Why Focused Strategies May Be Wrong for Emerging Markets

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- diversified business groups = main form of enterprise in emerging markets → as they enter the global stage → foreign investors pressuring groups to break up (conform to Western practice)
- "Western companies take for granted a range of institutions that support their business activities, but many of these institutions are absent in other regions of the world. "
- ie emerging markets lack...
  - securities regulation
  - VC firms
  - strong edu institutes
  - stable government
- ...making it hard to get
  - adequate financing
  - skilled HC

- thus, firms in EMs need to **be responsible for wide range of functions** → to ensure business runs smoothly
- adapt strategies to fit **institutional context** ie must take into account
    - product/capital/labor markets
    - regulatory systems
    - contract enforcement mechanisms

inst.	US	JPN	IND
capital mkts	• equity-focused • *monitor via:* disclosure rules	• bank-focused • *monitor via:* tying directors to investments	• illiquid equity mkts • nationalised banks • *monitor via:* bureaucrats
labor mkts	• many business schools/consulting firms • large pool of talent/skills → mobile workforce	• few business schools • training happens internally at company • company-specific talent dev → less mobile workforce	• few business schools • little training • scarce mgmt talent
product mkts	• liability laws = well-enforced • info dissemination = efficient • activist consumers = many	• liability laws = well-enforced • info dissemination = efficient • activist consumers = some	• liability laws = limited enforcem. • info dissemination = little • activist consumers = few
govt regulation	• low • little corruption	• some • little corruption	• high • much corruption
contract enforcement	• predictable	• predictable	• unpredictable
결국	• disadvantageous to have huge business groups	• kinda advantageous to have huge business groups	• advantageous to have huge business groups

- how to conglomerates add value?
    - **imitating functions of various institutions** present only in adv econs

product markets

- information is scarce due to...
    - **underdeveloped communications infrastructure**

        - inefficient/unreliable postal service
        - inefficient courier service
        - high rates of illiteracy
    - few mechs in place to **verify seller claims**
        - govt corruption → govt watchdog agencies unreliable
        - product analysts = less sophisticated
    - customers cant appeal if product sucks
        - law enforcement is slow/unreliable
- THUS takes much longer/more resources for EM firms to **build credible brands** / **already credible brands** THUS hold much power
    - what makes conglomerates w/ reputation for quality attractive?
        - greatly reduce cost when starting new businesses
        - spread cost of maintaining brand across n businesses
        - each group **has greater incentive to maintain rep**, since damage in one group will affect others as well
- promotion of group identity, rather than individual products

labor markets

- scarce skilled HC - why do EMs lack HC?
    - number of business schools = correlates with how many skilled managers available to lead firms in the future
    - less job training facilities/resources + **less experience** to learn from
- what makes big groups attractive to EMs
    - **spread FC of prof development** over all businesses in group
    - serve as their own **internal labor mkt** - develop mobile employees w/ transferrable skills
        - decline of one company → easily move employees to another
    - efficient allocation of new talent
        - talent transferred internally to where it's most needed
        - otherwise if each firm stood indply, they **would have to recruit publicly** → variance in public talent pool > variance in internal talent pool → greater risk / higher cost of finding necessary HC

capital markets

- scarce info → investors are scared to invest in unfamiliar venture
- adv econs: what mechs are in place to increase investor trust?
    - reliable financial reporting
    - communities of skilled analysts
    - aggressive/indp financial publication
    - VC firms / intermediary firms = specialise in assessing new ventures
    - SEC / watchdog agencies = keep check on untrustworthy entrepreneurs
- ...thus lots of accurate info = available to investors
    - and if info = inaccurate, investors **can hold corporations accountable**
        - securities litigation

        - proxy fights
    - **risk of investing in new enterprises = LOW with these mechs in place**
        - new firms / big companies = on reletaively equal ground when it comes to raising capital, bc investors are less biased towards big firms (risk is same whether they choose big or small firms)
- EMs: why are investors scared to invest in new stuff?.
    - scarce info available
    - few safeguards
- why do big diversified business groups have greater access to capital?
    - **can use their previous track records of RoR** to convince investors their other businesses are worth investing in
    - **both domestic and foreign investors trust them more**
        - **"Investors trust groups to evaluate new opportunities and to exercise an auditing and supervisory function."**
            - wouldn't a firm acting as its own auditor imply independence issues? why do foreign investors trust this?
    - act as their own VC: have internally generated K → grow existing businesses / start new ones

govt regulation

- what role does govt play in EMs?
    - regulatory decisions = harder to predict
        - criteria for licensing more subjective
        - use greater discretion in applying law
- why are big groups attractive in EMs
    - group = intermediates btwn child companies / govt
        - more experience, more connections = easier to maintain govt relationships

contract enforcement

- EMs lack **confidence in judicial system** that adv econs have → have no recourse if contracts are violated
- what makes busi groups attractive in EMs
    - leverage prior honest dealings to build trustworthy reputation
        - companies have incentive to stay honest ← one misdeed damages all other child firms
    - **reputation for honesty =** huge competitive advantage → can win foreign investment much more easily → access to foreign technology

why does diversification add value?

