond to borrowers that disappear from the EDGAR database. The remaining 852 loans mature or are renegotiated prior to maturity. The figure shows the percentage of loans that are renegotiated as a fraction of the elapsed stated maturity. For example, approximately 25% of the 852 loans are renegotiated after 10% but no more than 25% of the stated maturity has elapsed. For loans that mature, 100% of the stated maturity has elapsed and these loans fall in the right-more bin." (Roberts & Sufi, 2009)

"To understand when contracts are renegotiated, we take a graphical perspective beginning with graphic 1, which shows the distribution of loans over the fraction of stated maturity that has elapsed until renegotiation or maturity. In other words, for each loan, we compute the ratio of the number of days until renegotiation to the number of days until the stated maturity. For loans that mature, this ratio is 100%. The figure shows that most loans have a duration that is between 25% and 50% that of the stated maturity. On average, loans are renegotiated just after half (57%) of the stated maturity has elapsed." (Roberts & Sufi, 2009)

CHAPTER 2. THE PERFORMANCE SENSITIVE DEBT IN THE REAL SECTOR

The performance sensitive debt is going to follow the borrower´s company in every decision they make. Every impact in the capital structure, every use of funds that has a relevant inherence, the bank will supervise it through the same PSD.

The recurrent control over the company (borrower) is part of the nature, to maintain the suitable aspect of the performance sensitive debt. Talking to Carlos Daza, Bancolombia´s director of Pymes[6] in the city of Cartagena, tells us how this recurrent control will generate a new cost of maintaining their analytics team working continuously on their client information.

Papers that had study and research about the application of the concept of performance sensitive debt, no one talks about the cost of the increase of the work demand to the credit analytics team. This point is going to be touch in the conclusion, as an expected weakness of the performance sensitive debt.

The database for this segment is going to be based on the investigation done in first-world economies, such as United States and United Kingdom. The idea is not to compare the different economies, because each of them (First-world and emerging economies) is in different stages. The idea is to try to understand the actual image and how the local economy should be prepared for the future instruments that could take place on it.

2.1 Performance Sensitive Debt in developed economies

There are two scenarios to measure the risk of default of a company in a developed economy, rating agencies (public companies or big corporations) and the analysis of their financial ratios. Both of them are risky (nothing is safe at all); the rating agency is just an

[6] PYME, is the spanish term of small, medium enterprises (SME)

opinion of the professionals of the agency, you choose to follow it or not. While the financial ratios you are based only in one source of information, which is the same company, that needs the funds, creating an agency risk. Having the financial ratios, and detailing how the performance sensitive debt works, the idea is that the clients brings all the information that is relevant to the bank, to have the most suitable loan contract as possible. To understand how is the future of the company with the funds of the bank, how risky it is and how much value can it create.

A study done by Robin Chatterjee, about the implementation of the performance sensitive debt, in the United Kingdom, Tells us, what are the triggering factors taken into account in the performance sensitive debt. This gives the image of the key points of the company to know what aspects the credit analysis team will take into account.

Margin Description	No.	%
Debt / EBITDA	26.5	41.41%
S&P LT Debt Rating	12	18.75%
Utilization	8	12.50%
Interest coverage	5.5	8.59%
Moodys LT Debt Rating	5	7.81%
Amount Outstanding	2.5	3.91%
Debt (liab) to net worth (Equity)	2	3.13%
Comittment Level	1	1.56%
Debt / Capitalisation	1	1.56%
Fixed Charge coverage ratio	0.5	0.78%
Total	64	100%

Table 3: (Chatterjee, 2006); Triggering factors in the performance sensitive debt contracts;

The sample studied follow the next characteristics: 1. They had an ultimate registered in the UK; 2. Their debt contracts fell in the period January 1992 to January 2002; 3.Their debt contracts included a performance pricing condition.

The rating agencies represent 26,1% of the sample analyze, living the rest to internal information of the company. Concluding that this kind of debt doesn't takes only into account big companies or publicly traded companies.

These are the concepts of the ratios expressed on the table:

Debt to EBITDA (Debt/EBITDA): "A measure of a company's ability to pay off its incurred debt. This ratio gives the investor the approximate amount of time that would be needed to pay off all debt, ignoring the factors of interest, taxes, depreciation and amortization." (Investopedia, 2015) .

The formula of debt to EBITDA, tells us how is the proportion of the outstanding loan versus the operational income of the enterprise, with the objective to know, with exclusively the operation, the dimension of the loan, and determine then the paying ability of the company.

Utilization: "A metric used to measure the rate at which potential output levels are being met or used. Displayed as a percentage, capacity utilization levels give insight into the overall slack that is in the economy or a firm at a given point in time. If a company is running at a 70% capacity utilization rate, it has room to increase production up to a 100% utilization rate without incurring the expensive costs of building a new plant or facility." (Investopedia, 2015)

Interest coverage: "A debt ratio and profitability ratio used to determine how easily a company can pay interest on outstanding debt. The interest coverage ratio may be calculated by dividing a company's earnings before interest and taxes (EBIT) during a given period by the amount a company must pay in interest on its debts during the same period." (Investopedia, 2015)

Amount outstanding: The outstanding loans of the company in the moment that is going to ask for a new debt at the bank.

