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Private Equity in Developing Countries
Way out of the crisis – or obstacle?

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Private Equity in Developing Countries

Way out of the crisis – or obstacle?

The financial and economic crisis has led to a decline in foreign direct investment (FDI). So both UNCTAD and the G20 are arguing all the more strongly in favour of an investment-friendly policy and warning against protectionist trends (e.g. UNCTAD 2009 and G20 2009). At the same time, private-equity firms are claiming that they are honey bees investing equity and plugging gaps in credit financing (BVK 2008).

In economic development terms, investment incentives must be weighed up against the need for regulation – which may also hamper, or seem to hamper investment. A look at the business model of private-equity firms and at the consequences of private-equity investment may provide pointers.

1 "Time is money" and "Cash is king": the business model of private-equity firms

Private-equity firms acquire a stake in companies in order to sell them – or shares in the companies – again, usually after four to seven years, either to another investor who fits the company or by way of an IPO. The aim is to increase the profitability of a company within a certain time horizon in order to boost its re-sale value. Private-equity firms aim at an above-average return – a super return. To this end, they exert active influence on a company's management. They get paid for their commitment in both consultancy fees and special dividends. Any business parts that do not fit into their concept are discarded.

Private-equity investment is more short-term in character and, hence, more volatile than FDI: "Investments by private equity firms are often more akin to portfolio investment than to FDI, in that they tend to have relatively short time horizons." (UNCTAD 2007: xvi)[3] At the same time, they exert a much stronger influence on companies than portfolio investment: "*Here, the principle of buying shares and other fungible securities in order to sell them at a higher price is being extended to include whole enterprises*." (Köppen 2007: 55)

Emerging economies in Asia, Latin America, Africa or the former Soviet Union and Russia fit the concept of private-equity firms, since they are growing fast.[4] In

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[3] Private-equity firms are keen to refer to their investments as being long-term in nature. This is true if compared with day trading, say, but not if compared with FDI. Statistically, though, private-equity investments fall under FDI – despite shorter holding periods – wherever their share in a company exceeds 10%.

[4] Although the share of emerging markets in private-equity activity is low, viz. below 4% between 1990 and 2008 (World Economic Forum 2009: ix), it has risen substantially in recent years. At the same time, the influence of private-equity firms on companies, economies and policy-making of the country concerned can be considerable.

their cases, the pressure on returns exerted by private-equity firms is greater than in industrialized countries. This is because investors expect a higher risk premium. The crisis has aggravated this: where investors in emerging economies expected a risk premium 6.7% higher than in industrialized countries in 2008, this figure in 2009 is 7.2% (EMPEA 2009).

The crisis has led to a fall in investment by private-equity firms as well – on the one hand. On the other, they are adapting their business model: until now, private-equity firms have strongly leveraged their investments via credit (*financial engineering*). Now that credit is scarce and expensive, they are exerting more influence on business processes (*operational engineering*) – also via larger holdings and a stronger negotiating position. Moreover, companies can be had at fire-sale prices in the crisis.

2 Honey for whom? – Consequences of private equity

Private-equity firms' business interest is in obtaining the highest possible profit for fund managers. On this point, the effects are without doubt positive. But is private equity also a suitable sponsor of development? Let us take a look at the consequences of private equity for companies and economies.

Corporate governance

Private-equity firms invest, first of all, where they expect above-average returns. So, for every company scrutinized and invested in, there are ten more that are thought to be unsuitable (Berens 2005: 115). After an investment decision, structuring commences in order to obtain that super return within a certain timeframe. This means that long-term investment can suffer, and the sufferers are not fund managers and money providers, but employees and, often enough, suppliers and customers as well. Once private-equity firms in India discovered micro-credit institutions as investment targets, they jacked up interest rates (Singh 2008: 37).

Likewise, high consultancy fees and special dividends can hamper investment: they are not only expensive, but also restrict the options available for reinvesting corporate profits. Even worse: excessive dividends, like excessive credit financing, may increase the risk of insolvency (Schmidt/ Spindler 2008: 76ff).

The consequence: instead of promoting private investment, private equity may retard it. If the company's value is also raised by reducing wages, the workforce pays, e.g. by making wage sacrifices or with extended working hours.

