CAPITAL RISING

How Capital Flows Are Changing Business Systems All Over the World

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Defining the Entrepreneurial Ecosystem

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Introduction

This book is about capital, globalization, and entrepreneurship. When we first thought about writing it in 2006, an enormous capital bubble was building in the world. And as we put our final touches on the book in early 2010, the global financial system was continuing to respond to that bubble's implosion.

One thing that remained constant during these years of research was the powerful force that capital flows exert on global entrepreneurship. While increased leverage helped to expand the capital bubble during the mid-2000s—leading to a boom in private equity deals and cross-border mergers, the subsequent de-leveraging caused the bubble to pop quite suddenly—slowing down that activity. We expect these cycles to persist. Witness the recent report from the respected Institute of International Finance that suggests that net private capital flows to emerging economies will almost double from $349 billion in 2009 to $672 billion in 2010.[1] And a significant part of those capital inflows—$80 billion—headed toward emerging markets' mutual funds in 2009 thanks to the soaring returns they delivered to investors in those markets. Specifically, the MSCI Emerging Markets Index spiked 74.5% in 2009 while Latin America, the top performer among MSCI's developing-market indexes, yielded a nearly 98% return.[2]

What is important to remember is the upward trend in the flows of capital to markets around the world and their impact on firms, industries, and countries.

So, rather than focus our attention on the macro economic impact of capital's *cyclical* ebbs and flows, we chose to write about how capital's rising importance is moving economic history *forward*. To that end, our book seeks to explain why and how capital seeks places to invest and what policymakers in search of such capital can do to attract it. We believe that these international capital flows are a powerful economic force that influences the rise and fall of industries. To help explain these factors, we've created the concept of the Entrepreneurial Ecosystem (EE)—consisting of four key factors: financial markets, corporate governance, human capital, and Intellectual Property (IP) regime—that a country can shape to encourage or discourage capital flows.[3]

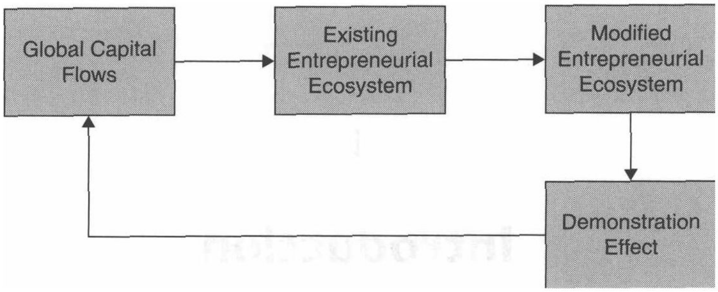

Figure 1.1 Capital Heliotropism Framework

But recently, more and more companies have been trying to reshape their EEs to attract capital. Why? Capital spurs entrepreneurship and entrepreneurship, in turn, creates jobs and tax revenue. What can policymakers do about this? They can lower restrictive barriers to encourage flows from a country with a surplus of capital into one that needs them. And if the demand for capital is sufficiently high, they can upgrade their country's corporate governance standards in order to overcome the reluctance of capital providers to invest in their companies.

Financial markets and corporate governance are among the factors that can determine whether industries rise or fall. If these are attuned to the standards that big capital providers expect, capital will flow toward the countries that do the attuning. And if countries resist such standards, their ability to attract fresh capital will lag behind those that do. The boost to the economic performance of countries that attract the capital creates pressure for all countries to upgrade their EEs.

We formalize the way such opportunities expand ecosystem value for all participants, creating demonstration effects; to be more specific, the Capital Heliotropism[4] Framework (figure 1.1) that describes how recipient countries' desire for international capital causes a gradual evolution toward greater corporate governance and financial market transparency. The Capital Heliotropism Framework links the following three key themes.

- *Capital seeks the highest profit potential.* Specifically, capital flows initially toward countries and companies where investors perceive an opportunity to profit from the existing EE.
- *Investment creates pressure to upgrade the EE.* Investors use their initial access to opportunities as a means to change the EE—so they can profit further by enhancing corporate transparency, streamlining capital markets, and building more globally competitive human capital networks.
- *High investment returns lead to a demonstration effect.* Ultimately, investors hope that the success of companies that benefit from the transformed EE will create a demonstration effect. As such, more companies will alter their EEs to gain access to capital. This can lead to a bottom-up

transformation in the approach toward entrepreneurship within a country.