This last triggering factor, doesn't mean anything if it is the only one in the contract, which leave us the question about, how many triggering factors can a performance sensitive debt has?

Debt to net worth: Debt/Equity Ratio is a debt ratio used to measure a company's financial leverage, calculated by dividing a company's total liabilities by its stockholders' equity. The D/E ratio indicates how much debt a company is using to finance its assets relative to the amount of value represented in shareholders' equity." (Investopedia, 2015)

Commitment level: This concept is quite broad, could be related to financial covenants. The idea is that the company follows a path that the bank marks as appropriate to keep or improve the financial situation.

Debt/capitalization: "An indicator that measures the total amount of debt in a company's capital structure. The total-debt-to-capitalization ratio is a gauge of a company's financial leverage." (Investopedia, 2015).

This ratio gives us the image of where the company is taking the sources to operate. The higher it is, the riskier is the company because the sources come from banks or external agents.

Fixed charge coverage ratio: "A ratio that indicates a firm's ability to satisfy fixed financing expenses, such as interest and leases." (Investopedia, 2015)

Based on the concept, the outlook of the performance sensitive debt is based on the payment ability of the company. Focusing more on their coverage of the debt based on their operational results. The rest, disregarding the rating agencies are not that important as the percentage given to the debt-to-EBITDA ratio.

This paper developed by Robin Chatterjee, can be backup by any other paper, where the importance of the Debt to EBITDA ratio exists. The performance sensitive debt is going to be based on the majority of cases in this ratio and not in the rating agencies.

To compliment the information throw by the investigation by Chatterjee, the results of the paper done by Asquith in the United States market. In the results we can appreciate the importance of the debt-to-EBITDA ratio for the performance sensitive debt, his analysis enhances the one done by Chatterjee. To have a complete view of the concept in the market, the sample studied includes 8671 loan contracts, and the results are going to be based on the number of contracts and the amount of money on them that are going to be measured with the different ratios.

Panel A: The number of facilities with interest-decreasing versus interest-increasing performance pricing by type of financial measure used in the pricing grid.

Type of performance pricing	Interest-decreasing contracts	Interest-increasing contracts
Debt-to-EBITDA ratio	1918	793
Debt ratings	634	630
Interest coverage ratio	312	114
Fixed charge ratio	167	77
Leverage ratio	291	146
Total	3322	1760

Panel B: The mean loan size ($ millions) for contracts with interest-decreasing versus interest-increasing performance pricing by type of financial measure used in the pricing grid. Standard deviations in parentheses.

Debt-to-EBITDA ratio	155 (263)	189 (295)
Debt ratings	623 (942)	710 (1040)
Interest coverage ratio	194 (307)	341 (445)
Fixed charge ratio	121 (230)	186 (315)
Leverage ratio	209 (406)	263 (354)
Entire sample	251 (518)	392 (715)

Panel C: The mean initial LIBOR Spread for interest-decreasing versus interest-increasing performance pricing provision by type of financial measure used in the pricing grid. Standard deviations in parentheses.

Debt-to-EBITDA ratio	195 (76)	143 (72)
Debt ratings	70 (61)	51 (46)
Interest coverage ratio	170 (85)	104 (70)
Fixed charge ratio	156 (83)	105 (70)
Leverage ratio	110 (69)	70 (49)
Entire sample	160 (89)	100 (75)

Panel D: Means of variables describing the potential changes in interest rates and average number of steps for interest-decreasing versus interest-increasing contracts. Standard deviations in parentheses.

Grid design statistics	Interest-decreasing contracts	Interest-increasing contracts
MaxLessBegin	—	37.1 (24.7)
BeginlessMin	63.7 (45.7)	—
Average pricing step	16.3 (7.8)	13.8 (7.7)
Average number of steps	4.9 (1.7)	5.1 (1.8)
Number of observations	3322	1760

Table 4: (Paul Asquith, 2005), Financial measures used in interest-decreasing and interest-increasing performance pricing contracts by frequency, size of loan, average spread over LIBOR, number of pricing steps, and average of potential change in interest rates.

Definitions: MaxLessBegin – The number of basis points between the rate charged on the contract at the inception of the loan agreement and the maximum rate in the performance-pricing grid. (Paul Asquith, 2005)

BeginLessMin – The number of basis points between the rate charged on the contract at the inception point of the loan agreement and the minimum rate in the performance pricing grid. (Paul Asquith, 2005)
Average pricing step – The average increase or decrease in interest rates associated with a one level change in the performance metric. (Paul Asquith, 2005)
Average number of steps – The average number of partitions in a performance-pricing grid. (Paul Asquith, 2005)

Comparing the panel A with the information taken from Chatterjee we can confirm the importance of the financial ratios in this kind of contracts, taking the place of the rating agencies. The rating agencies are important when third parties want to know financial information of a company (this third party could be a bank or a natural person, that wants to invest on it). Now for banks, if the include the performance sensitive debt, for both parties is going to be cheaper to base the credit risk on payment metrics as Debt-to-EBITDA, compare to having a rating agencies giving their professional opinion.