National finances

Since private-equity firms in many places enjoy tax breaks, the taxation authorities lose out on income. Despite commercial activities, and although private-equity firms like claiming that they have an entrepreneurial heart, they are classified as asset managers, and income from capital assets is usually subject to much lower taxes than commercial income. The capital gains earned when a company or shares are sold are often completely tax-free. On top of this comes tax planning, when private-equity firms include loans in order to depress taxable profit. Finally, since private-equity firms frequently have their registered offices in tax and regulatory havens (secrecy jurisdictions), they circumnavigate the taxation authorities almost entirely. The same applies to commitments in special economic zones with liberal fiscal and legal conditions (Singh 2008: 32). At the same time, the state shoulders the risk of any additional costs: if a company has to file for insolvency, the state may be called in to save the day, while any profit has already been privatized by way of special dividends (Schmidt 2008: 76ff).

The bottom line: both lost income and the risk of additional expense can be a drain on state budgets. This boosts public poverty and restricts the leeway for public investment.

Market clout

Private-equity firms operate in a close interaction with other financial players. They combine the monies of major institutional investors, like insurance companies or pension and sovereign funds. Hedge funds, too, invest in private-equity firms and assume the role of lender instead of banks – all the more so, in view of the credit crunch (Singh 2008: 11). Also, private-equity firms are starting to diversify their portfolios. They are extending them, for instance, to include hedge funds and investment in real property (Riecke/ Maisch 2008: 22).

In this respect, market clout comes both from the volume of the capital to be moved and from the ability to engage in speculative dynamics. The Altira Group advertises agro-investments, for example: dwindling land surface and suitable soil, coupled with a rise in demand from population growth, will lead to rising prices. Which is why, it is said, agro-investments are the premium investment class (Altira Group 2008: 38). So, if several players interact, relying on rising agricultural or food prices, this boosts prices: for investors a gain, for development policy a disaster.

Market clout is due not only to (1) the volume of the capital to be moved and (2) the ability to engage in speculative dynamics, but also to (3) political connections. In May 2007, for example, the sovereign fund "China Investment Corporation" gave US$ 3bn from its foreign-currency reserves to the private-equity giant Blackstone, so that the Chinese government now has a direct interest in Blackstone's success. The Altira Group has close ties to Rwanda's president Paul Kagame. He, in turn, loves to refer to himself as Corporate Executive Officer (CEO) of his country (Focus 49, 2007).

The upshot: the market clout of private equity must not be underestimated in view of their involvement with other players. Market clout and speculative dynamics harbour the risk that investment may serve the one-sided interest of investors – at the expense of development.

3 Investing in development: Proposals for the way forward

Firstly, private equity can block both private investment and public investment. Secondly, private-equity investment often brings a one-sided benefit for investors – at the expense of other stakeholders. To enable private equity to make a positive contribution, in the form of venture capital for example, in providing start-up funds for growth sectors, we need regulation – legally binding rules that are translated into practice. All should benefit from a growth sector like renewable energies. In other sensitive areas, like food, water and financial services, public investment may be better suited.

Regulation
As the G20 sees it, all system-relevant players should meet transparency criteria. Yet transparency is not sufficient – nor is it clear which players are system-relevant. All private-equity investment has economic-policy consequences that may be desirable or undesirable, meaning that it requires regulation. This includes:

- Extending co-determination:
  Corporate decisions, like capital increases, dismissals and the sale of companies or parts of companies, must be taken in the framework of co-determination of employees and other stakeholders.

- Permanent restrictions on credit leverage and/or abolition of fiscal incentives to incur high levels of debt, limits to dividend payouts:
  The risk of insolvency and bail-out by the state must be minimized.

- World Bank institutions, like the International Finance Corporation (IFC), regional development banks and the Multilateral Investment Guarantee Agency (MIGA), as well as any negotiations in the World Trade Organization (WTO) must be placed at the service of development:
  IFC, regional development banks and MIGA participate in private equity with their own funds and guarantees. Yet most private-equity firms are registered in secrecy jurisdictions (Fried 2008: 15f). This runs contrary to development. Instead of safeguarding the interests of fund managers and investors, it is precisely the interests of other stakeholders that must be protected. The WTO must agree on quality standards for private equity and promote adherence to them, instead of dismantling regulations (Krüger/ Reiners 2005: 41ff).

Public investment rather than public poverty
In many sectors, public investment can be much more suitable for overcoming poverty: the supply of food and water, but also financial services, will not usually withstand the pressures of a super return. Public investment is also particularly suitet to deal with crises: it can be channelled in a targeted fashion into labour-intensive sectors and promote structurally weak regions (Arbeitsgruppe Alternative Wirtschaftspolitik 2009: 130-136). This being so, public funds should increasingly flow into public investment, instead of promoting private equity. Tax privileges for private equity must be abolished.

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