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Creating the World in America's Own Image? Private Equity, Corporate Governance, and "Flying-Geese" Theory of Financial Development

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Abstract

Private-equity firms, especially for leveraged buyout funds, have suddenly arisen as the vanguards of global financial capitalism. They buy, transform, and sell companies. It is a new way of creating value for investors by motivating management to run more focused businesses for better corporate governance and by incurring debt to engender higher-risk, higher-return opportunities through creative financial engineering. This study explores the nature of private equity as a form of financial innovation, and introduces a new analytical framework that can shed light on the origination of private equity and its spread from the most advanced to the less advanced countries as a flow of investment capital in that particular format.

1. America the Trailblazer

The U.S. is the world's foremost leader in innovating numerous goods, services, and business models, the innovations that are gradually and selectively adopted by other countries. This trend setting has earlier occurred most dramatically in the manufacturing sector, notably since the end of WWII. It is, however, now taking place more frequently in the financial markets. The U.S. is usually ranked No. 1--or at least among the top five in innovative activities.¹ Ever since 1999, the U.S. Supreme Court formally ruled that financial business methods were patentable, U.S. financial institutions have been leading the world obtaining patents for financial products.

The year 2006 turned out to be a *near-perfect market* for financial business in the U.S. Its investment banking industry made \$29.1 billion after tax, a 43% rise on last year. Goldman Sachs alone set aside an unprecedented \$16.5 billion to reward its talent, equal to \$620,000 per employee across the firm² Such record-breaking profits made by the industry are in significant part the rewards for financial innovations in the form of private equity investments (venture capital and buyouts) and hedge funds' trades in derivatives—in addition to investment banks' own trading in futures, options, and derivatives and investing in bullish stock markets.

Financial innovations originating in the U.S. and other advanced countries are at least initially often controversial, as they often dramatically impact on the existing financial market structure and regulatory regime, raising levels of uncertainty and risk. They are, therefore, closely watched/monitored by regulators and policy makers not only in the U.S. but also in other countries to which innovations are sooner or later disseminated in this age of globalization.

This paper focuses mainly on the recent phenomenal growth of private equity (that involves both venture and buyout capitalists). Leveraged buyout (LBO) has lately seen explosive growth. This financial business model was conceived on Wall Street by investors like Jerome Kohlberg, Jr. in the 1960s and pioneered by his firm, Kohlberg, Kravis and Roberts & Co. (KKR), when it made the LBO of Orkin Exterminating Co. in 1964.³ Consequently, most of the world's largest private-equity funds are American in origin (such as Blackstone Group, KKR, Bain Capital, Carlyle Group, Lone Star Funds, Texas Pacific Group, and Bear Stearns Merchant Banking), though many are now also British and European in origin (e.g., Apax Partners, Bridgepoint Capital, Knightsbridge Capital, PPM Capital, Permira, Terra Firma Capital Partners, and Geutsche

¹ Most recently, for example, Isead, a prominent French business school, chose the U.S. as “the top country in generating new ideas, adapting them quickly and profiting from them” (“U.S. Is Ranked Leader In Business Innovation,” *Wall Street Journal*, January, 16, 2007, A19.)

² “American investment banks: Street ahead of the rest,” *Economist*, Dec. 23, 2006, p. 111. Among the reasons for profitable operations are (i) the booming M&As and private equity, coupled with bullish stock markets, (ii) a furious pace of trading in derivatives by hedge funds and other investors, an activity that produces prime-brokerage businesses for investment banks, and (iii) ratcheting up of the banks' own risk-taking in trading and investing on their own accounts.

³ KKR is credited by Harvard Business School as the first LBO in business history (Wikipedia, 2007).

Beteiligungs). In 2006, U.S. private-equity firms (322 funds) alone raised a record amount of money, \$215.4 billion.⁴ The global private equity industry is estimated to have over \$710 billion in assets at the end of 2006. Thus, the U.S. still dominates the industry (approximately 30%), though its market share has declined (e.g., down from as much as 68% in 2000) as other countries began to catch up. The trend is described as the ongoing phenomenon driven by “the new kings of capitalism” and “at the sharp end of capitalism today.”⁵

Why such sharp growth of private equity worldwide? How can we make sense out of this new financial development that has become pronounced first in the United States, the present leader of financial capitalism, and that is currently spreading to other countries? More specifically, what does this mean to the rapidly catching-up follower countries (especially, China and India) whose financial markets are increasingly integrated into the global economy? Is this growth of private equity just a passing faddish boom in financial business or will it here to stay as a new engine of corporate transformation for the foreseeable future? At the moment, we are at a loss, since there is no relevant conceptual frame of reference to rely on.

The purpose of this study is, therefore, double-fold: (i) to explore the rise of private equity (venture capital and LBO firms) as an “organizational” form of financial innovation (a new financial business model) in the U.S. and its spread to other countries, and (ii) to search for an analytical framework within which to understand the basic nature of this new financial development. We propose that the so-called “flying-geese” theory of economic development, when applied to and accordingly reformulated for the evolutionary development of a country’s financial markets, can provide such a much-needed frame of analysis. The reformulated theory also sheds light on the so-called “Lucas-Schultz” paradox of why capital does not flow smoothly from rich to poor countries despite a higher marginal productivity of capital in the latter.

2. Private Equity

What is the private-equity industry? Simply put, it is in the business of buying, transforming, and selling companies for profit. One description given by Britain’s FSA (Financial Services Authority) is:

The private equity market matches medium- to long-term capital with companies that are not quoted on a public equity market and which need financing to fund growth, development or business improvement. The capital takes the form of *both* equity and debt. The equity elements are typically provided by private equity funds, which in turn raise their capital from investors such as funds of funds, pension funds, investment funds, endowments and high net worth individuals. The debt is typically provided by banks, including investment, commercial and retail banks. Large proportions of this debt are often distributed to other entities, either other investment, commercial or retail

⁴ “Private-Equity Firms Raked in Record Amounts Last Year,” *Wall Street Journal*, Jan. 11, 2007, C6.

