Huge Reserves, Emerging Market 'Challengers' and Other Forces Are Changing Global Finance

Published : September 22, 2008 in Knowledge@Wharton

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

Rapidly developing economies (RDEs) have increasingly become drivers of change -- and sometimes disruption -- in global financial markets. That has important implications for companies in the United States and Europe as new players emerge, including sovereign wealth funds, state-controlled entities and acquisition-minded corporations.

As these groups bolster their foreign exchange reserves, they will increasingly look to buy assets beyond their borders, including controlling stakes in foreign companies, according to experts at Wharton and The Boston Consulting Group (BCG). At the same time, aging populations in the United States and in Europe will be seeking to liquidate some assets to finance their retirements. This combination of trends will present both opportunities and threats for companies in the developed world. Companies that do not run a tight ship could see unsolicited takeover bids from companies in countries with merchandise- or energy-related trade surpluses. Additionally, top executives at Western companies will need to understand sovereign funds' investment criteria and even get to know decision makers personally.

Seeds for this change date in part back to the Asian financial crisis of 1997 and 1998, says Wharton finance professor Franklin Allen. Back then, "The International Monetary Fund got many countries in Asia to do drastic things in exchange for loans," Allen explains. Most decided they never wanted to undergo such economic austerity again and they started building large foreign exchange (forex) reserves as buffers. Even countries relatively unaffected by the crisis -- such as China and India -- took the lessons to heart. Today, forex reserves for those two countries "have just become huge," he says. China now has some $1.5 trillion in reserves, up from a few hundred billion dollars just a few years ago. "India is building too -- nothing like the same scale but it is up to about $200 billion" and rising rapidly, Allen notes.

This build-up in forex reserves by many RDEs gathered momentum through export-led economic policies, particularly in Asia. Leveraging comparative advantages in labor costs and other inputs, many RDEs transitioned from command-and-control to more deregulated, market-oriented economies, though not always with private ownership. Their success helped create some large trade surpluses, often with high savings and investment rates.

Asia's long-standing "model of prosperity" has concentrated on exports, says Jeremy Siegel, professor of finance at Wharton and author of *The Future for Investors*. "Many of these countries are producing more than they are consuming and basically the government is expropriating the difference between the two. It is a mercantilist view. It is true of China and true of India."

That model has helped to create what Ben Bernanke, the Federal Reserve chairman, has labeled a "savings glut." Regardless of what happens to world economic growth this year, these trade surpluses are expected to continue to grow strongly in the foreseeable future.

Richard Marston, Wharton finance professor and director of the George Weiss Center for International Financial Research, notes another key aspect of today's global financial imbalances. "Everyone talks about the Chinese [trade] imbalances and neglects the far larger imbalances due to increases in

commodity prices," he points out. "You can see it in the Middle East, in Russia, and even in commodity producers such as Brazil. There's been a tremendous windfall due to this massive [increase] in commodity prices."

Whatever the source, the huge increase in global liquidity has helped moderate world interest rates and finance a large U.S. trade deficit and -- until the current economic slowdown -- a spending spree by U.S. consumers, who have reduced their savings rate to near zero. This is the other side of what some call a global financial imbalance: The world's richest country is borrowing from poorer nations.

Shifting Capital Inflows

Borrowing to finance the twin deficits (trade and budget) has come largely through issues of relatively low-yielding U.S. Treasury securities. That exchange looks likely to be redirected. "China and others are not happy with the U.S. Treasury bond interest rates," Allen says. As these investors seek higher returns, expect attention to turn to corporations in the United States and Europe, he says. New money from the BRIC countries -- Brazil, Russia, India and China -- and other RDEs increasingly is seeking outward investments through mergers and acquisitions and other strategic stakes.

The most visible examples of these shifting capital flows came late in 2007 and early in 2008. That is when some of the biggest nameplates on Wall Street and in Europe turned to offshore money, largely sovereign funds, for bailouts from the severe credit crunch sparked by the U.S. subprime mortgage crisis. Investors from China, Singapore and Middle East oil-producing countries injected some $60 billion to $70 billion into Citigroup, Merrill Lynch, Morgan Stanley, Bear Stearns, UBS and Credit Suisse. Following the moves, some Europeans questioned how much foreign investment should be permitted in their banking systems. The United States took a more laissez-faire attitude -- at least initially. That contrasts sharply with the outcries over other recently proposed foreign acquisitions. Strong negative public and government reaction in 2005 derailed the China National Offshore Oil Corp.'s $18.5 billion bid to acquire Unocal, a U.S. oil company. The U.S. Congress helped torpedo that bid on strategic grounds. In 2006, similar politics blocked Dubai Ports World from gaining control of six U.S. port operations.