Confronting panel A with panel B, we can conclude that for companies that have a debt rate, are the biggest in the market and the ones that move more capital in this kind of debt contracting. Even though debt rate is not the most popular measurement for this contract is the second one that moves more capital.

Panel C also corroborates to the idea of debt rate is for big companies, the bigger the companies, more guarantees the bank can have, is a company that has a mature position in the market with their market share solidify, and the challenge is to maintain the position and/or investments in other markets to expand their income sources. Panel C shows us, how financial ratios measurements have a higher spread over the LIBOR compare to the debt rate measurement. The companies with debt rate are normally the ones that are trading publicly and for regulations issues they must have it.

From this a conclusion, could open the door for small and medium size companies to also apply for this kind of debt contracting, is not only a privilege, of having this suitable debt contract, for the big companies.

2.2 Interest increasing and Interest decreasing performance sensitive contract

There are two types of performance sensitive debt as it was explain in the introduction, the performance pricing declining or increasing, each of them tries to follows the natural performance of the company and cover the implicit risk of them.

To expose the sample and the information on the table in Asquith 2005; we can compare the difference between the two options of the performance sensitive contracts.

Performance sensitive debt (Decreasing rate): The image that gives this model is that is designed for companies that are in basic stages of life, trying to cover more market, discover new clients, being the principal objective to growth and improve financial results.

"In a traditional bank loan a borrower has an option to repay the loan without penalty at any time. This prepayment option allows borrowers whose credit quality improves to obtain lower rates on their loans if they are willing to incur refinancing costs. Performance pricing incorporates this option into the loan contract and provides a mechanism for the borrower to obtain lower interest rates without incurring refinancing costs. We hypothesize that the value of this option, and thus its likelihood of adoption, is positively related to the probability of prepayment and to expected renegotiation costs." (Paul Asquith, 2005)

Asquith also exposed the difference between the prepayment option and the performance sensitive debt; understanding that the objective is to reduce extra costs and time for both parties searching the optimization of the commercial relation ship

“Although they are similar, there are differences between the prepayment option in a traditional bank loan and the interest-decreasing performance pricing feature. First, in a bank loan, lenders must incur renegotiation costs if a borrower threatens to/or prepays. Second, a lender’s loan portfolio deteriorates if a borrower with above average credit quality refinances with a different lender. Third, the new interest rate on a refinanced loan is based on multiple measures of the borrower’s performance, and on the future credit spread above LIBOR for the firm’s risk class. By contrast, in a performance pricing contract changes in interest rates are pre-specified, so there are no renegotiation costs. In addition, by pre-specifying changes in interest rates, borrowers are less likely to defect to other lenders. Finally, any future reductions in interest rates are based on single measures of firm performance and on current credit spreads for risk classes.” (Paul Asquith, 2005)

Performance sensitive debt (Increasing rate): On the other hand, the image given by this option, is that the debt contract was designed for companies that has a strong position in the market and the challenge is to maintain their financial results and then continue expanding. Their risk is not as higher as the ones with the other performance sensitive debt contract.

“In contrast to a borrower’s option to prepay in a traditional bank loan, lenders do not have the option to require repayment unless an actual or technical default occurs. Therefore, in a traditional bank loan the lender is not compensated for small risk increases. It follows that the initial interest rate charged on the loan must reflect any such expected decline in credit quality. This problem can be avoided either by setting the covenants very tightly at loan inception (Dichev and Skinner, 2002) or by requiring all loans to be demand loans (Rajan and Winton, 1995). Either alternative allows the lender to force renegotiation when credit quality deteriorates, but both increase the borrower’s liquidity and bankruptcy risk, since there is a possibility that
a borrower may not have immediate access to capital if they violate a covenant or have a loan called.” (Paul Asquith, 2005)

Focusing on the two columns of table 1: The confrontation of the two columns, show us how is more popular in the market the interest-decreasing model. To have an overview of the interest rates in the interest-decreasing we must analyze the panel D, in which we can appreciate how the interest rate should be over the market, but attracting the clients to improve their performance for the reduce of it.

2.3 Incentives for the corporations

The objective for the banks is to lend their money, covering all the risk, having a return and improving the borrower financial and operational situation. Would be complimentary information for the topic to know how companies are doing during the performance sensitive debt and after the debt contract reached its maturity.

