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ALTERNATE EXIT STRATEGIES FOR INTERNATIONAL PRIVATE EQUITY

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INTRODUCTION

Christopher J. Mailander addresses a critically important aspect of international direct equity investment in his paper, *Searching for Liquidity: United States Exit Strategies for International Private Equity Investment.*[1] A primary consideration of any investment in an unmarketable security, domestic or foreign, must be the potential exit strategy by which the investor can eventually convert the value of the investment into cash. As Mr. Mailander points out, it is particularly difficult to plan for this eventual liquidity in international markets. In the less developed emerging markets, this uncertainty is a major deterrent to investment.

In many emerging markets, lack of liquidity has severely de-

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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).

pressed valuations of equities and has created opportunities for investors to purchase assets at a price that is low, relative to replacement cost. For these investors, the "search for liquidity" in emerging markets will accelerate as these investments mature. For many investments, the ability to liquidate will be the primary determinant of success.

Mr. Mailander has presented a thorough description of American Depositary Receipts (ADRs)[2], which also have a global counterpart, Global Depositary Receipts (GDRs)[3], which are traded in other markets in the world. Mr. Mailander has also noted the increased number of listings of foreign companies on the Nasdaq. These are highly desirable avenues for liquidity, but are available in emerging markets only to the largest companies or those in which investors anticipate an exceptional rate of future growth. Even for these companies, it is reasonable to expect that investors and regulators alike will insist on accounting that conforms to United States or international standards and a level of disclosure comparable to that required by the SEC for similar United States issues.

A great number of the investments currently being made in emerging markets will probably not qualify for ADR issuance or Nasdaq listing because of their limited size or their lack of general appeal to investors. Furthermore, as the number of investors in these markets increases, there will be an increasing volume and variety of such investments. The exit strategies for emerging markets and other smaller investments are more likely to be found in one or more of the following categories.

ALTERNATE EXIT STRATEGIES

1. SALE TO A STRATEGIC BUYER

Companies in emerging markets that have had direct equity investment by United States investors often become ideal acquisition

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

3. *See* JOHN DOWNES & JORDAN 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").

targets for the entry of companies from developed nations into these markets. Typically, the United States investors will have insisted on the application of generally accepted accounting principles or international accounting standards and will have introduced management organization and procedures commensurate with those of more developed countries. In addition, the United States investors provide a convenient bridge of communication to potential acquirers, and often are creative in suggesting strategic positioning which leads to investments or acquisition by others.

2. LISTING ON LOCAL OR REGIONAL EXCHANGES

There has been an explosive growth in portfolio investments in emerging markets by United States mutual funds and institutional investors, as well as investments from regional investors and those from other developed countries. This has fueled the development of local and regional exchanges throughout the world, which offer investors at least a minimal degree of investment support and marketability. Public offerings on these exchanges should provide an increasing opportunity for liquidity of securities that otherwise would remain unmarketable. In addition, local exchanges provide a vehicle for later stage financings.

3. SECURITIZATION OF CASH FLOW STREAMS

Many investments in emerging markets create streams of cash flow, which can be joined together and sold to institutional investors, either through registered offerings or as private placements under Rule 144A.[4] This is particularly true of infrastructure investments, such as power plants or water systems, which are often structured as Build–Operate–Transfer (BOT) transactions.[5] By joining several of these in a securitized offering, the risk of any one of these investments can be mitigated.

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4. *See* Mailander, *supra* note 1, at 93-96 (describing private placement offerings generally).

5. *See* David A. Levy, *BOT and Public Procurement: A Conceptual Framework*, 7 IND. INT'L & COMP. L. REV. 95 (1996). "In a BOT project, either the government or a private entity identifies a need for a development project. The government then grants a concession to a private sector enterprise to build the project and operate it for a fixed period of years after which time the project is transferred to the host state." *Id.*

4. ARRANGEMENTS BUILT INTO FINANCING INSTRUMENTS

Recognizing the difficulty of assuring future liquidity, private equity investors often build arrangements into their financing structure instruments, which by the terms of the instruments allow a payout in the absence of a market for the equity. One approach is to make the form of investment subordinated debt, with an interest rate and repayment schedule that provides at least a minimally acceptable return. The debt is coupled with warrants[6] or equity conversion, which allows the holder to realize a full equity return if the investment is successful.

Another approach for investors purchasing a minority interest in a business is to provide for a put[7] to the majority holder under certain stated conditions. For example, such a right to put the shares might be exercisable if the majority holder refuses to accept a bona fide offer to acquire the company by a qualified prospective buyer. These devices, which are common in United States venture capital investing, may not be available or enforceable under the laws of all emerging countries. In many situations, however, they are attractive to the majority owner who wants to retain control of the enterprise.

CONCLUSION

NEW APPROACHES

The ultimate dynamic of the United States securities industry is its ability to design investment products that match the needs of investors and companies seeking capital. The development of equity markets in emerging economies is still at an early stage. One can already recognize, however, a combination of forces that will lead to creative future solutions. For example, institutional investors and wealthy individuals look to emerging markets to offer superior returns; private equity investors hold stock interests in companies that need later

6. *See* DOWNES & GOODMAN, *supra* note 3, at 570 (defining a warrant as a "type of security . . . that entitles the holder to buy a proportionate amount of common stock at a specified price, usually higher than the market price at the time of issuance, for a period of years or to perpetuity").

7. *See id.* at 451 (defining a put option as a "contract that grants the right to sell at a specified price a specific number of shares by a certain date").

stage financing or are seasoned enough to be acquired; and direct equity investors have developed advanced management and reporting procedures that have created a more attractive environment for other future investors. The United States financial community will organize these elements in novel ways to benefit investors, while matching the needs and opportunities of developing countries.