⁵ “The new kings of capitalism,” *Economist*, Nov. 25, 2004.

banks who were not the primary finance provider or institutional debt market participants. The private equity business model is not constrained to capital provision, rather it extends to the application of *expertise and strategic vision* to the privately owned companies (FSA, 2006, p. 12, emphasis added).

Furthermore, private equity firms are of two types: venture capital and leveraged buyout firms. As will be discussed below, the former is well regarded as something socially desirable, since they directly promote entrepreneurship and commercialization of new ideas and technologies. On the other hand, leveraged buyout funds have been often vilified as “vultures,” “gluttons,” “Barbarians at the Gate,” and “the locusts”--all connoting their greediness.

2.1. Venture capital (VC)

VC funds are basically structured to invest in, and nurture, promising business startups and take them public by initial public offerings (IPOs) on the public equity markets (i.e., stock exchanges) at a future time when they become successful. Indeed, private equity firms were originally crafted mostly for this purpose. To be more precise, there is also angel capital (or “business angles”), which is differentiated from venture capital. Angel capitalists use their own money to invest in early-stage startup companies. In fact, it is said that they stand between “friends and family” and VCs, investing in 10 to 20 times more startups than VCs. They normally invest relatively small chunks of capital (anywhere between \$25,000 and \$1.5 million in each portfolio company) in a diversified group of entrepreneurial ventures.⁶ In contrast, VCs may be more dependent on other investors’ money.

Both angel and venture capitalists foster and assist promising new ideas to develop into successful sustainable businesses. These funds once played the key role of spawning and helping high-tech companies like Intel and Google grow and prosper on their bright ideas in Silicon Valley. The venture-capital business quickly became the envy of the world and has come to be widely adopted in other countries. Up until the late 1970s, only a few wealthy families, such as the Rockefellers and Whitneys in the U.S., used to be the most active investors in private equity funds, buying and managing young fledgling ventures. These days, however, institutional investors (pension funds, endowments, and insurance companies) and a large number of wealthy individuals (though not as rich as the families of the Rockefellers class) are the major capital contributors. Although the absolute amount of money invested by venture capitalists has risen, only less than one-fifth of the total money in private equity is said to be allocated to venture capital, while the rest is spent on buyouts of established companies.⁷

2.2. Leveraged buyout (LBO) funds

LBO firms acquire and manage undervalued companies, privately owned or publicly listed, and sell them for profit within a relatively short period of time, normally within

⁶ See Wainwright (2003).

⁷ “The new kings of capitalism,” *Economist*, Nov. 25, 2004,

three to five years. For this operation, the LBO firms heavily depend on debt, borrowing from banks and issuing bonds to other investors. The increased debt of companies helps reduce the companies' exposure to corporate-income tax, use heavy interest payments to manage cash flows, and encourage management performance with equity-based incentives, notably stock options.

As far as LBO is concerned, there are three ways to create value: (i) value arbitrage: buying low and selling high; (ii) balance-sheet restructuring (designing value-adding links of equity and debt via financial engineering); and (iii) income-statement restructuring (improving business performance to generate cash flow). These operations may not be separated in a clear-cut way but rather may occur simultaneously in combinations (Blaydon and Wainwright, 2000).

(i) Value arbitrage involves buying weak companies at a low price and selling them at a high price later on. The acquired companies may be merely riding on business cycles or “boom-bust” cycles, doing poorly on a downswing but rebounding on an upswing. This is no different from the basics of stock market investment. It is a purely financial transaction without adding any economic substance to the acquired companies' real assets.

This type of financial deals occurred right after the Asian financial crisis of 1997-8 devastated five East Asian countries (Thailand, Malaysia, Indonesia, the Philippines, and South Korea). Foreign LBO firms, especially from the U.S., were popularly called “vulture funds” and feared because they were thought to feed on financially distressed local enterprises. The host governments were concerned that local industries would be bought out by foreign interests at fire-sale prices, adversely affecting their national efforts to develop and build up domestic industries. For the most part, however, the acquisition of troubled local firms in post-crisis Asia was mostly done by foreign manufacturers of the same industry, and these foreign acquirers injected capital as well as technology, thereby strengthening, on the whole, those acquired enterprises (Zhan and Ozawa, 2001).

(ii) Balance-sheet restructuring (*financial engineering*) is probably the most controversial of the three types of operations, since it necessarily raises the liabilities (debts) of the purchased companies.

This feature of private equity is perhaps the most profitable for the industry yet the most troublesome for society and policy makers. In fact, as the private-equity firms aggressively push for profit maximization by financial engineering, the industry is at risk for becoming a liability for the entire economy. The *BusinessWeek* recently published a cover story article, “Gluttons at the Gate,”⁸ and listed four warning signs: (i) “huge dividends and fees”-- record sums of dividends and enormous fees for everything from dispensing advice to covering their taxes; (ii) “serial charges”—collecting excessive payments from companies several times a year, thereby jeopardizing the companies' financial health; (iii) “debt bombs”—loading-up of debt on companies to such an extent of lowering their credit ratings and even driving them bankrupt; (iv) “quick flips”—

⁸“Gluttons at the Gate,” October 30, 2006, pp. 58-66.

taking companies private to the public stock market within a short period of time (in some cases less than a year) after buyout. These signs signal the excesses of financial capitalism. No wonder, some call the rise of private equity “the purest capitalism” (so called by ABC Radio National, Nov. 19, 2006).