As the tables quoted in the paper, in the investigation done by Asquith, this is a well-introduced concept in the market; that's is more natural with the operation of the company – meaning that the rate fluctuates with the operational ratios- and also mitigates the information asymmetry, risk that bank is absorbing.

For the borrower is going to be a more transparent, because based on the information given the ratios are going to be established. The responsibilities are more complex for both parties, the borrower side must have a well structure accounting information and department to be always producing the data demanded for the bank, and on the other side the bank will have a continuous analysis with the client´s company.

The idea is that in the long run, the performance sensitive debt pushes the company to outperform their operational expectations. Taking in account that if the company doesn't performs as it should and the operational ratios fail to achieve the expectations of the bank, the bank will cover the default risk automatically, avoiding also the renegotiation costs.

An interesting question is how, with complex database, the traditional debt and the performance sensitive debt improve their client's situations after the debt contract is celebrated. Obviously, having new sources of capital will improve the immediate future, but how profitable it is in the long run.

Having to improve (or maintain) the operational ratios, will lead to a company more efficient a capable to, in one hand, to pay their debt easily, in the other hand to improve their organizational daily basis, having then a short-term and long-term benefit.

2.4 The emerging market

Before introducing the corporate emerging market – in this case Colombia- there is a need to introduce the whole national economy to have an overview of the reader should expect.

The challenges of an emerging economies goes from changing the set of mind of the society and their leaders, focusing them on a long-term path. Investing in infrastructure, institutions, and the people learning what kind of leaders they want, voting for the candidates with a global perspective and capable of transforming the comparative advantages into competitive advantages.

Passing from selling oil, to invest in refinery and sell their derivatives; investing in the infrastructure creating a solid supply chain in a country that has two seas and all the climatic zones that can produce any commercial and exotic fruit.

The topic of the paper is to understand the actual conditions of the corporate national market to face new kind of instruments. The performance sensitive with all the aspects exposed in the last chapter, the idea is that it should be include as an alternative for

companies to finance their operation or at least to be analyze by financial institutions and understand the virtues this concept has.

Later then, the paper is going to explain the corporate environment of Colombia, how it is structure, the sizes of companies and then analyze the scenario of the inclusion of the performance sensitive debt.

First understand the importance of the SME[7] in the economy, analyze their sectors and main financial characteristics, then the same exercise but with the numbers of the top 1000 companies in Colombia. With the characteristics over the table, conclude how would be the inclusion of the performance sensitive debt in the local market.

[7] Small, médium enterprises.

CHAPTER 3. COLOMBIA'S BUSINESS SECTOR

The basic characteristics of a third-world country economy or an emerging market in the high influence of corruption and lack of diligence from the local government to improve the quality of life for the society and they also are used to omit their responsibilities with the local entrepreneur to achieve an environment that promotes the creation of new companies.

Colombia differs easily from their neighbors, because is the only country with a internal war that has existed since the 1960´s. Forcing the government to use around 4% of their GDP just to confront the guerrillas phenomenon –Guerrillas is just the tip of the iceberg-.

"For years the Colombian war system has grown economically unsustainable due to the unprecedented and uncontrollable expansion of its military force; as of now, the military is comprised of almost 500,000 personnel. The salaries, social security costs, health benefits, and future pensions of the military require an economic productive base much larger than what the Colombian economy can currently produce. This economic climate is a ticking bomb, which led the National Association of Financial Institutions (ANIF) to issue a stern warning that the public debt, actual and anticipated, could reach 290% of the gross domestic product (GDP), with 144% from pensions, and 97% from health benefits. What the report failed to underscore is that most of these future payments would stem from payments to the armed forces (police, military and security services), a sector that has expanded exponentially since the early 2000s as part of the war system dynamics." (Richani, 2013)

With high inclusion of the war and corruption phenomenon in the society and in the economy, there has been a lot of effort by private enterprises and with some public institutions are trying to transform the national landscape for the entrepreneurs. There

have been papers remarking the inherence of the war in the competitiveness of the companies in Colombia.[8]

3.1 Business sector of Colombia

"It would be a change that doesn't follows the reality of the market"

Carlos Daza

Taking into account all the difficulties that an emerging market has, banks and companies are on unstable environment in which one part must confront all the challenges of creating and operate an enterprise. Meanwhile, the bank lends his money with a difficult to read economy and with quite a lot of informality and lack of organizational structure by its counterpart. The government with the objective to improve and promote the creation of new enterprises, created laws that reduce the taxes for the first years of the SME in the market. There different kind of laws with the objective to reduce the costs of constitution and operation of the SME. The numbers shown by the ministry of commerce expose how this SME are focus then on the constitution and operating part of the project, forgetting about how the company should be structure and organized to have formal and solid position in the market. The numbers exposed by the ministry of commerce are: Of the total number of the SME in Colombia, 53,5% doesn’t pay taxes, 42% doesn’t have any accounting information and 45% of the SME doesn’t have any registry that the company has been established.