We believe that if decision makers embrace the concepts in our book, capital heliotropism will yield a world that is safer for global entrepreneurship—spreading jobs and wealth to a broader swath of the world's citizens.

We hope this book is valuable for anyone who makes a living out of creating new opportunities to enrich the lives of workers and the communities in which those workers toil. Those who create such opportunities—including government policymakers, capital providers, and business leaders (both of start-ups and existing companies)—can benefit from reading this book.

This book offers readers a prescriptive and practically focused approach that fundamentally changes the way managers make strategic decisions by highlighting previously hidden risks and opportunities. Specifically, the frameworks presented in the book help managers make decisions such as the following.

Where to perform activities. While traditional economic theory would lead managers to perform business activities in the countries where they can be performed at the lowest cost, our book demonstrates that this is not always the case due to the economic pressures created by global capital. For example, Wal-Mart—which had traditionally expanded into countries such as Germany through acquisition—rethought its India strategy. In response to the risks and opportunities presented by India's evolving retail entrepreneurial ecosystem, Wal-Mart chose a value-chain-splitting strategy in which it joined its back-office skills with its partner's retailing ability. The Indian government, using an industrial policy approach, has forbidden foreign investment in retailing by foreign firms such as Wal-Mart. This has allowed Indian business groups with access to global capital such as Reliance to get into retail.[5] Most observers in India wrote off Wal-Mart's prospects in potentially one of the largest retail markets in the world. Wal-Mart, however, demonstrated its strategic savvy by deciding to exploit its core competence in supply chain and logistics management. It has entered into a joint venture with one of Reliance's local rivals—Bharti Enterprises—to provide supply chain and logistics services to Bharti's retail operations in India. We analyze how Wal-Mart's success in India depends on many factors including its understanding of India's evolving EE, its appreciation of the impact of availability capital to its local competitors, its need to reassess its strategy in the light of other countries' business ecosystems, and its ability to execute an innovative strategy fast in order to preserve its strategic options for the future. The important point here is that Wal-Mart recognized a need to change its strategy given Indian government regulations and the availability of global capital to Indian firms such as Bharti (and its local rivals such as Reliance), if it wanted to take part in an emerging market opportunity. By broadening the way managers think about how to configure their activities globally, our book helps them capture the significant growth opportunities within emerging markets while avoiding costly pitfalls.[6]

Which growing industries to invest in. In most countries, an entrepreneur seeking venture capital would be likely to build a business plan around a patented technology targeting a huge market with a staff of top-notch engineers. Our book shows that due to differences in IP regimes across countries, a Chinese entrepreneur, for example, would be more likely to attract foreign capital by providing a service and hiring people with strong operational skills. How? We've found that due to weak IP protection in China, venture investors are loath to invest in technology-intensive start-ups. Consider the experience of IDG Ventures, that invested in China and had one investment that was worth 100 times what IDG paid for. IDG focused on service-oriented investments with strong management teams and avoided investments involving IP since China does not protect it. Success with such service-oriented growth industries extended to its investments in Vietnam as well—where IDG had a $100 million fund. Examples of such service-oriented investments include Cyworld Vietnam, which has received two rounds totaling $1.7 million from IDG Ventures Vietnam, is a social networking company based on the South Korea's Cyworld brand. YeuAmNhac JSC, whose name means "love music" in Vietnamese, aims to build an online music community. The third company is Vinapay, a mobile payment service offering electronic refill of prepaid cell phone airtime and mobile payment of expenses such as cab fares and airline tickets.[7] Michael Greeley, a former partner in a U.S.-based IDG fund, also thought corruption in China was still a significant concern, which is why he made a series of small investments in companies rather than a few big ones. He implied that in China, the government can take over a company more easily or corruption is more of a threat when a foreign VC invests above a certain amount per transaction.[8] By helping entrepreneurs understand how venture investors view the global opportunities and risks in their markets, our book helps them to choose business models most likely to attract the capital they require to grow.