At the moment, although there is nothing illegal about these transactions, they often border on fraudulent activities. They at least raise ethical and social issues. In fact, this is probably why this wealth-driven business activities constitute the “wealth-driven” phase of economic growth that may even be considered the stage of “drift and ultimate decline” of the entire economy (Porter, 1990). Private equity firms’ long-term orientation seems to have vanished considerably, turning into short-term profit making via “quick flips” which in some instances are within a few weeks.

(iii) Income statement restructuring means running business more efficiently and more profitably, adding substantive economic value to the assets of companies. It is generally believed that LBO firms can serve as a powerful engine of corporate transformation by creating value of economic substance. These firms can strive to make companies run better over a period of five to ten years by injecting new management teams. Given the nature of private-equity funds, however, their focus is mainly on management, not so much on technological side of companies’ products and production, a belief that in the main, management should be made better to produce better bottom-line results.

2.3. High risks, high returns

The expected—and actual—rate of return on private-equity investment is high as it reflects high risks and long-term commitments on the part of capital contributors (investors’ capital being locked up for as long as 10 to 12 years in the funds). Because of the high risks (i.e., high profitability deviations in both directions, positive and negative) most private-equity funds are offered only to institutional investors and high net worth individuals, who can afford to have their money locked up for a long period of time and to risk losing their investments in the case of business failures. In the U.S., for instance, most funds require \$2, 5 million of net worth (exclusive of primary residence) and at least \$200,000 of individual income for two documented years.⁹ High risks are correlated with, and compensated by, high returns in the private-equity industry. Successful funds are said to reap annual returns as high as 30%. In short, private equity is basically a *high-income luxury* financial product; only those investors rich enough to bear substantial financial losses should be allowed to purchase.

In this respect, value creation for investors occurs in two types: *stock-market value creation* (stock markets create value for shareholders) and *private-equity value creation* (private-equity funds create value by buying, restructuring, and selling companies). This means that actually two different types of investors have thus emerged. This development can be explained in terms of three-periods analysis:

⁹ Or at least \$300,000 of joint income (with spouse) (Wikipedia, 2007).

Period 1: “In the beginning there are the stock markets.” Initially (in the *pre*-buyout period), public stock markets register/signal different levels of value creation for the shareholders of listed companies as indicated by stock prices. Stock prices are the gaugers of how the listed companies are performing.

Period 2: Now, suppose that LBO funds are born. They acquire those public companies that they think are undervalued (not maximizing corporate value) and whose management they think can be made better. The existing shareholders of original companies must earn satisfactory profits (otherwise they will not sell) when they sell their shares to the LBO funds. Hence, any buyout offer makes their stock prices higher than their initially prevailing market prices, an additional charge known as a “deal premium.” The buyout firms usually target those listed companies that have a large amount of cash (retained earnings) and a stable flow of income earnings. These characteristics enable the buyout firms to load up debts on companies that used to sit on a large sum of cash. Cost cutting efforts to increase company profitability may take the form of laying off workers and shifting production to lower-cost locations (including those overseas), which often causes frictions with labor unions and the local communities.

Period 3: A deal, once completed, leads to the post-buyout period, during which private-equity value creation occurs as a result of value arbitrage, balance-sheet restructuring (financial engineering), and/or income-statement restructuring, as seen above, all of which involve higher risk-taking because of the heavy use of debt. In fact, to avoid a default risk, another financial transaction called “credit-default swaps” usually occurs. And finally, later on, when companies are taken back to the public stock market successfully, private-equity value creation is to be reflected in new stock prices, higher than the original ones.

In summary, private-equity value creation equals initial stock market value creation + additional risk-taking (via value arbitrage, balance-sheet restructuring, and/or income-statement restructuring), which is the post-sellout stock-market value creation. This is why news about buyout deals normally result in higher stock prices in anticipation of companies’ improved value creation. While companies are in the hands of private-equity firms, however, the class of equity shares held by private investors is *no longer* the same as that of those equity shares previously publicly traded on stock exchanges. These are two different kinds of shares (as different as apples and oranges, though they both are fruits), since entirely different levels of risk are involved. In other words, two different classes of shareholders are created in the process: public-equity vs. private-equity shareholders. And corporate governance is driven more intensively and more aggressively (in terms of financial engineering) for value creation by private equity than by public equity.¹⁰

¹⁰ This does not necessarily mean that private equity always yields higher returns than public equity, however. For example, comparing private equity funds with public equity market in the average annual net returns to investors, 1986-2003, the overall average for European private equity was 19.0%, as opposed to 12.3% for European public equity. The same comparison for American private equity was 12.4%, as opposed to 17.1%. Harper and Schneider (2004).

2.4. Corporate governance

What does this mean to corporate governance—and shareholder interest? For years, public-equity shareholders were unfamiliar with how much more value could be created by private equity firms. Hence public-equity shareholders rather passively handed over companies to LBO firms and corporate chieftains. It is said that a deal premium was actually somewhat smaller than in corporate takeover deals (21% vs. 25% in 2006), and that public-equity shareholders are now rebelling against private-equity firms and company directors, demanding higher deal premiums.¹¹ In other words, the new shareholder activism is in the making. And this is construed as a move to close the return gap between stock-market and private-equity value creations.

