The New Capitalism: Lessons for Asia?

Joergen Oerstroem Moeller | 11 Jun 2007

The world is moving away from the textbook edition of capitalism towards a new paradigm of which we know very little. Funds are transferred from place to place seamlessly. Reputable economies benefit. Economies not living up to the expected and/or required scoreboards are penalised by dwindling investments, auguring the prospect of an economic backwater in the making. Stock markets are at a record levels and judging by traditional theories, out of line with reality.

According to the financial dailies, the activities of investment funds constitute a major reason for the rising stock market indexes in the US and Europe. These funds are on the prowl to buy, often through unfriendly takeovers, of what used to be profitable, viable and well-managed enterprises. The bids are consummated through offers up to 30 – 40% above current market prices. The willingness of such institutional investors to pay a higher price makes stock market prices well above the historical average for price/earnings ratios of approximately 17, irrelevant.

This gives rise to some naive, simple albeit fundamental questions: Why do institutional investors think they can manage the enterprise in question so much better than the existing professional managements and boards, both of whom presumably know their business quite well?

The answer to that simple question is quite worrisome. Normally the typical "New Capitalism" transaction works in such a way that right after the purchase, the fund mortgages an enterprise through the roof, after which a large dividend is paid out, compensating the fund for a part of its investment. This manoeuvre suggests that the predator has limited its potential loss and is able to boast a short-term gain flowing from the take-over regardless of the capital outlay.

Now comes the tricky part of such transactions, of which, there are essentially two models:

The newly acquired enterprise may be broken up and its constituent components sold separately for a high price to other companies able to or expecting to generate higher revenue and profit. This model is on the table in the competition between Barclay's Bank and the Royal Bank of Scotland Group's take-over of the Dutch bank, ABN-Amro. Much of the interest revolves around the fate of ABN-Amro's American subsidiary, Lasalle Bank Corp.

The second option involves investing up front with a view to increase market share and profits in the years to come by running a **higher** risk than previous management. Such a model is pursued by the various American funds that have taken over English football clubs such as Manchester United, Liverpool and Aston Villa. To generate higher revenue and profits, these clubs need to win something every year and preferably, it has to be a major European trophy or the English championship.

Even an amateur investor knows that only one club can win and second place could well lead down a road towards bankruptcy. The argument runs that audio-visual channels are a big market, opening the window for virtual spectators and a larger fan base. Correct, but spectators and fans support the winning club. But very often, the overwhelming supporter base limited to the hard-core fans, thus not necessarily generating more revenue than before. In 2001, the English club Leeds United mortgaged itself to dominate the domestic league and succeed in the European Champions League. It failed, had to sell the best players (assets in the business vocabulary) to pay back loans and is now plying its trade in third division of English football, generating negligible income and remains largely forgotten - all in the space of five short years.

New capitalism, at least in the US and Europe, dictates that a considerable part of a business is mortgaged to generate a rise in revenue and profits, on the back of anticipated economic growth and accepting higher risks than were previously considered. If the US and European economies start to slow down, somebody down the financial chain will face heavy losses. In tandem, even with strong growth, the question remains as to how takeover funds plan to squeeze more profits out of an enterprise than was probably running optimally under incumbent management.

Lesson number one of new capitalism is not so much about economics, but concerns the social, the sociological and ultimately, the political. In 1965, private investors owned approximately 80% of US shares with 20% in the hands of institutional investors. The owners of such enterprises and employees were the average American. Owner's and employees' stake in enterprises were congruous - they owned the enterprises and they worked for these enterprises. This is not the case any longer. Private investors now account for less than 1/3 and institutional investors for more than 2/3 of total shareholding. The bond between owners and employees has been cut; they are not the same group of people anymore.

The institutional investor looks almost exclusively at profits. Investment may be steered abroad. Outsourcing is on the agenda. Both policies hit the employees. The risk for the institutional investor is negligible. This risk is further mitigated through diversification with regard to sectors and countries. The employees are burdened with all the risk through job insecurity and downward pressure on wages through outsourcing.

The second lesson to draw from new capitalism is that the relationship between owners and employees has become asymmetrical, no longer working in the same direction. This growing dichotomy may not be visible during periods with high growth, but will certainly surface when an economic slowdown calls for burden sharing. Lopsided distribution of benefits is one thing, unequal burden sharing another!

Lesson number three of new capitalism portends stringent rules about the origins of money channelled into funds not confined to terrorism and financial crime. New capitalism tends to make capital tracing difficult, creating a feeling of insecurity. Although financial surveillance and vigilance is believed to prevent whitewashing through these funds, global money can be earned in dubious ways without breaking rules or contradicting legal guidelines. Regardless of whether this is the case or not, the point remains that anonymous owners take control of enterprises with the sole objective of making more money without really bothering about the economic impact on nation-states or employees in affected companies. Sometimes a legal framework is created to permit risks at odds with good corporate governance.

The combination of the spread of capitalism in Asia, and the liberalisation of Asian financial markets accompanied by the rise of Asian companies may make it worthwhile for Asian policymakers to take a look at European and US experiences to pre-empt what in some cases may be classified as unexpected and sometimes unwanted behaviour in their markets with knock-on effects in the economic, social and political realms. If not, future operations undertaken by respectable and reputable investment funds, in many cases furthering growth in Asia, may well be looked upon with suspicion by the domestic population.

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