Unlike those oil company and port acquisition proposals, none of the recent investments in financial institutions by sovereign funds involved a controlling interest. But against the background of a credit crunch and a real need for cash injections, the deals thrust sovereign funds onto center stage. U.S. and European companies realized they were blinking more brightly on the sovereign funds' radar screens and on the screens of flush -- and newly confident -- RDE and energy-producing firms.

Rising Sovereign Stars

Sovereign funds in early 2008 totaled some $2.5 trillion. That compares with some estimates for private equity firm investment pools of $1 trillion, hedge funds of about $5 trillion, U.S. mutual funds of $10 trillion and pension funds of $60 trillion. Some projections peg sovereign funds at $15 trillion to $20 trillion within 10 to 15 years, possibly sooner. Morgan Stanley estimated in March that sovereign funds could soon bypass the forex reserves of central banks.

Sovereign funds investing in the United States appear to enjoy an advantage. Recent reports note that government-held investments in stocks and bonds and the like are exempt from taxation, Siegel says. Yet private foreign investors would face withholding taxes of up to 20%. "Some think we should change our law and force the funds to pay tax on that," Siegel adds.

"The sheer scale of funds under management tells me [sovereign funds] are the new guys on the block," notes Wharton management professorMichael Useem. He believes they resemble the large mutual funds of 15 to 20 years ago, which went from "almost nothing" to wielding strong influence in corporate governance today. "Managements have taken note that these big institutional holders will have 1%, 2% or sometimes 3% to 4% of a large publicly traded company," Useem says. Shareholder activity levels vary, but their stakes have brought "a new kind of power and influence ... especially when companies falter." Sovereign funds could follow a similar path.

A common concern in the United States and Europe is that sovereign funds -- and similar capital pools tightly connected to governments -- might harbor noncommercial motivations. The rise of sovereign funds, along with hedge funds and private equity, "has changed the balance of the global financial

 All materials copyright of the Wharton School of the University of Pennsylvania.

system," states*Global Risks 2008*, a Global Risk Network Report prepared in collaboration with the Wharton Risk Management and Decision Processes Center, the World Economic Forum, and several global finance and insurance corporations. "Sovereign wealth funds, which have become particularly important as rising oil prices and global economic imbalances have massively increased the foreign reserves of certain countries, present a new set of challenges, including relative lack of transparency over investment strategies, concern over possible political intervention and potential large-scale market moves," the report says.

Reasons for Concern

Here is one example that causes some observers to worry: In 2006, a sovereign fund from Norway shorted bonds from banks in Iceland having financial difficulties. The fund was forced to back off after strong protests from Iceland politicians. Whatever the fund's motivations, the incident was a reminder that other sovereign funds could one day act with strategic rather than financial purpose. "Sovereign funds don't have to just follow monetary goals, although many do," notes Allen. "They can pursue other goals. And since some have gotten so big, they have a lot of power -- and not just in financial markets. If they concentrate that power in a certain industry, they have the potential to distort markets, such as in commodities."

Sovereign funds contend they are passive investors seeking the best financial return. But concerns about them already run so deep that by March the European Commission, the IMF and other world financial organizations and nations were working on market-oriented best practices or codes of conduct for governance and transparency, in some cases in cooperation with the sovereign funds themselves. U.S. Sen. Charles E. Schumer of New York early this year was considering legislation targeting similar concerns.

Apart from such codes, would limiting the stakes that sovereign funds are permitted to hold reduce the risks of non-market-oriented influence? "It would be difficult to limit stakes because the question with China, for example, is who are 'they?'" Allen says. "The Chinese government controls many companies and investment funds. It could simply set up two entities instead of one and gain control that way."

Others view sovereign funds as important sources of capital that offer corporations new opportunities, even if -- perhaps especially if -- they were to concentrate investments in one area. "Some in the media report on them as a threat, but I don't think that is the way to look at it," says Rajiv K. Kacholia, a global strategist at GE Commercial Finance. The funds could transform sectors for the good, he explains. "Imagine if a number of sovereign wealth funds started taking large positions in venture capital investments in companies seeking alternative energy solutions. You'd have a large potential force which is complementary to a lot of other venture capital firms." Expect to see more partnerships involving Western companies and sovereign funds, including venture capital firms, Kacholia says. "The funds are great potential partners for large projects."