If the notion of corporate governance is narrowly interpreted merely as value maximization (higher dividends and higher share prices) for the sole benefits of investors, private-equity value creation is judged as more efficient than the conventional one under public equity (i.e., only through public stock markets). Given the fact, however, that private equity is becoming ever increasingly short term-oriented (i.e., “quick flips”), dividends/fees-extractive, and debt-loading, these excesses most likely jeopardize the long-term health and viability of the acquired companies. Because of the very nature of private equity, transparency and accountability inevitably decline as equity is taken out from the public view (stock exchanges and their accompanying regulations)—with the result of greater potential pitfalls for ethical compromises and fraudulent activities. This capital-market transformation away from public equity (associated with transparency) and toward private equity (characterized by private secrecy) may be interpreted as a phenomenon in which “forsaking the sunlit uplands of global finance, the market for capital is plunging into the shadows.”¹² The corporate governance under private equity may be detrimental to the whole economy as it increases the social costs, while raising the private gains only for a privileged group of private equity investors. Interestingly enough, however, the private-equity industry claims (i) that their purchases of publicly listed companies make management more long-term oriented (usually, 3 to 5 years), since management is freed from the pressure of stock prices (value creation on stock exchanges) on a quarterly basis, and (ii) that private equity can protect buyout firms’ financial engineering skills and secrets from competitors, thereby encouraging them to become even more innovative. It should be noted, however, that financial products are now patentable, but that many firms may prefer to keep their business secrets in house without applying for patents.

3. An Appropriate Frame of Analysis

3.1. Stages of financial development: a reformulated “flying-geese” theory

¹¹ “The New Activist Investors: More Shareholders Fight Buyout Firms, Management For Bigger Deal Premiums,” *Wall Street Journal*, Jan. 24, 2007, p. C16.

¹² “The dark side of debt,” *Economist*, Sep. 23, 2006, p. 11.

What sort of analytical framework can help us understand this recent development in the global capital markets? Here we propose a reformulated version of the so-called “flying-geese” theory of economic development. The theory of economic development was originally expounded by Kaname Akamatsu in the 1930s (Akamatsu, 1935, 1962) and has recently been expanded¹³--and more widely accepted in academia.¹⁴ The theory shows two dynamic patterns of global economic growth: structural changes in individual countries, and a hierarchical alignment of countries at different stages of development. The first pattern emphasizes the *changing industrial structure* of a growing country as it moves up in technological and economic development, a changing pattern from low value-added (low technology) to higher value-added (more knowledge-intensive) industries. In other words, it is a *progression* of industrial development in the manufacturing sector from low-tier type (e.g., apparel and textiles) to mid-tier type (e.g., steel, basic chemicals, and heavy machinery) to finally, higher-tier type (e.g., automobiles, electronics, telecommunications, and most recently, Internet-enabled services), the pattern trail-blazed by two successive hegemonies (first lead geese), the U.K., and the U.S. (Ozawa, 2005). The second pattern is concerned with a hierarchy of countries within which new technologies and their resulting industries are initially innovated and adopted in the first lead-geese countries (initially the U.K. under the Pax Britannica, and then the U.S. in the post-WWII period)—and later on, migrate to the follower-geese countries. Such an interactive structural transformation has been facilitated and promoted by *both* market forces and government development policies/strategies. What the original theory envisioned is thus (i) the *qualitative evolutionary transformation* of a country’s industrial structure over the course of growth and its accompanying necessary changes in institutions (a country’s regulatory, incentive, and governance systems), and (ii) a hierarchy of countries within which *new technology and industry transmigrate from the most advanced to the less advanced*. It stresses the structural dynamics of the global economy in an ever-integrating environment.

This very idea of structural transformation can now be extended and applied specifically to the financial dimension of economic growth--that is, how the financial markets evolve structurally over time. We draw on historical experiences and trace out the normal/typical sequence of financial (“money sector”) development that corresponds to the sequence of industrial (“real sector”) development.

A historically derived pattern of financial development is summarized below in stylized form in terms of a three-phases model (as illustrated in Figure 1):

INSERT FIGURE 1 HERE

Phase I. In the early stages of a country’s economic development, *family-based and trader-based finances* are most predominant. It is increasingly supplemented by *bank-based finance*, while the capital markets (stocks and bonds) are still in the

¹³ For example, *inter alia*, Kojima (2003, 2004, 2005), Kojima and Ozawa (1984, 1985), and Ozawa (1992, 2003, 2005).

¹⁴ See, for example, Radelet and Sachs (1997) recognized the theory as one of the three major doctrine of development strategy, along with the “big push” and the “import substitution (i.e., infant industry)” theory.

embryonic state. Family-based finance (often supplemented by friends) is basically motivated to set up and run family-owned businesses so as to provide sustenance and wealth for future generations. It is basically long-term oriented. This type of business is governed by trust, and the ownership interest is protected by blood relations. On the other hand, trader-based finance provides short-to-medium-term funding for specific transactions such as provision of raw materials and sales-outlets for farmed-out (commissioned) production, usually in the context of a cottage industry. Nascent local banks also provide commercial loans to successful founder-owned businesses against the latter's assets as collateral. In this phase, therefore, there is no separation of ownership from management. Accordingly, the issue of corporate governance is hardly relevant in the modern sense of the term. Stock exchanges, if ever established, still remain inchoate and largely illiquid.

The industries that develop in this early phase are mostly labor-intensive, low-end manufacturing (such as textiles and garments, sundries, and other light industries) and localized services (mostly petty trade and elementary health service). The amounts of capital required for local businesses are relatively small, and this explains why family-based and trader-based finances are adequate and prevalent. If a developing country is on track to rapid development, family businesses are likely to diversify to supply and implement existing companies (i.e., through forward and backward business linkages).

In the meantime, the local government normally sets up, runs, and owns basic infrastructure industries such as transportation, telecommunications, and utilities—and special-purpose banking (e.g., for small business finance and long-term infrastructure development). On the whole, local enterprises are intended to serve as contributors to, and as essential builders of, their national economy—rather than as pure return-maximizers for owners, even if listed on their nascent public stock exchanges.¹⁵

Phase 2. The intermediate stages of economic development are typically characterized by rapid growth (hence rising savings) and more modern, larger-scale industries (e.g., steel, basic chemicals, heavy and electrical machinery). These industries exploit internal scale economies and are far more intensive in the use of physical capital (machinery and factory facilities)—and of increasingly more human capital (educated and skilled workers and technology) than in the previous phase. The need for capital, therefore, far exceeds the capacity of families to finance. As a consequence, family-based and trader-based finances thus decline. Instead, bank-based finance rapidly grows in importance as the banking sector itself benefits from rising savings. The secondary sector (manufacturing and construction) grows rapidly, while the primary sector contracts as a percentage of GDP.

