

THREE ROLES FOR THE PRIVATE EQUITY MARKET IN FOREIGN INVESTMENTS: COMMENT ON MAILANDER'S "SEARCHING FOR LIQUIDITY"

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INTRODUCTION

Christopher J. Mailander's discussion of the private equity market identifies what is, by most measures, the central concern of equity investors in foreign enterprises—how to get out of a foreign investment after getting in it.¹ His strategy for resolving this problem is to make available the liquidity necessary for an investor to exit a foreign investment by tapping the United States capital markets. This

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1. Christopher J. Mailander, *Searching for Liquidity: United States Exit Strategies for International Private Equity Investment*, 13 AM. U. INT'L L. REV. 71 (1997).

can be accomplished, according to Mailander, through the use of American Depositary Receipts (ADRs)² on the private equity markets and through the private equity markets themselves.³ It seems evident that the capital markets have adopted this strategy and that the worldwide market growth in ADRs, as well as Global Depositary Receipts,⁴ strongly supports this trend.⁵

In this brief comment, I propose to extend Mailander's analysis by defining the categories of actors in private equity markets. The three categories of actors that I suggest have somewhat different incentives and strategic aims. These actors tap the private equity market in different ways and at different points in the cycle of foreign investment. Finally, I suggest that the varying moments at which these categories have an incentive to tap the private equity markets indicate when ADRs make sense as a vehicle for structuring a foreign investment.

I. THREE CATEGORIES OF PRIVATE EQUITY MARKET PARTICIPANTS

Consider the hypothetical situation of a state-owned mineral company in a Central Asian republic, such as Kazakstan, undergoing privatization. The privatization, in order to be successful, will have to perform several distinctly different functions. First, the company will have to attract capital from abroad for the purpose of modernizing its facilities. Second, the company will have to attract foreign management skills in order to utilize the new equipment, exercise adequate financial and other internal company controls on cost and quality in production, and have the necessary expertise to bring products to foreign markets. Third, the company will often have to negotiate a series of difficult political problems internal to the country, including

2. See *id.* at 83-85 (describing American depositary receipts or ADRs generally).

3. See *id.* at 80-81 (describing the utilization of the United States capital markets for exiting foreign investments).

4. See JOHN DOWNES & JORDON ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 220-21 (4th ed. 1995) (defining global depositary receipts as receipts "for shares in a foreign-based corporation traded in capital markets around the world").

5. See *Wall Street's Global Equity Boom*, *EUOWEEK*, Nov. 1996, at 47, para. 15, available in *LEXIS*, News Library, Abisel File (stating that through September 1996, 151 ADRs were created in 46 countries).

terminating large numbers of staff and accommodating the state's desire to retain residual interest and control in the enterprise. In addition to managing these political problems, the company will attempt to influence the climate of the state's foreign investment laws to make it favorable for repatriating profits, moving capital in and out, and generally fostering internal financial conditions such that foreign capital would be willing to enter the country in the first place. Any of these three functions provides a daunting task in many places throughout the world. The aggregate effect of the different functions makes it likely that the sources of external capital for the privatization project will not be able to operate merely as passive investment capital.

The privatization hypothetical is an extreme case in that it describes a country with essentially no financial infrastructure or financial markets, but illustrates a problem pervasive even in less extreme cases. An investor group entering under such circumstances must be prepared to handle an illiquid, even if profitable, investment for some significant period of time and must address the need for active management of the investment. These circumstances often involve direct management of the enterprise itself.

Mailander correctly observes that such a situation is analogous to domestic venture capital situations.⁶ In this situation, the venture capitalist is not merely the supplier of capital, easily invested and easily withdrawn. On the contrary, the venture capitalist is frequently an investor in an illiquid investment in which the investor must participate directly in management to bring it to profitability. In this sense, the hypothetical foreign investment is active and managerial, classical venture capital. I would characterize the investment, however, as "analogous to" rather than an "extension of" United States domestic venture capital. In practical terms, the political issues involved in working abroad in countries with no financial or legal infrastructure in such areas as bankruptcy, creditors' rights, or capital markets, introduces problems for which the domestic venture capital legal and financial "tool-kit" may have little meaning. The problems, in a deep sense, are the same, but the solutions often are not.

6. See Mailander, *supra* note 1, at 75-76 (noting that investors will structure their investment to give themselves more control of a company).

A. THE FOREIGN ENTERPRISE ITSELF

This hypothetical suggests three categories for accessing capital markets, specifically, private equity markets. The first category is the foreign enterprise itself, seeking investors from outside the country. Typically, internal sources of investment capital are either unavailable or available only at economically infeasible interest rates. As Mailander notes, the foreign enterprise, or those individuals conducting its privatization, need capital, but have no realistic possibility of entering the United States public markets to issue equity.⁷ The process is difficult even for long-established foreign enterprises in developed countries because of differences in accounting procedures, regulatory concerns, and numerous other problems. This forces foreign enterprises back to the private equity market and to the issue of how passive or active any potential investor will be in managing the investment.