inst. dimension	**inst. that groups imitate**
capital mkt	• VC firm

	• PE provider • mutual fund • bank / auditor
labor mkt	• business schools • certification agency • relocation service
product mkt	• certification agency • regulatory authority • extrajudicial services
govt reg	• lobbyist
contract enforcement	• courts • extrajudicial services

- cons of business groups
    - the more and more diverse activities in a group, the harder it is for admin to **coordinate, control, and invest efficiently** in each one
        - better for companies to be indp/specialise in one thing unless it can offer concrete benefits to affiliates
- how should a conglomerate decide how to expand?
    - **identify opportunities** based on its strengths
        - ie group with brand name recognition in market x → leverage reputation → develop new products targeting market x
    - install **mechs to ensure consistent execution**
        - strong internal auditing system
    - **manage corporate brand**
        - emphasize importance of never compromising on quality
    - **develop strong track record across variety of services**
        - eg group acting as VC → must have experience in growing businesses into magnets for capital, train workers to identify deals + startup experts

investors: what are they worried about?

- issue: difficult to tell which segment of conglomerate is actually adding value
- solution: conglom. managers can develop rep for transparency / communication with investors

OECD Report: Abusive Related Party Transactions

1. background
    a. main issue of related-party transactions:

i. risk of **controlling shareholders** deriving personal benefit at expense of **non-controlling shareholders**
ii. misrepresentation of co's financial situation
    1. (ie inflating assets using related party transactions etc)

b. what do abusive related-party transactions cause…
    i. loss of business opportunities
    ii. overpayment on an asset
    iii. expropriating funds
    iv. "The increase of **centrally-administered, group affiliated financial entities** in some Asian countries, for example, means that the potential for **intra-group loans made by this central finance company** increases the risk to listed entity in the group."
    v. **tunneling:**
        1. selling asset at inflated price *to* listed entity
        2. buying asset at reduced price *from* listed entity
        3. **controlling shareholder** getting **loan guarantee** from LE

c. combating abusive related-party transactions
    i. electing and training **indp directors** on the board
    ii. hire more **indp external auditors** to monitor txs
    iii. need more **indp judges, lawyers, and securities market regulators**

2. what are related-party transactions?
    a. 2 types of **control structures** in asian business groups
        i. simply majority ownership
            1. family/SOE forms **holding company** → owns 51%+ of **listed company**
        ii. complicated network ownership - eg 채볼
            1. made up of cross-shareholding / interlinked boards → grant control of **listed co** to a founding family
    b. what do these structures imply ?
        i. decisions = unilateral ← lack of democratic board dicussion
            1. much higher risk of **controlling shareholder** realising private interests
    c. pros of pyramids
        i. **controlling shareholders** have means / incentive to monitor mgmt in everyones best interest
        ii. Box 6 - Examples of other Related Party Transactions
            1. Transactions involving the sale or purchase of goods
            2. Transactions involving the sale or purchase of property and/or assetd
            3. Transactions involving the lease of property and/or assets
            4. Transactions involving the provision or receipt of services or leases

5. Transactions involving the transfer of intangible items (e.g. research and development, trademarks,
license agreements)
6. Transactions involving the provision, receipt, or guarantee of financial services (including loans and
deposit services)
7. Transactions involving the assumption of financial/operating obligations
8. Transactions that include the subscription for debt/equity issuances
9. Transactions that involve the establishment of joint-venture entities

iii.

Business Groups in Emerging Markets - Paragons or Parasites?

1. Khanna and Yafeh (2015) propose a business group taxonomy that explores how and why business groups form in different environments.
2. diversified business groups = made up of
    a. legally indp firms that operate in diverse array of industries
    b. bound together by 2 ties
        i. formal (equity)
        ii. informal (family)
    c. 2 directions
        i. vertical (pyramid)
        ii. horizontal (cross share-holdings)
    d. politically strong force
        i. close relations with govt
3. research Qs
    a. K&Y (2015) explore the Q of **why do business groups around the world vary so widely?** from an institutional perspective, which claims agents form BGs in response to the economic and institutional environment they are in
    b. what dimensions can we define busi groups along?
        i. structure
            1. horizontal diversification / vertical integ?
            2. how involved in financial sector is it?
        ii. ownership &control
            1. how pyramidal?
            2. how big of role does family play?
        iii. interaction with society
            1. rel. btwn bg & govt
            2. how much monopoly power does bg have?
4.