¹⁵The economy in this phase may be interpreted as basically undergoing the Marxian M->C (“commodification of money”) round of capitalism in which capital is converted with complementary factors via production into commodities.

Banks naturally serve as the overseer of borrowers, contributing to better corporate governance. The people are, on the whole, eager to safeguard their newly accumulated savings as deposits with banks rather than to speculate on the stock exchanges. Banks' role as a financial intermediary (i.e., indirect finance) is thus preponderant. In fact, this is the stage at which banks are regarded as "the headquarters of the capitalist system" (Schumpeter, 1934). The whole economy industrializes at a rapid pace at first and then more gradually later on (as it goes through the inflection point of S-shaped growth curve).

Capital-market-based finance (especially equity, if not yet bonds) also takes off, particularly when the country is capable to attract foreign capital inflows. As some industries developed in the previous phase mature, many small family-owned businesses may go through consolidation via mergers and acquisitions, and some choose to be listed on local stock exchanges. The usual principal-agent problems, therefore, arise as a result of gradual separation of ownership and management. Depending on a country's culture and traditions, however, the multi-stakeholder model is likely adopted rather than the shareholder model at this stage of economic development. In many developing countries, business enterprises are still regarded, by and large, as the social organizations responsible and accountable for the welfare of their local communities in terms of employment creation and national economic development—rather than as the pure economic organizations devoted solely to the maximization of profits and shareholder value. Shareholder activism is, therefore, not likely to be socially respected and accepted. The notion of corporate governance (value creation) is accepted not so much for the purpose of earning high returns for shareholders but in the interests of multi-stakeholders (employees, suppliers, creditors, and communities—in addition to shareholders).¹⁶

Phase 3. In the most advanced stages of capitalist development, as seen in the first lead-goose country (currently the U.S.), the capital markets become strategically crucial and complex for corporate finance, though bank loans still remain overall more significant in financing businesses. The tertiary sector in the advanced economy turns dominant, accounting for easily more than three-fourths of GDP, and the entire economy is increasingly driven by intellectual capital (knowledge, ideas, and talent). Both the primary and secondary sectors sharply decline as percentages of GDP. That is, the New Economy gains on the Old Economy. The former is driven by a synergy of technology and finance, as aptly described by Mandel (2000): "If technology is the engine for the New Economy, then finance is the fuel."

New financial products (such as options, futures, swaps, securitized products, and other derivatives) are innovated one after another. And new financial business models such as hedge funds and leveraged buyouts are experimented and adopted as mainstream business practices—especially in the lead-goose country. That is, in a mature capitalist economy higher-risk, higher-return financial activities are

¹⁶ In terms of the neo-Marxian model of growth, the economy in phase 2 experiences a rapid succession of $M \rightarrow C \rightarrow M' \rightarrow C'$ (investment--reinvestment). M is resource (natural capital)-based, M' is more physical-capital, and then increasingly more human-capital-enabled.

relentlessly introduced and pursued. Demand for such financial products and architects is basically high-income-elastic; it is the type of products suitable for high-income countries. High-income countries can afford risk-taking in speculative financial investments, and many financial transactions practically border on pure gambling in nature, so much so that the epithet “casino capitalism” applies (Strange, 1997).¹⁷

In the latest evolution of the financial industry in the most advanced capitalist economy, the capital markets (shares and bonds) themselves go through a radical makeover away from public equity and more toward private equity, though they are still interactive and cannot be separated (not mutually exclusive). This development creates two different groups of equity investors: public-equity shareholders and private-equity shareholders (the latter with a much higher degree of tolerance and acceptance of higher risks).

The financial markets are more susceptible to the problems of asymmetric information (i.e., adverse selection and moral hazard) than in manufacturing industries. Hence, a higher level of institutional adaptation and adequacy—especially in terms of regulatory controls and ethical standards—is required. This is the very reason why the financial markets are more heavily regulated than others. And any lead-goose country in financial development needs to cope with this institutional challenge. (This is best illustrated by the legislation of the controversial Sarbanes-Oxley Act of 2002 in the U.S.—controversial because of its onerous regulatory control on internal accounting which many argue weakens the competitiveness of the U.S. financial market and drives investors from public equity into private equity.)

It should be kept in mind that the above stages model is highly stylized. It is meant to delineate the fundamental/underlying historical patterns. Each individual country has its own historical trajectory, which is necessarily differentiated from each other in the evolutionary characteristics of financial market development.

4. Private Equity firms as the New Financial Multinationals

How does the development of private equity fit into the stylized pattern? We will apply the FG theory to discuss the structural compatibilities of private equity for different phases of financial development.

Since private equity is a high-income financial business model, it is mostly irrelevant to phase-1 countries that have a relatively low level of per-capita income and savings. Economic growth that is accompanied by both financial market development and appropriate institutional setup is the basic prerequisite for creating the demand for private equity and attracting foreign private-equity capital. In phase 1, family-owned businesses are prevalent and dominant. Interestingly enough, in a sense, they themselves can be regarded as the “crude” class of private-equity investors in their own ideas. By and large,

¹⁷ This final phase corresponds to the MM’ stage where money (M) directly begets more money out of purely financial transactions (M’)—rather than out of real-sector production.

the financial institutional infrastructure still remains decrepit in phase-1 countries, and the illiquid underdeveloped stock markets in particular are a barrier to the “exit” strategy of private-equity investors. (“Micro-private-equity” model--analogous to “micro-banking”—in the form of “micro-angel capital” may be conceivable, however.)