Rapidly Emerging Companies

Companies from the BRIC countries and other RDEs pose additional challenges. They are on the hunt for acquisitions and merger partners with motives that range from a desire for growth, profit, scale, technology, natural resources or R&D expertise to a search to add new brands, customers and distribution channels.

In *The 2008 BCG 100 New Global Challengers: How Top Companies from Rapidly Developing Economies Are Changing the World*, The Boston Consulting Group updates its list of the 100 top challengers -- as competitors, customers, candidates for partnering in mergers or acquisitions, and as potential acquirers. Eighty of the 100 top companies hail from BRIC countries. The BCG 100 grew at a compound annual growth rate (CAGR) of 29% from 2004 to 2006, "close to three times the rate of companies in the S&P 500 and Fortune 500," bringing 2006 revenues for the select group to $1.2 trillion, according to the report. "Still more impressive -- and perhaps more worrisome for managers defending their home markets -- the group's international revenues grew even faster, achieving a CAGR of 37% from 2005 to 2006. As a result, the BCG 100 generated 34% of their revenues offshore, compared with 32% in 2004."

All materials copyright of the Wharton School of the University of Pennsylvania.

Certainly, Indian companies "are becoming a lot more assertive" in making outbound mergers and acquisitions, Allen notes. Last year, in a huge M&A deal, India's Tata Steel acquired Anglo-Dutch steelmaker Corus Group for $13.6 billion. That made Tata Steel, a BCG 100 Global Challenger, the world's sixth-largest steelmaker. Tata's chief competition in the auction was Brazil's CSN, another BCG Global Challenger.

Reasons to Sell

In the United States, companies are finally going to see "the ramifications of [the country's] huge cumulative trade deficit" and relatively low savings rate, says John R. Percival, adjunct professor of finance at Wharton. The main destination for the huge, RDE-related dollar holdings will be the United States. "They will spend here, and not in retail, but they will want to buy assets, real estate and companies, because that is what we have here in the U.S., lots of wonderful companies."

Expect U.S. shareholders to welcome RDE participation, at least indirectly and if only at first. This all occurs as the Baby Boom generation enters the retirement years, Percival explains. "They have lots of stock, but who is going to buy it all?" The countries with all the dollars, he points out.

Siegel agrees. As the aging of the developed world requires it to import goods from the much younger developing world, he notes, "We will get a huge shift of ownership of assets, from being Western-owned to being increasingly owned by investors from developing countries. That is the very long-run view. China is a little bit of an aging country, too, so that will be a slightly different dynamic, but it will happen with India and other developing countries." So there is a demographic component, a government trade-policy component, and an energy and natural resources component to the shift, Siegel says.

Expect RDE companies to follow the Japanese model and build manufacturing plants in their U.S. competitors' backyards. "When the Japanese built their auto plants here, it was not about reducing shipping costs," Percival says. "They had revenues in dollars but expenses in yen. The only way to hedge exchange rates in the long run is to have revenues and expenses in the same currency."

One unwelcome result could be a backlash of financial or trade protectionism, Percival notes. "Will Congress say, 'Wait a minute, Americans don't own anything anymore?' What happens when the Saudis want to buy Boeing? What happens when [Venezuelan President Hugo] Chavez wants to buy up U.S. assets?" Notes Allen, "If the U.S. wants to run a trade deficit of up to 7% to 8% of GDP, then there will be a lot of consequences. [Foreign entities] can come back and buy us."

In July, one high-profile purchase occurred when the Abu Dhabi Investment Council bought a 90% stake in the iconic Chrysler Building in New York City, investing some $800 million. The purchase was reminiscent of a similar deal in the 1980s when some Japanese investors, flush with export-generated cash, were buying up real estate and other assets in Hawaii and elsewhere in the U.S. But when they wanted to buy famous properties such as the Pebble Beach Golf Course in California and New York City's Rockefeller Center, the Japanese groups were met with negative public opinion (though both deals went through). Such politics could prove to be the biggest constraint to RDE investors seeking acquisitions in the U.S., says Daniel Stelter, senior partner and managing director in BCG's Berlin office and global leader of BCG's corporate development practice.