As every country in the world the majority of enterprises in it are going to be classified as micro, small or medium size. The differential on it is the organizational structure. “The difficulties of a commercial bank is the high level of informality that exists on the constitution and daily basis of the companies, in which there is a habit that the companies

[8] Alexandra Montoya, Ivan Montoya and Oscar Castellanos – Competitiveness of the SME in Colombia, actual situation and future challenges.

trough their accounting team prepare different financial statement with the objective to trick banks and fiscal entities.” (Daza, 2015)

Having to deal with the disorder on the organization of the companies, generates an extra cost, because the analysis team must go further to confront the information. We must take into account that the primary source of information in the same company, creating then asymmetry of information.
The competitiveness of banks can be related to the ability to understand their clients. Carlos Daza, talked about how companies have a precarious structure; banker must teach the entrepreneurs to organize the company in a way the banks could lend their money.

The idea of the government through different public and private institutions, like Acopi[9], Prolocombia[10], Innpulsa[11] and investment banks, is to take advantage of every entrepreneur impulse, to organize them to create competitive companies with a global vision. Including the advisory of how the company should be structure and promoting good corporate practices.

Before giving any number of the Colombian economy of the presence of SME, we must understand the presence in the world of this kind of organization. The IFC (International finance corporation[12]), concludes the following aspects about the impact and situation of the SME around the world.

“Small and medium enterprises (SMEs) account for about 90 percent of businesses and more than 50 percent of employment worldwide. They are key engines of job creation and

[9] Association of the SME in Colombia
[10] Governmental entity which prepares companies to export
[11] Governmental entity that promotes the development of technological start-ups
[12] Member of the World Bank group, being the largest institution with a global Outlook that focus on the private sector in developing countries.

economic growth in developing countries, particularly following the global financial crisis.” (International Finance corporation, 2012)

The importance for every economy the existence of SME, is how they can be adaptable in any traditional and new market, even though their rate of mortality is high, their share in the total number of enterprises in every economy does not vary that much, because the constitution rate is high that can imply the number of cancelled SME. (

“(…) SMEs are drivers of competition, growth, and job creation, particularly in developing countries where up to 80 percent of economic activity takes place in the informal sector. Barriers to entry into the formal sector include excessive bureaucracy and regulation”. (International Finance corporation, 2012)

Colombia as we told, also suffers from the excessive bureaucracy and confusing regulation for the standard entrepreneur –doesn’t have any managerial or legal knowledge, but has an idea that worth his investment on a new project-. These barriers damages the daily basis of the SME, because the lack of appropriate knowledge will affect in the medium and long term.

In Colombia the numbers are following the global trend. “Micro, small and medium enterprises, according to information of the Presidency of the Republic, "They represent 96% of the business of the country and 33% of the working population. Its participation in the industrial employment ascends to 60% and in the value added of the industry to 48 %. In the trade, they represent 95% of the employment and 74 % of the production.

"Nevertheless, according to the numbers of CONFECAMARAS (Colombian Association of Chambers of Trade), SMES in sales only contribute 33%, whereas the big companies that in quantity are 2%, they contribute 67% of the sales. Of the previous thing, it is possible to deduce that though SMEs only generate the third part of the sales, which can be

equivalent to the same proportion of the GDP, they are the big generating ones of employment, in reason to which the big companies you have best levels of technology, which gives them major productivity." (Angelica Marcela Acosta, 2007).

Understanding the numbers of the importance of the SME in Colombia, we can remark the importance of the banks to teach them how they should organize their companies to present it for a loan with them. If banks don't focus their commercial strategies to the SME sector, the market would be really small, just 4% approximately of the market must shared by all the financial institutions, taking into account that for these big companies, international financial institutions also compete with the local banks to try to be the lenders of these corporations.

Every country has their parameter to measure the size of an enterprise, based on their number of personnel or the amount of assets. In Colombia is based on the amount assets in proportion of the minimum wage (for example, a micro enterprises has in assets 180 times the minimum wage). The standardize classification, follows the next table.

The SMEs in Colombia		
Size	Amount of workers	Total assets
Micro	1 to 10	Up to 92,750 USD
Small	11 to 50	Between 92,750 USD and 927,500 USD
Medium	51 to 200	Between 927,500 USD and 563,640 USD

Table 5: (Angelica Marcela Acosta, 2007)

Size of the Enterprise	# of enterprises	(%)
Micro	1.336.051	93%
Small	46.200	3%
Medium	7.447	1%
TOTAL MSME	**1.389.698**	**96%**
Big enterprises	1.844	0%
Informals	50.575	4%
TOTAL	**1.442.117**	**100%**

Table 6: (Angelica Marcela Acosta, 2007)

The table 5 is based on an economic census done in the year 2005, in which we can see the deep inclusion of SME organizational models in the local economy. To understand how banks can read the market is separating the SME by sector. The sectors of an economy are three (general picture): manufacturers, Services and merchandising.