As might be expected, as soon as a catching-up country moves into phase 2, the economy becomes structurally more compatible to private equity investments. In fact, venture capitalists from the advanced countries are eager to take high risks because of the potential high rewards in rapidly catching-up countries such as China and India (which epitomizes successful phase-2 countries). As China and India’s earlier-developed (lower-tier, traditional) industries (such as textiles, food, and retail) mature and consolidate, some family-owned businesses are anxious to be acquired or merged by others or ready to be bought by private-equity firms. Furthermore, startups in newer high-tech industries are popping up. All these developments create new profitable opportunities for financial services. Here, venture capital can play an important role and may be in great demand, offering a favorable environment for private-equity firms.

Indeed, India is drawing many more throngs of American and European venture capitalists than any other newly emerging countries—because of its phenomenal growth, its liquid and transparent stock markets, its abundance of family-owned companies, its well-functioning legal system (to protect private property) and its democratic government, and all other institutional legacies it received as a nation of the British Commonwealth. Major private-equity players are already operating with their offices in Mumbai, Bangalore, and Delhi. They are reportedly making deals at a furious pace:

“In the first nine months of 2006, India saw 329 venture capital and private-equity investments worth a total of \$5.9 billion—more than double the tally for 2005—with some 60% coming from foreign players... The size of deals is growing, too: from around \$8 million four years ago to an average of \$25 million today. The record for 2006 was set by Idea Cellular, which in November received \$950 million from a clutch of investors including Providence Equity Partners, ChrysCapital, Citigroup, and Spinnaker Capital. A new benchmark may be on the horizon: Reliance Communications is in talks with private-equity players such as Blackstone, Texas Pacific, and kkr to fund its \$10 billion bid for cellular carrier Hutchison Essar.”¹⁸

It is also said that Indian companies currently offer the highest rate of return on equity in Asia, approximately 21 percent—for example, compared with 9% for China. This induces western private equity firms to expand their investments. Over the past few years, New York-based Warburg Pincus has sold for a total of \$1.6 billion its stake in Bharti Airtel, a regional carrier, which it bought at \$300 million in 1999. Telecommunications and outsourcing were the first industries that drew interest from private-equity companies. They are now diversifying, however, away from these areas into others such as health care, food, real estate, travel, and hotels.¹⁹

¹⁸ “Private Equity Invades India,” *BusinessWeek* online, January 8, 2007.

¹⁹ *Ibid.*

China, too, has its unique attractive features that are conducive to foreign private-equity investments. It adopted market capitalism by opening the doors in 1987, while retaining a communist (yet pro-business) government. A combination of economic freedom, political stability (though “forced”), and a relatively open market has sparked heady growth. State enterprises began to be rapidly privatized, and entrepreneurs started new businesses in the private sector. As a result, new stocks and bonds have been offered in large numbers on the local stock and bond markets. Consequently, “a record 21% of funding for Chinese companies will have come through the country’s share and debt markets [by the end of 2006],” and “funding from outside the banking system will have grown sixfold since 2002, to 8.6 billion yuan (\$1.3 billion).²⁰” In other words, “state equity and debt” are being converted into public equity and debt.

Although China is still a communist country, it makes the most active use of the stock market. Three of its largest state-owned banks—the Industrial and Commercial Bank of China, the China Construction Bank, and the Bank of China—have been successfully privatized by IPOs. The Industrial and Commercial Bank of China’s IPO that raised about \$21.6 billion, was the largest IPO in history. Some of the world’s largest financial institutions such as Citigroup, UBS, HSBC, Goldman Sachs, and Merrill Lynch, the major chieftains of financial capitalism, all acquired minority stakes in these big Chinese state banks ahead of public listings, and earned huge profits.²¹

It is against this backdrop that American and European private-equity firms are venturing into China. Open for foreign investors are a great variety of industries ranging from pharmaceuticals and electronics to food and beverage to real estate to private equity itself. Intel’s venture-capital unit is known as a key player on China’s private-equity scene, having invested more than \$200 million in local startups since as early as 1998.²² During the first half of 2005, consumer electronics was the No.1 industry drawing the largest amount (\$50 million out of a total of \$323 million in all industries) of investment from foreign private-equity firms. Real estate, however, came to rank first (\$105.9 million out of a total of \$687.3 million) during the same period of 2006. Since foreign investors are known to have a tendency to pay more than locals, Beijing was worried that inflation would be fueled and that many local Chinese might be priced out of the housing market. This concern apparently prompted the implementation of new rules to curb accelerating foreign investment in real estate in July 2006.²³

Moreover, the host country is in the midst of heavy and chemical industrialization, increasing demand for energy and causing environmental problems. Interestingly enough, venture capitalists are finding new businesses; “from June 2005 to June 2006,

²⁰ “Chinese capital markets: Out of the shadows,” *The Economist*, Dec. 16, 2006, p. 78.

²¹ *Ibid.*

²² “To China, With Venture Capital,” *BusinessWeek online*, July 24, 2006.

²³ “Foreign Investors Weigh Property Curbs in China,” *Wall Street Journal*, July 26, 2006, B6.

American venture capitalists put \$100 million into China-based start-ups focused on alternative energy, double the investment in the period a year earlier.”²⁴

There are also some strong signs that other developing economies, such as South Africa and Latin America, are now targeted as the new frontiers of private-equity capital. Surprisingly, South Africa now ranks third as a host after North America and Israel when the stock of private-equity investment is measured as percentage of GDP (at the end of 2005). Blackstone Group, Bain Capital and KKR are reportedly bidding on a big retail chain Edcon (Edgars Consolidated Stores) that has over 900 stores across southern Africa and a market value of about \$2.6 billion. The *Economist* describes these private-equity investors as “far-flung barbarians.”²⁵ This may not be a surprise, since South Africa is also a nation of the British Commonwealth, with well-developed financial markets and capitalist institutions. Private-equity multinationals are thus strongly drawn to Anglo-American countries. Israel, too, is closely aligned with the Anglo-American world.