B. THE UNITED STATES INVESTOR GROUP MAKING A PRIVATE EQUITY INVESTMENT

The second category is the United States investor group considering making a private equity investment in the foreign enterprise. Even if the United States investor group believes the underlying business opportunity offered by the foreign enterprise is a good one, a wide range of tasks must be performed if the opportunity is to be realized. The United States investor may necessarily be the one to perform these tasks. As a consequence, although investors may structure their investment through a private equity market that may appear to be a means of primarily passive investment, the need for active management may very quickly assert itself. Considerations of risk, control, and liquidity, appropriate for a venture capital type investment, are therefore on the table from the very beginning for the United States investor. Indeed, the lesson arising from the currency crisis in South Asia suggests—insofar as the crisis is in part the result of loose credit by distant, poorly informed, and passive financial markets—that nothing substitutes for on the ground supervision. The economies of Indonesia, Malaysia, the Philippines, and Thailand

7. *See id.* at 102 (stating that only a small number of foreign companies have received private equity capital during developing years).

might have been more suited to active, venture capital style investments, rather than passive, remote investments. Whether or not the increased monitoring costs of an active, venture capital style investment would have been worth the expenditure in South Asia remains, at this writing, necessarily unanswered.

C. THE UNITED STATES INVESTOR GROUP LOOKING TO EXIT THE INVESTMENT

The third category is the same United States investor in a foreign enterprise now looking to exit the investment. This is the "exit strategy" scenario that Mailander discusses extensively.⁸ In this context, the role of the private equity market is quite different than in the first two categories. In this category, the function of the private equity market is not to structure an in-bound foreign investment by a United States investor that will be risky and illiquid. Rather, the function of the private equity market, from the standpoint of the exiting investor, is to discover the means to free the investment and make it liquid. As Mailander explains, the private equity market in this scenario functions to allow the investment to be passed along, often with the help of ADRs, from the original United States investor to other investors.

II. DIFFERENCES IN INCENTIVES

The picture that emerges illustrates the process of tapping the private equity markets in order to "round-trip"⁹ an investment. The private equity markets are tapped first by the foreign enterprise or its promoters and second, albeit simultaneously, by the United States investor in undertaking the business opportunity. The private equity markets are tapped third as the exit strategy for the United States investor seeking to cash itself out, therefore passing the investment that it has presumably developed and brought along to other investors in the private equity market. From the standpoint of the United States investor, the journey is a circle from liquidity to illiquidity and, lastly, back again to liquidity.

8. See *id.* at 78 (discussing the importance of a viable exit strategy in ensuring a successful investment).

9. See DOWNES & GOODMAN, *supra* note 4, at 494 (defining round trip trade as the "purchase and sale of a security or commodity within a short time").

It bears noting, however, that the strategic aim of each party differs as they go to the private equity markets. The parties differ over their respective attitudes toward control over the business enterprise. For example, particularly in some state privatizations, the state's purpose may truly be to unload the state enterprise into private hands, in which case it will have a concern only for the price it receives for the assets. It is far more common, however, that the foreign enterprise or its promoters seek the maximum capital they can obtain from abroad with a minimum loss of control. The concern of the United States investor is, of course, exactly the opposite of the foreign enterprise. The nature of its investment, in order for the business opportunity to have the possibility of profitability, will often be an active, venture capital style investment. The illiquidity of its investment will practically guarantee that the United States investor will seek control in many forms.

The incentive for the United States investor at the moment of exit, however, is entirely different than the incentive at its point of entry. At the investment exit, the United States investor is no longer concerned with control and cares only about price and liquidity. If the investor has completed a successful investment with the foreign business enterprise, it leaves behind a structure that should bear a more passive form of investment, with fewer monitoring costs, and thus, appropriate for equity investors investing through ADRs or other such trading instruments. If the United States investor has not completed a successful investment, it may be difficult to exit the investment at all. Both the in-bound investment and the exit strategy tap the private equity markets in some general sense. In practical terms, however, the differences in attitudes toward control and liquidity at the moments of entering and exiting produce different types of investors in the beginning as opposed to the end. As Mailander observes, both groups negotiate their arrangements in equity form. I have suggested that the difference is captured by passive investors, on the one hand, and venture capital style investors who actively monitor the investment, on the other.

III. WHEN TO USE ADRs?

This final observation is reflected in the point during this round-trip investment process at which ADRs are likely to have a role.

ADRs are a form of investment aimed primarily at passive investors for whom liquidity, or tradability, is important. The model ADR reflects an underlying investment that actively trades on some other foreign stock exchange. Thus, the ADR form will not take place primarily in that sector of the private equity market that makes the initial investment into the foreign enterprise. It is not a vehicle, along the lines of international venture capital, for making an investment in which the investor intends to engage in active monitoring and management. On the contrary, the ADR is a means primarily to allow passive investment in foreign enterprises. The consequence is that ADRs appear as part of an exit strategy rather than on the "front end" of a foreign investment by a United States investor.

CONCLUSION

Conflicts over liquidity and control are irreducible. What the United States investor desires through control is to compensate for the initial investment's lack of liquidity. Likewise, the foreign enterprise's desire to retain control in the teeth of the same demand by the United States investor cannot be papered over by any financial instrument. The financial instrument can do nothing more than reflect the ultimate compromise, the bargain, between the interests of the investor and the enterprise.

Similarly, no financial instrument, whether an ADR or anything else, can create liquidity as part of an exit strategy where the underlying investment has not reached sufficiently disciplined maturity to attract purely passive investors. An investment that is illiquid by reason of its economic fundamentals will not be made liquid by selling it through an ADR form. The investment, in whatever form, will not attract buyers seeking a liquid, passive investment. A financial exit strategy is critical in any round-trip foreign investment, but no amount of financial alchemy will create liquidity that does not exist in the first place.