How to manage mature businesses. Managers typically look to harvest the cash that mature businesses generate—starving them of investment. Our book demonstrates that global capital flows enable managers to revitalize mature businesses—thus making them capital recipients that can reward investors with high returns. For example, we demonstrate how Infosys, Wipro, and TCS of India have become major global players in the software and IT outsourcing industry by using their access to global capital markets. In the process, they have forced major changes in the way IBM, Accenture, and EDS operate globally. For example, Accenture invested in India where it planned to hire so many people that by August 2007 it would employ more people there than in any other country.[9] And in the mature coated paper industry, the role of private capital is opening up entirely new strategic possibilities. Instead of focusing managers on squeezing out costs, private capital is giving managers in mature industries a new competitive weapon—using the power of the U.S. government to raise tariffs against Chinese competitors. How? In March 2007, the U.S. Commerce Department raised tariffs on Chinese coated paper companies—accusing them of lowering these companies' cost of capital through low-cost loans and debt forgiveness. And one U.S.-based coated paper company, NewPage, is owned by

Cerberus Capital Management, a private equity fund whose chairman John W. Snow, served as former president George W. Bush's Treasury Secretary from February 2003 to July 2006.[10] Given private equity firms' access to power, they can spur surprisingly effective government-backed strategies for managers of their portfolio companies. By changing the way managers think about maturing businesses, our book helps them spot investment opportunities that will benefit their employees, clients, and investors.[11]

Whether to exit declining businesses. If an industry is declining, managers traditionally seek to get out of the business or try to shrink it to a profitable core. But we demonstrate that global capital flows enable industries that are declining in developed countries to deliver cheap sources of new capacity that satisfies the needs of the rapidly growing developing countries. As a result, managers might change their perspective—for instance, the decision that it makes more sense to invest in the business so it can fit more effectively with a global acquirer with a proven track record of buying and improving such declining operations. For example, in its 1992 acquisition of a Mexican steel mill, Mittal used its IP—a highly sophisticated pre- and postacquisition process—to transform Mexico's struggling Sicartsa steel plant into a rapidly growing and much more efficient operation which it ultimately bid to acquire for $1.4 billion in December 2006.[12] Having listed its shares on the New York Stock Exchange (NYSE), Mittal enjoys access to massive pools of capital that it uses to finance such deals as part of its global acquisition strategy. Moreover, Sicartsa's investors turned their share of a declining industry into valuable equity thanks to Mittal's application of its IP—funded by the global capital access. By helping managers to identify global partners in declining industries, our book shows how they can brighten substantially the future for their employees, customers, and investors.

Where to seek capital. Traditionally entrepreneurs seek capital from venture investors and/or public equity markets in the countries in which they operate. Our book shows that the emergence of global capital markets creates a wider variety of options for entrepreneurs. For example, Wall Street gave the cold shoulder to the IPO of a Massachusetts-based genetic engineering firm so its CEO flew to London whose Alternative Investment Market (AIM) helped him raise $30 million for Asian expansion.[13] Specifically, Elliot Entis, current director and former CEO of Aqua Bounty Technologies of Waltham, MA is developing genetically modified fish for aquaculture. Entis recounted how potential Wall Street underwriters gave him 15 minutes and showed him the back door while London capital providers held a long meeting with him. In March 2006, Aqua Bounty sold stock in London worth $30 million, which it planned to use to expand in Asia. By providing entrepreneurs an expanded view of where they can raise capital, our book helps them lower their cost of capital and obtain the fuel they need to grow.

How to hire managers and coordinate global operations. When a U.S.-based company seeks to open up operations in a new country, it typically assigns a young executive who has demonstrated his or her potential in the United States. Our book demonstrates that global capital flows make this instinct obsolete. We illustrate the importance of placing managers in new countries that have "cultural bridging skills." For example, the $440 million hedge fund, Monsoon Capital, seeks to invest in Indian companies whose younger generation of management—while part of the founding family—has significant U.S. educational background that enables them to understand the expectations of U.S. investors and manage the business accordingly. Similarly, we explore the example of ChrysCapital, a Mauritius-based venture firm, that demonstrates the importance to investors of finding managers who can apply skills that bridge cultures—say between the United States and India. ChrysCapital financed Spectramind, a call center. Spectramind was started by the GE executives who ran GE's call center in India. The executives sought capital to build their own company to find new clients who would pay for their GE-honed call center management skills. They were so successful that, three years later, Wipro acquired Spectramind for $300 million.[14] By explaining in detail how managers can plan to staff and coordinate global operations, our book seeks to enhance their profits from global expansion.