It should be noted in passing that it is phase-2 countries--not phase-1 countries, that are likely to experience financial crises, as was the case with East Asia in 1997-8 and Russia and Latin America in the 1980s, particularly when some phase-2 countries are still in their early/immature stage of financial integration into global capitalism and not well equipped with strong capitalist institutions.

Phase 3 countries are in a good position to host foreign private-equity firms as well as to set up their own counterparts. The U.S. and the U.K. lead the world, along with other advanced Anglo-American countries (Canada, Australia, New Zealand)²⁶. On the other hand, Germany and Japan have been somewhat less enthusiastic about the arrival of buyout funds. Their financial markets and corporate governance systems have long been dominated by banks (universal banking in Germany and the main-bank system in Japan). However, they, too, are nevertheless increasingly entering the private-equity industry.

A recent episode in Germany illustrates this trend. In April 2005, Franz Muntefering, then the chairman of the governing Social Democratic Party, branded private-equity investors as “locusts.” His remark, however, ironically served to educate local investors about this new financial business and to help it catch up and grow. In August, Angela Merkel’s cabinet approved Germany’s first law to promote private-equity investment, which made private-equity funds qualified as limited partnerships with a lower tax rate instead of as investment funds. Indeed, the locust incident appears to have popularized private equity in Germany: “In the first half of [2006], the number of private equity

²⁴“A Light Bulb Goes on, and China Starts Thinking ‘Alternative Energy’.” *New York Times*, Jan. 19, 2007,

²⁵ “Private equity: New gates to storm,” *Economist*, January 20, 2007, pp. 84-5.

²⁶ Australia, for instance, seems whole-heartedly embracing private equity. In fact, Australia pioneered a new privatization form of investment in infrastructure (such as highways and airports) between state and local governments and pension funds, which soon involved private investors. The practice has recently spread to the United States where some states and cities were able to lease public properties to private investors. Infrastructure investing is attracting private-equity groups because of “the predictable cash flows, the limited competition, high barriers to entry and regulatory protection.” (“The popularity of infrastructure investing,” *Economist*, January 20, 2007, p. 83).

transactions in Germany nearly doubled from a year earlier, to 106 from 54. The value of the deals was 20.8 billion euros, or \$26.3 billion, up 51 percent from a year earlier.²⁷

Japan was once known for its protectionism against outside capital. It is now open than ever, however, and M&A deals are booming with an eye to promoting management reforms and exploiting scale economies. Companies with undervalued shares feel threatened by hostile takeovers, and even seek the help of buyout funds. As a result, domestic and foreign buyout funds targeting Japanese companies have increased. Their capital is estimated to stand at more than Y2 trillion (\$17 billion). Texas Pacific Group, for example, expects that as many owner-managers who built their businesses during the high-growth period from humble beginnings are retiring soon, good M&A opportunities will emerge in the consumer-related, electric machinery and financial industries. This American private-equity firm sets aside \$1 billion annually for its investment chest in Japan.²⁸

The opportunities for foreign private-equity funds to make deals in Japan seem abundant, now that *keiretsu* (postwar industrial conglomerates) have started to break up. Corporate reforms are in progress, and the acquisition market has been liberalized, allowing “triangular mergers” in which the shares of a foreign company that buys a Japanese company as its subsidiary are exchanged for the existing shares held by the stockholders of the acquired company. Precisely because of the foreign threat of takeover, however, the Japanese companies themselves are consolidating, thereby warding off the foreign invasion. The Japanese themselves are quickly learning the tricks of the LBO game.

5. Concluding Remarks: Structural Differences Matter

Venture capital and LBO businesses have taken root first in the U.S., and are spreading to other countries. This is the latest business innovation in the arena of global corporate finance and governance, along with hedge funds that are increasingly tying up with private-equity firms for risk dispersion. Venture capitalists helped push the frontier of high-tech entrepreneurship in the information-technology-based industries, first in America’s Silicon Valley during the dot.com boom of the 1990s. Private equity has created an entirely new class of investors who are willing to make higher-risk, higher-return investments than public equity. The demand for such investment opportunities has risen particularly from institutional investors who are no longer satisfied by conventional returns on stocks and bonds--and from wealthy individuals who can afford higher risks and losses. Private equity has set a new standard of value creation for investors by compelling management to perform more efficiently, hence more profitably, for business owners. At the same time, however, there is danger that because of the very nature of leveraged financial engineering, the companies are exposed to the greater risks of default and potential bankruptcy than ever before. This leads to a divergence between market and national interests.

²⁷“The buzz on Germany private equity,” *International Herald Tribune*, Oct. 21-22, 2006, p.11.

²⁸ “Rush of M&As reflects new dangers, opportunities,” *Nikkei Weekly*, Nov. 20, 2006, p. 1, p.3.

This paper considers how private equity as the latest financial innovation occurred most successfully in the U.S. and has been spreading to the rest of the world. In the process, U.S. –and European—private-equity firms thus have turned into the new financial multinationals. These multinationals are venturing out in a direction from advanced to less-advanced countries. Private equity has therefore emerged as a *new format of international capital flow*—just like, and in addition to, the conventional formats such as foreign direct investment (with its variants, e.g., whole ownership, joint ventures, greenfield investment, and mergers and acquisitions), portfolio investment, bank loans, and intra-company finance. In short, capital thus does not flow in vacuum. The flows are distinctly differentiated in terms of formats. This is, indeed, quite contrary to the assumption widely accepted in neoclassical economics that capital flows “unpacked” smoothly—without any specific formats.