Principal activities of the SME in Colombia[13]

[13] The numbers in bold are not the sum of the ones inside the table; the percentajes inside the table are the ones of the most representatives activities of each type of business.

	%
Services	**52,4**
Medical practices	2,6
Basic highschool education	2,3
Specialized medical services	2,2
Comerce	**23,2**
Non-specialized food and drink retail	2,1
Wholesale diverse products	1,8
Maintaince of machinery	1,3
Manufactury	**19,3**
Textils	2,8
Panela[14]	1,2
Other activities	0,7

Table 7: (Angelica Marcela Acosta, 2007)

Number of societies constituted

Year	**Big**	**Medium**	**Small**	**Micro**
2005	90	316	2.419	24.856
2006	56	150	1.432	28.133
2007	176	599	3.460	32.562
2008	39	89	1.218	24.748

Table 8: (Angelica Marcela Acosta, 2007)

[14] Panela is a national product, that is use in the food industry, can be a juice, condiment, candies, etc.

Number of societies cancelled

Year	Big	Medium	Small	Micro
2005	41	128	447	4.930
2006	53	126	435	3.273
2007	59	161	540	4.179
2008	26	97	315	2.560

Table 9: (Angelica Marcela Acosta, 2007)

Societies cancelled-to-societies constitutes

Year	Big	Medium	Small	Micro
2005	45,6%	40,5%	18,5%	19,8%
2006	94,6%	84,0%	30,4%	11,6%
2007	33,5%	26,9%	15,6%	12,8%
2008	66,7%	109,0%	25,9%	10,3%

Table 10: Cancelled (Table 7)/Constituted (Table 8)

The main characteristic of the SME market, if a bank reads it, is the high rate of societies that cancelled their operation per year. This could be highly related to the informality and lack of organizational structure inside each company.

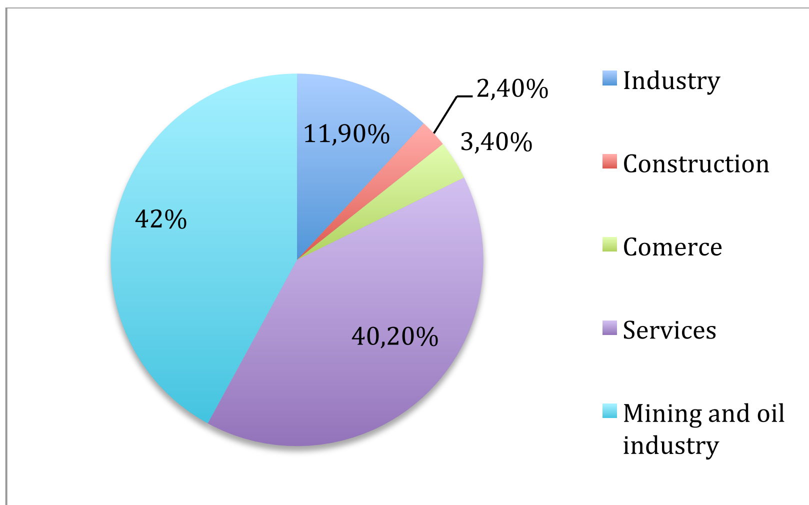
The sectors in which the SME are developing their operations, health sector, textile sector and non-specialized wholesale/retail, are ones that can reflect solid numbers, but the lack of capital, and well-prepared personnel can drive to the end of the companies.

The biggest 1,000 companies of Colombia

If we try to compare the sector in which the SME and the top corporations of Colombia differed by activity, there are going to be only a few that would do that. Companies with

activities related with the energy sector are ones that cannot be in the SME; maybe as supplier but is not going to be directly involved.

The activities of the biggest corporations started based on comparatives advantages; being in the correct place and with the correct people to develop the idea, and working decade through decade. As any country, in the top corporations, there is one company of retail and wholesale, also social activities –health and education-, and one related to agricultural activities. Taking out the traditional business such as banks and the ones of the energy sector.



(Superintendencia de sociedades, 2013)

Graphic 2: Share of each sector in the net income of all the 1000 biggest companies of Colombia.

Colombia is a country that has the virtue of having coal and petroleum, international companies exploit the first one and Ecopetrol exploits the second one –by far, the biggest company of Colombia, which has mixed ownership-.

The other important share is also based in a monopoly economy; the most important companies of the service industry are the ones that offer the public services, such as

energy, water, and gas. These kind of companies are protected by the government, because is easier to control them if there is just few, and specially when their services are related to fundamental rights of the human being.

Taking into account the 96% of the enterprises of Colombia –the SME- and the residual 4% lead by the biggest economies of the nation. If we focus on the percentages presented by the institution that regulates the societies, Superintedenencia de Sociedades, 82% of the 1000 biggest companies are based on the mining industry and services.

