Do emerging economies have the right stuff?

Part Two of Joe Bartlett’s in-depth analysis of the prospects for private equity in emerging economies outlines an action plan designed to create the right environment to stimulate a viable venture capital investment culture.

In a number of countries, it makes no sense at all to talk about “venture capital” in the sense we are using the term, because the fundamental political and cultural elements are missing.

To be sure, the entrepreneurial spirit exists in any state (no matter, for instance, how corrupt a market may be: small shop keepers and, indeed, opium growers are entrepreneurs). But it is naïve at best to talk about venture capital in an ordinary sense if you are looking at a state that is pervasively corrupt or violent, governed by a government that cannot govern and with a significant element of population alienated by the loss of tribal structure and without any replacement by a stable, modernised ethic and culture.

Venture capital needs a secular state, relatively stable representative government, independent judiciary, constitutional guarantees of free inquiry, public expression and the ownership of property to start, let alone flourish. Absent those betterments, venture capital is unlikely to prosper because, by its nature, the process involves high risk/high reward investing by both the providers of capital and of the so-called sweat equity (those entrepreneurs who invest their talents at sub-optimal pay in anticipation of significant returns via their shareholdings).

The assumption in this second part of our analysis, therefore, is that the “modernisation” processes in the target emerging markets have been completed to a satisfactory cultural and political level. As a result, the issue under review has to do with other missing elements, some not so obvious, which block a flourishing entrepreneurial economy.

One such sine qua non is adequate legal protection for both debtors and creditors in the event of business failure. Without the protection of limited liability, it is unrealistic to expect capitalists to invest in high risk/high reward situations. In some jurisdictions, a company’s owners are responsible if bankruptcy ensues; they must dig into their pockets if and as a business shuts down, and this in general is a risk that cannot be adequately insured against. Those jurisdictions are essentially off limits to venture capitalists. Equally, in the absence of a well-structured bankruptcy code, investment, even in the form of credit, is often unavailable; lenders will not participate in a venture where they cannot collect a fair proportion of the debtor’s remaining assets if the business fails.

Further, it is hard to attract entrepreneurial capital in jurisdictions where employees are guaranteed lifetime
jobs. The typical graph of a venture-backed firm in the United States, even one that winds up being eminently successful, is an upside down bell shaped curve, the firm going through a period of disappointing results and missing forecasts. The ability to downsize and weather the storm is central to the underlying economic analysis. An economy heavily weighted with socialist principles is not likely to attract risk takers. And many newly modern states are, or at least have been, socialistic.

The experience of the Enterprise Funds

Venture capital in the United States has been mainly a product of private sector initiatives. However, in emerging markets, where private capital is scarce, it is likely that the process will be jumpstarted by state supplied infusions of capital, direct investment or guarantees, from the incumbent government or supranational organisations. It is further likely the initiatives will take their cues from existing programmes, such as the Enterprise Funds and the Community Development Venture Capital Alliance of the US.

When the iron curtain fell, the US Congress set up a series of investment funds to sponsor entrepreneurial activity in the newly-liberated Eastern European countries, the total capital amounting to $957m, distributed amongst ten nation-specific funds. The record of these funds deserves special attention. With the exception of the American Enterprise Fund in Poland (which entailed the largest commitment, other than Russia), the investment performance of the portfolios acquired by the ten funds (Poland, Hungary, Slovakia, Bulgaria, Baltic States, Romania, Albania, Russia, Central Asia, and the Newly Independent States) has been disappointing by US standards. Of the $740m of the $957m that actually has been committed, as of 30 September 2000, $418m has actually been spent and the value of the resultant portfolio was given at approximately $194m, or 45 percent of invested capital, a number which would be somewhat higher if funds spent on technical assistance were not included in the calculation.

As one might imagine, the more developed the country, the more successful the investment track record. The Polish Fund is actually up, largely as a result of the vibrant Polish economy and secondly, the fact that a seasoned executive from a veteran VC fund took charge from the beginning. Whatever their collective performance thus far, John Birkelund in the most recent survey of the Enterprise Funds, reasons that the initiative has been, if viewed on a macro basis, successful. The Funds’ activities have stimulated $500m in private investment, supplementing the original government capital; and, upon the occasion of company sales, capital has been recycled into the region. This led Birkelund to conclude that “more than $1.3bn in private sector investment” has been stimulated.