This book is organized to answer four broad questions:

- How and why are these capital flows occurring?
- What has been the impact of these flows on the global economy and the economies of individual countries?
- How will this phenomenon affect my life as an entrepreneur, manager, or policymaker?
- What are the ways I can benefit from or protect myself from this new wave of globalization?

In general, we seek to describe the phenomenon of capital flows, present new ways to think about what causes them to rise and fall, and describe ways that our readers can profit from this framework. Chapter 2 addresses the first question; chapters 3 through 5 answer the second one; and chapters 6 through 10 tackle the last two—through case studies and methodologies for each of the key EE participants. And here follows the contents of the chapters in a gist.

Chapter 2, "Capital Rising: Globalization, Capital Flows, and the Emerging New Entrepreneurial Ecosystems," introduces the role of capital flows in shaping globalization. It argues that globalization has changed the nature and meaning of entrepreneurship. This chapter suggests that the primal role of capital in shaping entrepreneurship demands a new approach for policymakers—the EE.

Chapter 3, "The Impact of the Entrepreneurial Ecosystem on Countries," explains how the contours of a country's EE can either attract or repel capital. We explore cases to illustrate how countries fall into one of three categories—leaders, loungers, or laggards—depending on their choices about their EE and conclude by highlighting the key lessons of these cases for EE participants.

Chapter 4, "The Impact of the Entrepreneurial Ecosystem on Growing Industries," demonstrates that a country's EE is an essential determinant of the success or failure of growing industries within that country. We explore two cases of successful Indian companies that benefit from certain elements of India's EE and discuss implications of these ideas for EE participants.

Chapter 5, "The Impact of the Entrepreneurial Ecosystem on Maturing and Rejuvenating Industries," argues that changing EEs attract entrepreneurs and capital to industries that formerly did not enjoy much dynamism. We provide case studies of mature industries and rejuvenating ones that enjoyed a boost in economic performance thanks to changing EEs in the countries that host them. We then summarize the implications of these cases for EE participants.

Chapter 6, "Implications for Policymakers," advocates the idea that policymakers must act promptly to shape their country's EE in a way that is consistent with their growth goals. This chapter presents seven mini–case studies that illustrate several benefits and risks of such EE reshaping.

Chapter 7, "Implications for Capital Providers," similarly argues that analyzing a country's EE is essential for capital providers seeking to maximize investment returns. To bolster that argument, the chapter presents 10 case studies of capital providers and their investments, and these case studies highlight both the opportunities of making smart choices about EEs in which to invest and, just as importantly, which ones to avoid. To help capital providers, we present a capital receptivity index (CRI) that we believe ought to be an essential tool in their pre-investment due diligence process. We describe a six-step process for exploring, closing, and exiting successful investments illustrated through interviews with a private equity firm that uses the process.

Chapter 8, "Implications for Managers in Existing Industries," contends that thanks to changing EEs around the world, managing a company in an existing industry is not a life sentence to slow growth. Instead, we suggest that evolving EEs create opportunities for global acquisitions that can spur higher growth. We examine cases of such global acquisitions and provide a methodology based on the lessons of these cases that we believe can help managers grow their companies profitably.

Chapter 9, "Implications for Entrepreneurial Managers in New Firms and Industries," argues that CEOs of start-up companies ought to tread carefully when it comes to global EEs—wonderful opportunities as well as enormous risks await them. We help these CEOs seize the opportunities and shun the risks. We emphasize the importance of using rigor when making key business decisions by exploring 10 case studies of global start-ups. As we explore each of these cases, we examine specific lessons that we believe entrepreneurs can use to help them as they expand their start-ups. And we conclude with a six-step methodology that we believe can help entrepreneurs apply these lessons to their own businesses in a rigorous fashion.

Chapter 10, "Seeking Congruencies and Resolving Conflicts among Ecosystem Participants," recognizes that while the foregoing chapters have explored EE participants in isolation, the complex reality is that these participants interact. When such interaction is harmonious, that harmony boosts the odds that good investments will get funded. Conversely, disharmony among these elements increases the chances for an unhappy outcome. Chapter 10 analyzes the 47 cases we explore in this book and categorizes them based on their success or failure. It draws lessons from these outcomes and recommends a six-step process for business leaders to work with EE participants to find sources of harmony while addressing and resolving sources of conflict.