As we can appreciate, in the top 10, there is 50% share of companies related with the oil; 30% with services; 10% manufactory (Bavaria) and 10% in general merchandising. These enterprises count with a complex financial structure, in which the banks have a high level competition to be the capital source. At this level, normally the financial sources comes from the public market, the first five companies trade in the local market. These top 10 is based on the net sales, but for having all the companies with the same measurements, that's why the table is in financial ratios.

The rest of them have a huge capital source from external private capital, such as Telmex, Bavaria, Exxon, were the investor or their mains offices decide to support the financing of the operation or long term investments. The empty space that local banks can take advantage, what Carlos Daza argued about, are short term financing; even though the finance department is always searching for cheaper options, avoiding any stable relationwith a bank.

The next table is taken from (Diario La Republica, 2014)

Ranking 2013	Name	Economic sector	ROA	ROE	Leverage
1	Ecopetrol	Oil	9,90%	17,32%	42,84%
2	EPM	Public services	4,24%	7,37%	39,90%
3	Organización terpel	Oil trader	4,79%	8,74%	45,24%
4	Almacenes Éxito	General merchandising	4,21%	5,58%	24,58%
5	Pacific Rubiales	Oil	3,76%	9,96%	62,29%
6	Comcel-Claro	Telephonic and internet services	17,31%	28,95%	40,21%
7	Reficar	Oil refinery (Owned by Ecopetrol)	-1,61%	-5,24%	69,37%
8	Exxonmobil	Oil trader	7,87%	19,55%	59,75%
9	Bavaria	Alcoholic beverages (Owned by AB Inbev - 95%)	9,54%	15,21%	37%
10	TelMex Colombia	Telephonic and internet services (Owned by Slim)	8,26%	11,18%	26%

These top 10 can give us an image of how the big companies of Colombia are dedicated to, the big companies are the ones that started earlier and transform the comparative advantages into competitive ones. Some companies are completely foreigners, investing in Colombia, and their natural advantages (Oil and mining).

If we have a top 10 of the SME, the most important ones are related of how they transform the niche in which the enterprise started and how did they solidify their position so well that they explore international markets. The difference also between the biggest ones and the SME, in the majority of cases is the informality and lack of knowledge in managing to make the company profitable.

Is difficult to exposed have a general view of how the SME and the top 10 will perform with the macroeconomics variances. Based on what we have from the current situation, which are the numbers of the top 10 companies and how -In a general picture- SME perform in the market and in which the sectors there are focusing, we have a path in which the performance sensitive debt can find its space to start complementing the traditional loan.

Focusing on the inclusion of performance sensitive in the SME financing alternatives, because are this kind of companies that have lack of alternatives finding financial resources. The high rate of internationalization of the top companies, make them organizational competitive such as a company of any first-world economy. Especially when these big companies are the ones that have empirical knowledge of the costs of a rating agencies, and have a bigger portfolio of financing alternatives. The reader must remember that even though the biggest companies of Colombia, produce 2/3 of the GDP, only represents the 4% of the enterprise market.

"Ferri and Jones (1979)[15] suggest that the big firms have an easier access to the markets and they can find resources with better conditions. The bigger it is, is expected that the volume of information available is larger. This will reduce the information asymmetry and will make possible that the big enterprises have an access to a more economic financing resource (…) " (Valderrama, 2010)

Based on Valderrama (2010), the biggest companies in Colombia are not in a need of financial resources in comparison to the SME; their well-formed structure and results make them the commercial target of any bank, competing with the cheapest rate they can offer. In the SME, the risk, the information asymmetry, is higher; including to these factors the lack of structure and business plans, make them a risky client for the bank. Concluding

[15] The paper is entitled, Determinants of financial structure: A new methodological approach – Journal of Finance – 06/1979

that for this kind of companies-SME- the debt that a bank can offered should have the lowest risk exposure as possible, so will be short term debt with a high interest rate.

Having the challenge to improve the economic environment for entrepreneurs to keep creating and going forward to improve their business model, the performance sensitive debt could be one interesting financing alternative.

What Carlos Daza explained of how the commercial departments of banks tries to do to improve their market share, is to have a fluid communication between the clients and the bank. Teaching them how to structure their company and also to have all the documents as it should be.

The informality must be look as a percentage inside the SMEs, in which, some departments could be completely –operational and commercial- developed and other ones that are forgotten- as the accountably department and legal issues. They focus only on the operational aspects putting the rest organizational responsibilities as a secondary objective; this aspect is the one that matters for the commercial bank, how legal and formal the company is. For later then celebrate a debt contract.

The tendency and future of the SME is quite difficult to tell, meanwhile the top 10 companies are supervise by so many governmental entities, following every movement, because is that 4% of the total amount of the enterprises in Colombia, there is 2/3 approximately of the total GDP. The final idea of the local economy is to create the correct environment to maintain the rhythm in which SME are constituted and reduce their mortality rate.

CONCLUSIONS

The performance sensitive debt is a complete tool that will improve the lending conditions for the banks and for the SME side will also enhance their position with their debt contracts.