Birkelund is also pleased with the “establishment of experienced investment or loan organisations in the host countries, with offices now staffed largely by local personnel.” As he puts it: “The success of the Enterprise Fund experiments has rested chiefly on three factors: the composition of fund boards and their selection of management, the provision of sufficient capital to take advantage of local investment opportunities and cover operating costs, and management’s concentration on developing individual business rather than giving general advice or producing consulting studies.

In the US, harnessing the power of venture capital as an economic development tool in areas underserved by traditional venture capitalists has been coordinated by a non-profit agency: The Community Development Venture Capital Alliance (CDVCA). The relatively new field of community development venture capital (as mediated by the CDVCA) has as its goal the use of the tools of venture capital to promote business growth in economically distressed rural and inner-city areas.

Only a few CDVCA member funds existed in 1990; today there are more than 50 in the US and 10 overseas. The US based funds now have an estimated $300m under management. Kentucky Highlands Investment Corporation (KHIC) is one of the nation’s oldest and best-established CDVC funds, having invested more than $65m since inception in more than 145 companies, which in turn have created 8,000 jobs in Western Kentucky.

A realistic action agenda: meeting the risks head on

1. Ignorance. The likely domestic participants in emerging markets are unlikely to know “how to do” venture capital. They are not trained to understand the metrics of investing in this asset class. They do not rub
up against people who, by pooling their knowledge, can help them figure out how to do it right. They may be familiar with standard, anecdotal texts but do not have enough hands-on instruction so as to be able to internalise the lessons to be learned.

The most direct approach is to promulgate educational programs designed to familiarise entrepreneurs, managers and investors and other interested parties (as well as intermediaries and regulators) on “how it is done” in the mature VC markets such as the US. There is also the opportunity for distance learning, which combines academic experts with experienced practitioners who can package academically valid, skills-oriented exercises, to bring through the use of internet-enabled diagnostics and streaming video technology, the best and brightest pedagogues to anyone with PC access, available 24/7.

2. Lack of standardisation. Venture finance can be particularly advantaged by standardisation of transactional documents and processes because of the sector’s sensitivity to the “friction” occasioned by high transactional costs. If deals can be memorialised, with all the bases covered, as well as sensitive to the nuances of often complex tax, securities law and other regulatory imperatives, the finance end of the business becomes at last efficient. And that’s what standardisation is all about.

- Legal risks. One of the main elements of risk in venture investing in those jurisdictions outside the handful of democracies which enjoy reliable and fully built out systems of legal rules is the risk of eccentric and corrupt dispute resolution and contract administration. If the parties to a venture transaction (whether investors, customers or vendors), cannot rely on enforceable agreements with predictable consequences because of a bankrupt (or nonexistent) legal code and framework, then the “crapshoot” element of the process introduces unsupportable risk.

In that context, it has been suggested that the legislatures in emerging states should adopt verbatim the Delaware General Corporation Law if the state wants to attract private equity investment. Arguably the objective can be accomplished without requiring what some would perceive to be an heroic act of self-abnegation. A system could be instituted that takes advantage of current trends in the law to administer contracts, wherever executed and regardless of the parties’ respective residences, by adopting one of two sets of internal legal codes, either UK or New York. The contract for the sale of, say, airplanes or the construction of a paper mill may be between an Indian vendor and Egyptian customer; if competently prepared, however, the agreement will contain choice of law and submission-to-jurisdiction clauses which specify UK or NY rules. Thus players in major commercial transactions are accustomed to create in effect their own body of law, to be enforced by a consensually selected body, which applies the rules predictably, competently, neutrally and honestly.

One solution that takes advantage of well-established principles and methodologies is to adopt the long-growing trend in venture finance to create an interpretation and enforcement body composed of retired or part-time judges. These would be recruited to act under the supervision of Non Government Organisations (NGOs) meeting in Delaware (if the issue is corporate governance) and/or in New York (if the issue is contract interpretation). The body will be formally constituted, with a set of procedures mimicking, say, the United Nations Commission for International Trade (UNCITRAL) Arbitration Rules. Delaware law is imported to regulate the relationships between shareholders and directors; and the Uniform Commercial Code governs the remaining aspects of the transaction. All any emerging nation has to do, then, is to agree formally, as the price for venture investors “coming to their party”, to honour and enforce the rules borrowed for the purpose.