conventional literature	what Khanna and Yefeh (2015) argue
BGs have negative impact on social welfare	BGs have **ambiguous** impact on social welfare: pros = make up for institutional voids, can be used by govt as instrument for increasing social good (Carney) like building infrastructure in return for govt support cons = rent seeking, monopoly power, negatively affect market efficiency
lack of literature on group **origins**	use historical data to present **dynamic view** of how groups not only respond to their economic environment, but also shape and influence it - both chicken and egg
groups are a corrupt pyramidal way of disenfranchising minority shareholders	groups are **not always a way** of disenfranchising minority shareholders

5. diversification theories - conventional wisdom
6.

pros of diversification	cons of diversification
IF firm has extra value-generating resources (entrepreneurial skills, tech) that are applicable to other industries, diversification could be beneficial to shareholders	can lead to "empire building"
lowers risk (see carney)	agency problems between division managers (ie disalignment of incentives

7. diversification discount = lower in emerging markets
    a. **divers. discount** empirical evid
        i. diversification premium exists in poorer asian countries (indonesia, thailand)
            1. prices are higher for goods from diversified business groups
            2. though this premium has been found to DECR as markets develop

            3. "companies affiliated with chaebol, used to be traded at a premium until the early 1990s - but thepremium turned into a discount starting around 1994 (see also Ferris et al.,2003).
        ii. diversification discount exists in richer countries (hong kong, taiwan)
            1. prices are lower for goods from diversified business groups
        iii. **possible reasons for existence** of a diversification discount:
            1. issues with information flow in EMs (lack of transparent, reliable financial reporting) means raising capital internally > more efficient than communicating with external capital sources
                a. BUT internal capital markets can be inefficient (Shin and Park 1999) because it **overinvests in weak opportunities**
            2. but are internal capital markets the main reason why BGs form in EMs? and is it because of information problems in financial markets?
                a. e.g. south korea: as financial mkts went from underdeveloped 1980s → mature and liberalised 1990s, BG performance declined (bc they no longer had a leg up in accessing capital)
                b. BUT BG performance decline could also be explained by
                    i. 1997 financial crisis (where IMF forced SK to restructure its BGs)
                    ii. subsequent transitional period into second generation of chaebol owners
            3. empirical studies have found that when BGs in SK and RUS make investment decisions, they are **more sensitive to the cash flows of rest of group** than their own cash flows, hinting that an **internal capital mkt** exists within where resources are transferred across firms
8. BGs also make up for missing institutions related to entrepreneurship
    a. group brand name/reputation
    b. internal talent market
    c. e.g.: Hyundai set up training center for technical training, and a research institute
9. why do BGs (rather than fully owned conglomerates) form?
    a. beneficial to controlling shareholders in that:
        i. group structure protects controlling shareholders from investor pressure and takeovers
        ii. gives controlling shareholders **undisputed control** (ie u own >51% of the group, you control group at a quantitative level)

Pyramids: Pharoah Capitalism

- pyramid business groups prevalent - 15 families control 84% of GDP in hong kong
    - control rights > equity claim

        - as gap grows, market value of firm drops
- structure
    - family holds 51% stake in top firm
        - top firm holds 51% stake in the firm below it (so family holds 0.51 * 0.51 = 26% of firm 2)
            - second firm holds 51% of firm below it (so family holds 0.51 * 0.51 * 0.51 = 13% of firm 3)
    - hard to kick manager out, since he owns most of the firm
        - BUT manager **has incentive to ensure firms perform well,** since he will make good returns on his equity
        - vs. in companies with diffused leadership: managers are easier to replace, but bc they hold smaller stake in company, incentive to do well not as big
    - need two listed entities in each level for it to be considered a business -- need transparency (listed entities need show all info on largest shareholders, etc)
- what problem do pyramids solve?
    - “capitalist’s quandary” (yoshisuki aikawa of nissan): **how to raise money from outsiders, without having to give up control over assets?**
- what problems do pyramids have?
    - gap between **control (family at the top)** and **ownership (actual stakeholders in the firm)** at the base → family could be tempted to divert resources from base companies (return: $0.13 per $1) to top companies (return: $0.51 per $1) = AKA TUNNELING
- pyramids are a threat to minority shareholders: so why do they buy shares at all?
    - **danger discount:** minority shareholders can buy stock at cheaper price
        - cost per share (minority) = 40% lower than cost per share (controlling)
    - heavily diversified → more stability
        - firms within act as support systems for each other, **offering ‘mutual insurance’** (if u crash i’ll bail u out) - hard to find on free market