The globalization of entrepreneurship is a powerful phenomenon with the potential to boost worldwide employment and wealth. To learn more about how to harness that potential, read on.

2

Capital Rising: Globalization, Capital Flows, and the Emerging New Entrepreneurial Ecosystems

Globalization is now on everyone's mind. Journalists like Tom Friedman of the *New York Times* write popular paeans for it. Pundits like Lou Dobbs of *CNN* vehemently criticize it. Academics like Jagdish Bhagwati of Columbia University argue passionately for it. Policymakers like the former U.S. Trade Representative and current World Bank President Robert Zoellick embrace it. Leaders like Hugo Chavez of Venezuela denounce it downright. Researchers everywhere pore over its statistics. Amidst all these, common people, however, remain mesmerized, confused, puzzled, and worried, but not fully informed by it. So, what is globalization and why does it evoke strong views?

Globalization of Trade and Services

The main reason for this state of affairs is that almost all observers—journalists, pundits, academics, policymakers, and elected officials—are focused on largely one facet of globalization, namely, increased cross-border flows of goods and services. Rising imports and growing exports are easily visible. Their impact on local economies through lost jobs and closure of factories and offices are easy to observe. While learned men dissect the reasons for these developments ascribing them all largely to impersonal forces of globalization, the person on the street affected most by these developments remains unenlightened and fearful.

Indeed, global trade flows have been rising since the end of the Second World War almost continuously except for a few hiccups here and there. As a recent *Wall Street Journal* editorial pointed out, global trade has gone up from $2.3 trillion in 1980 to $19.7 trillion in 2008.[1] Recently, global economic recession has slowed down this expansion but most economists expect trade flows to resume their upward trajectory when the global economy revives. What is more, almost all the major countries in the world—developed as well as developing—have participated in the surge of global trade. Witness the increase of China's exports to the rest of the world in the past three decades. Indeed, the growth of Chinese exports has become a major talking point in all the forums where globalization is a topic of discussion. Other countries too ranging from India and Korea to Brazil and Mexico have been able to participate more fully through rising exports and substantially rising imports. True, countries such as the United States and United Kingdom have seen their imports grow faster than their exports but they too have participated in the global growth in trade. Indeed, barring a few, very poor countries in Africa, almost all countries seem to have participated in the growth of international trade in goods and services. So, for the question "Is globalization a fact?" the answer seems to be in the affirmative.

Another interesting question is whether all countries feel they have benefited equally from this surge in global trade in goods and services. Here, opinions vary. Mainstream economists strongly believe that the global growth in exports and imports is a testament to the recognition of how trade growth leads to increased national welfare in all countries. This is strongly in accord with the traditional trade theory that posits that trade leads to optimal exchange between nations on the basis of comparative advantage and optimal usage of resources. In turn, such exchange and usage leads to increased welfare for participants in international trade.[2] Of course, the more nationalistic or mercantile view asserts that international trade imposes unequal burdens on countries. The proponents of such a view suggest that export-driven countries such as China, Germany, and Japan tend to gain in new jobs and register balance of payments surpluses that tend to shift the burden of adjustments on other countries that pursue more market-oriented policies. In this formulation, countries such as the United States end up with balance of payments deficits as well as loss of jobs, especially in labor-intensive sectors.

The response of the classical economists to such carping criticism is to resort to two arguments, one macro and the other micro. The macro argument refers to differences in savings rates in different countries. Since such differences between countries, especially in different phases of economic development, are considered normal, the economists go on to suggest that the resultant differences in balance of payments are also inevitable and the way to deal with them is through macroeconomic policies.[3] The micro argument refers to the notion that international trade allows for better allocation of productive resources between different sectors and that the problems facing countries is merely one of transitory nature. Again, the way to deal with them is through public policies, this time focused on adjustment assistance and retraining for workers displaced by imports.[4] Unfortunately, both the suggestions are somewhat esoteric and rarely do they allay the concerns of people affected by trade policies.

What is more, such a bloodless analytical view of globalization reinforces the popular view that globalization is largely for the benefit of large corporations.