If a state buys in, and continues to buy in, the activity can proceed with the legal risk minimised. There will always the possibility of a subsequent government going back on its word. But the ability to police that wrong is obvious: withdrawal of the facility if, as and when a state reneges. And barring a renege, the application of rules and enforcement machinery, which have been refined in the US, the UK and elsewhere extensively during the post-war period, should limit unnecessary risks of judicial eccentricities.
3. Lack of liquidity. One obvious risk of private equity investing generally, and venture investing in particular, is that the investors can get in but they can’t get out. Trade sale is always a possibility of course, but, in numerous instances, a sale may not be sufficiently attractive to make the risk/reward equation work. What remedies are there to this?

A global IPO marketplace

Here, the first question is whether, with some significant effort, the prospect of an international marketplace for IPOs can be constructed. Arguably it can, given the appropriate amount of thought and energy. In the first place, we are moving in that direction, with the slow but steady growth of Nasdaq: the goal seeming to be the creation of one huge Nasdaq market (or series of linked markets) and the ability of issuers to multi-list. For venture capital, I am advocating the adoption of a universal listing standard, to go with the adoption of the UCC and Delaware law. And, part of the standard would be to take into account and mitigate inherent exogenous risks in emerging markets. The accounting requirements would be with US GAAP (or its successor), plus governance principles borrowing from current Nasdaq listing standards, as they are being augmented in light of the weaknesses revealed recently, and seemingly continually, in the US markets.

Universal listing standards, in terms of number of shares and size of the company, are not far away from what Nasdaq is attempting to create, as it advances its universal vision. And, the idea of an NGO to administer the process is consistent with its supra-national flavour.

Syndicated pools

This international IPO construct is one part of the liquidity project. Another vital component I foresee must be the creation of syndicated pools to provide exits for the security holders in those companies which, while successful, are too small to participate independently in IPOs and for which a trade sale is not (yet) an attractive option. Arguably one can syndicate almost any category of security, in the right environment and with the right metrics. Coupled with the inauguration of universal accounting and legal standards, and the enhanced governance standards described above, the securities of participating issuers will become eligible, if underwritten...
by a neutral body, for deposit in centrally administered and underwritten syndicated pools. These would resemble unit trusts or exchange funds. The administrator is, again, a creation of contract, employing neutral experts recruited to apply the appropriate underwriting standards serving as the equivalent to ratings.

Once the securities of a given issuer are rated as eligible, the holders may deposit the same in exchange for cash and/or notes. The appropriate pools (which might be segregated by region or, if large enough, by country) then sell certificates to the public, perhaps arranged in tranches or strips, much in the way the securitisation of so many other asset classes is implemented in today’s market. The advice I am getting at the moment is that, in order to take advantage of the mathematics of diversification, each pool would have to be quite sizable, say $500m to $1bn in size, but the need and opportunity seems so great that a series of billion dollar pools should not be a major obstacle.

The point of all this is to introduce capital into the process in two ways. First, through venture investing, meaning equity capital supplied by the private markets and marshaled through private equity funds sponsored by the conventional (and perhaps some less conventional) sources. In an ideal world, no additional incentives would be required from the public sector at the initial investment stage, except perhaps exemptions from local taxation.

Government participation could then, secondly, be limited to that phase of the process where it can have the maximum impact and be least susceptible to unintended consequences. That is to say, the pools described above, which enforce market disciplines through the neutral administration of strict underwriting standards, could be credit-enhanced so as to reduce risks, through government-sponsored insurance.

For purposes of illustration, assume the local government assures the pool that each investment in its jurisdiction will return at least 20 per cent of its cost. Absent a truly horrific default experience across the board, the certificate holders in the pool should at least get their capital back, if only eventually. Again in an ideal world, insurance could be provided commercially but sovereign faith and credit could go a long way towards leveraging the amount of capital available at the back end. If Turkey, for example, wanted to attract venture capital, one price would be sovereign participation which backs up the reinsurance facility, pro rata to the amount of the activity the Turks are willing to solicit. This, in turn, enhances the rating and liquidity of the pool certificates in the public international markets.

Post script - and an invitation

The foregoing material is neither abstract nor theoretical; I am currently working on two assignments, in each case advising on the feasibility of what will be called ‘venture capital’ funds focused on emerging markets. Whether either becomes a reality is currently uncertain, however, the current sponsorship in each case is distinguished and much is likely to depend on the feasibility of realistic exit mechanisms, including particularly the syndicated pool structure. The challenge is to collect and analyse informed suggestions (and constructive criticisms) of the syndication thesis. What are the practical problems and opportunities? What will potential certificate however require prior to investing? What maximum level of sovereign support, insurance, and guarantee will be feasible? Who will administer the underwriting standards for acceptances into a pool and, in accordance with what criteria?

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