No wonder, then, neoclassical economists are accordingly puzzled by a relatively small flow of capital from rich to poor countries despite of the latter’s supposedly much higher marginal productivity of capital. This puzzle is known as the “Lucas-Schultz” paradox (Lucas, 1990; Schultz, 1964). One explanation of the paradox is given in terms of institutional factors, particularly in terms of government policies and private property protection (Harberger, 1998; North, 1999, De Soto, 2000). Lothian (2006) empirically—i.e., in terms of econometrics—found that policies such as “pursuit of price stability, fewer direct interventions and sound institutional structures” are the key determinants of capital flow to poor countries. True, policies do matter. Financial transactions entail many more complex problems of asymmetric information (adverse selection and moral hazard) than trade in tangible commodities, the problems that can be alleviated by appropriate policies and institutional setups.

However, another factor—and perhaps an even more fundamental reason—exists. It involves *differences in structural market characteristics* that are inherent in and specific to the different stages of financial development *pari passu* with economic growth, the stages that can also explain a path of institutional development. In this regard, the new “flying-geese” theory of financial (“money sector”) development is introduced as a reformulation of the original theory that applied only to industrial (“real sector”) development. The new model explicitly recognizes these structural differences in stages of financial development and treats them as its primary explanatory variable. It demonstrates that *developing countries at lower stages of financial development have basic structural incongruities with certain forms of capital (such as private-equity buyout funds and hedge funds) earlier innovated in advanced countries, especially in the U.S.—incongruities that cannot be rectified by policies alone.*

In sum, combined with the propositions (i) that cross-border capital flows take place in differentiated specific formats, and (ii) that capital moves, overall, from rich to less rich countries, (iii) the proposition that countries are at different stages of financial development means that the structural differences caused by different stages of financial development can go a long way in explaining why the capital (say, in the form of buyout capital) does not flow so smoothly from rich to poor countries as posited by neoclassical economics.

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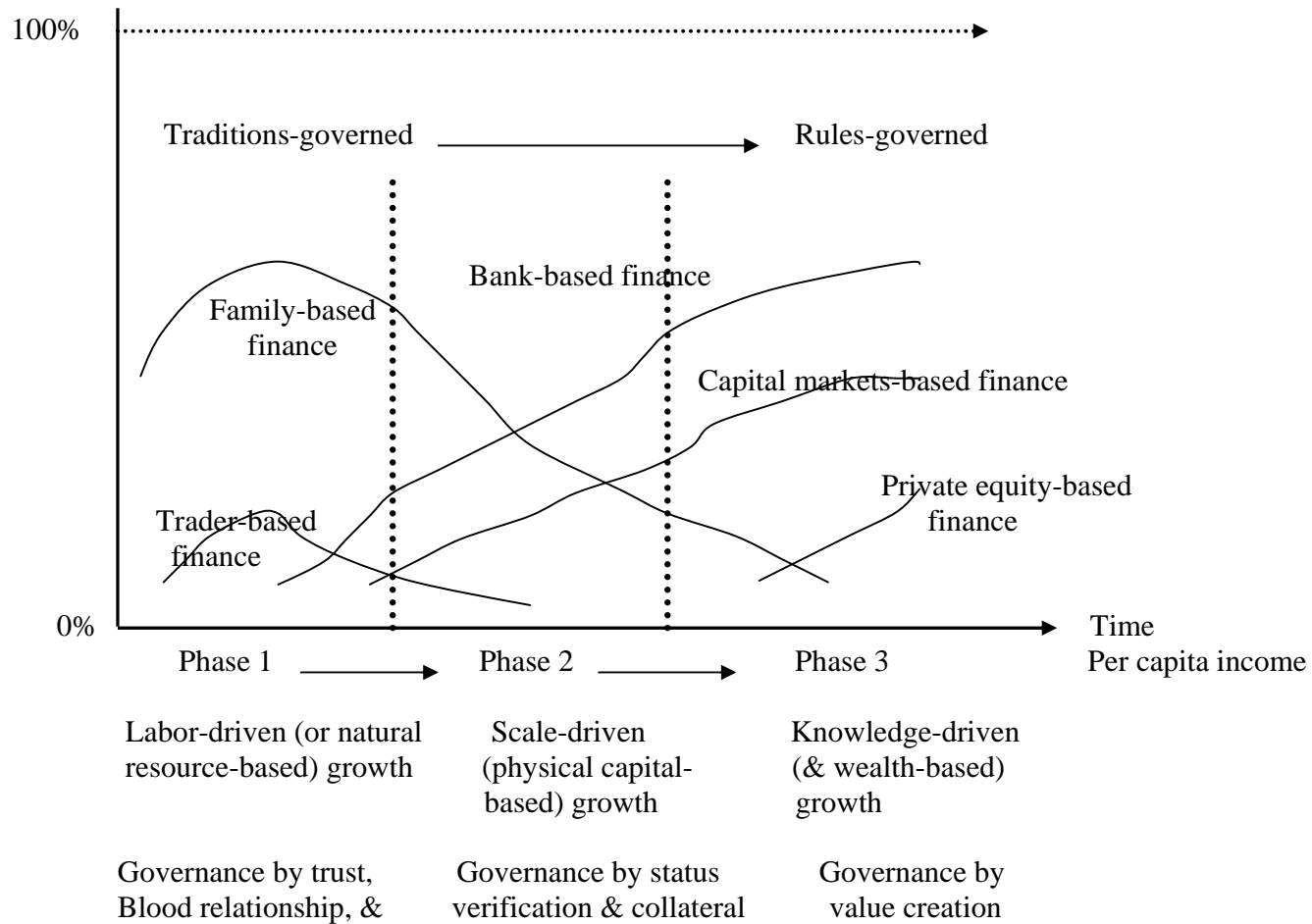
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Figure 1 Evolutionary financial development and governance structure, flying-geese style



Note: Not drawn to scale, only schematically shown.