There has not appeared to be any major reaction to the Chrysler Building purchase, at least initially. But the fact that the sovereign fund sought out a real estate investment was interesting on its own merits. Some sovereign funds had their "fingers burnt" by getting into the U.S. banking equity market too early, only to see the value of many of those investments fall, in some cases dramatically, notes Stelter. The sovereign funds for now may look to avoid financial assets in favor of other asset classes, he says.

Marston points out that as countries become "enormously productive," they will run trade surpluses, accumulate wealth and gain influence. He agrees that a widely held concern exists about government-owned or government-controlled funds. But he notes that "companies always have to worry about hostile takeovers by any investor, whether from Ohio or from France or China, particularly if they are underperforming." What matters is not so much the source of capital but the acquirer's intentions. "If they just want the brand ... well, that sometimes happens with the takeover of one American company by another American company."

All materials copyright of the Wharton School of the University of Pennsylvania.

Not a New Threat

Marston also notes that "we've had cross-nation M&A since World War II." Today there are more players, but "most companies are not worried one way or the other. A GE or a Boeing would see great opportunities in the accumulation of great wealth around the world, and they would certainly reemphasize their global production and their global marketing, but it would not be a source of particular concern to the CEOs or CFOs of those companies."

BCG's Stelter agrees that fast-growing companies from RDEs will increasingly look for opportunities to acquire companies in the U.S. and in Europe long term. In the short term, however, a slowing world economy could impede the growing stream of external acquisitions by the up-and-coming companies from RDEs, he says. For one thing, these companies will have less to work with in the short term. Stelter notes that equity markets in India were down some 30% during the first half of 2008, and China has seen a 20% drop following a stretch of exuberance.

While top-performing companies from RDEs will likely grow relatively faster than many of their counterparts from developed countries, RDE company stock prices have and can overshoot their basic value. The companies "can still lose some market value, and if they do, they will not feel as at ease as they otherwise would to do acquisitions," Stelter says. Some RDE companies -- such as those in China -- will have support from their governments, and that will underpin some ongoing level of acquisitions, he adds.

Meanwhile, the emerging middle classes in many RDEs offer U.S. and European companies opportunities for sales and more efficient operations bases. The opportunities will vary by sector, notes Kacholia. But companies that view the rise of these economies as more of a threat will adapt more slowly. And while some smaller companies will fail to benefit, "anything that touches infrastructure, heavy engineering, construction -- anyone involved in any aspect of airports or shipping ports, bridges, tunnels and roads -- should do well. It's great to be in the cement business, manufacturing airplanes, or an airplane parts supplier."

For companies planning to tap RDE markets, Percival warns, "You are not the only one going. Not everyone will make money." Companies must ask themselves, "What is my believable story about my competitive advantage?" Percival says. "If you are thinking of going into the insurance business in China, which is highly regulated, for example, then you'd better have an 'in' with the government."

What Managers Should Be Thinking About

Looking ahead, Siegel advises that companies recognize the fact that their shares will increasingly be owned by foreign investors. "There is really nothing they can or indeed should do about it. Why would you want to steer away a buyer? It is a huge opportunity," he says. "If managers don't run their companies well, the stock price goes down and it could get unsolicited takeover bids financed from abroad." As with any takeover bid, management may or may not be happy about it, "depending on the price. It could be their savior or it could be a hostile takeover."

Fifteen to 20 years ago, American CEOs and CFOs had to learn how to work with big institutional holders and equity analysts, notes Useem. To be an effective top team member today takes "knowing how sovereign wealth funds work and building a relationship with their officers. It's important for top executives to know the funds' investment criteria, but also to get to know the people who are decision makers personally. It's very important to become personally acquainted. Personal relationships still matter in international business."

Either way, the playing field is shifting quickly. Recognizing this, BCG, in its *New Global Challengers* report, recommends that companies consider the following to best prepare for the changes already under way: 1) Challenge-proof your business model by speeding innovation, lowering costs and revisiting how your company adds value. 2) Attack challengers on their home turf where economically viable. 3) Acquire fast-growing RDE-based players. 4) Convert challengers into partners and customers.

In the meantime, experts say, expect sovereign funds and RDE-based companies from the BRIC countries and the Middle East to continue to tip the scales of capital flows.

All materials copyright of the Wharton School of the University of Pennsylvania.

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

All materials copyright of the Wharton School of the University of Pennsylvania.