If we take into account the position of the commercials banks in respect of the high level of informality, is quite difficult for them-the banks- to understand every client with the doubtful information. To cover that risk the bank could implement debt contracts with a pricing grid. Explaining to the client how it works and how the contract works for both parts. Creating then an incentive of having well organized all the information of the company for the bank to read better the company, with the objective to have a reduction in their financial costs.

If we put on the table the position of the banks, in which the bank must go to visit the companies, in first place to know if there are real, and later on to understand how the enterprise works. In the short term the banks are going to continue this pedagogic practice, and is going to maintain during the time because the constitution of new SME. The performance sensitive debt will promote not only the basic responsibilities of having all the documentation, and having periodic deadlines to present the files that the will demand.

For the bank would be an advantage because it will build a relation with a client, it will couple them with an expensive financial source but with the option in the future to decrease the interest rate. They have then a new client and the risk virtually covered. And if the client improves it financial conditions, having better ratios, the interest rate is going to decrease, meaning also an advantage to the bank, because the financial institution is going to have less risk exposure and the client is going to confortable with his financing source because is cheaper than what it was on the first day.

On the client's side, would be a more challenging process that would pass from having none financial resources due to the lack of organization inside the company, to invest time and money organizing the company for a relatively expensive capital source. The entrepreneurs must understand that for small companies banks prefers even to avoid lending the money, if they lend it would be short-term[16] and expensive rate. In this scenario the manager of the company must invest on the accounting team to legalize every financial aspect of the company and prepare them to have financial reports every demanded period by the bank. The advantages are the capital source and if the operation outperforms its indicators, it will have a lower interest rates. At the end the client –the entrepreneur or manager of the SME- will have a solid accounting team with the capacity of understanding the critic financial ratios of the company and the ability to generate reports.

Universities and investigation teams that count with data about the debt contracts between the banks and its client, should compare the effect on the results of the clients after having a performance sensitive debt contract versus the results of having a traditional loan. The theory and Logic will demand that the companies that have a performance sensitive debt will have better results than a traditional loan. With the traditional loan, the company will focus on having the sources to pay the bank and avoid any default scenario, on the other side the company with a performance sensitive debt will try to improve their performance with the objective to improve the rate and have the reduction of their financial costs.

It should be a medium-term task[17], for the banks to start analyzing how would the internal operation of the performance sensitive debt. For the banks, and especially for the commercial departments with the traditional loans, they must have a close relation with the client to understand how they are performing; this approach could be done offering a

[16] From the moment concepts starts to be used in the real sector, till the first year of commercial activities.
[17] From the end of the first year, till the third year of commercial activities

new loan or just talking with client, to measure how they are doing. This commercial model could be absorb or at least reduce in frequency once the performance sensitive debt is celebrated. First of all the study before celebrating the contract must be more detailed, due to the determination of the indicators which are going to affect the interest rate. The periodic visits of the bank to the client´s office are going to be replacing with the periodic financial report. And the bank will need to introduce a model that calculates the rate depending the information given, covering automatically the increase or decrease of risk exposure.

On the bank side, the optic of the performance sensitive debt must be analyzed with more attention due to a possible increase in costs. The responsibilities of the analysis team are going to be done continuously to have a verdict every period to increase/decrease or maintain the rate of the client, supervising the model. When the current labor only takes into account the moment zero, in which the bank is analyzing the client to determine what rate, they should charge for the whole duration of the debt contract.

This last aspect should open a new door of investigation in which the relation between benefit and costs comparing the traditional debt and the performance sensitive debt. Being the traditional debt less complex for the bank to carry on, while the performance sensitive will demand continuous supervision or at least periodic. But on the other side and as was exposed all the qualitative costs the performance sensitive debt mitigates, that are going to potentiated the benefits of it.

The inclusion of the performance sensitive debt will be a challenging movement to the financial institutions, to prepare their departments but also a new alternative for the market. The inclusion will promote the improvement of the organization to be fulfilling all the requirements of the bank and to maintain the continuous communication with the banks.

On the long term, the expectations of this concept, the performance sensitive debt in the market will be fully understood by the SME segment and would be part of their plans of competitiveness, searching for financing sources with the short-term objective to reduce the rate the fastest as possible to reduce the financial expenses and increase the free cash flow of the company. Also the bank will have two scenarios and in both of them its activity is controlled, if the SME improves its financial conditions, it will be better for the bank, because the client is outperforming and rate will compensate that effort, having then a happy client and less risky one also. On the other scenario in which the performance doesn't achieve the indicators determined by the bank, the interest rate is going to compensate the risk exposure.

As the paper has demonstrated, the performance sensitive should be taken into account as part of the future of debt financing. This product is used in economies such as the American and the European (some countries), proof the adaptability to the market and mentality of the entrepreneurs and bankers. The mitigation of the information asymmetry risks makes the performance sensitive debt a fully complete evolution of the traditional debt.

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