

Industrial Policy from Private Equity/Venture Capital Perspective

Short Overview

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Outline

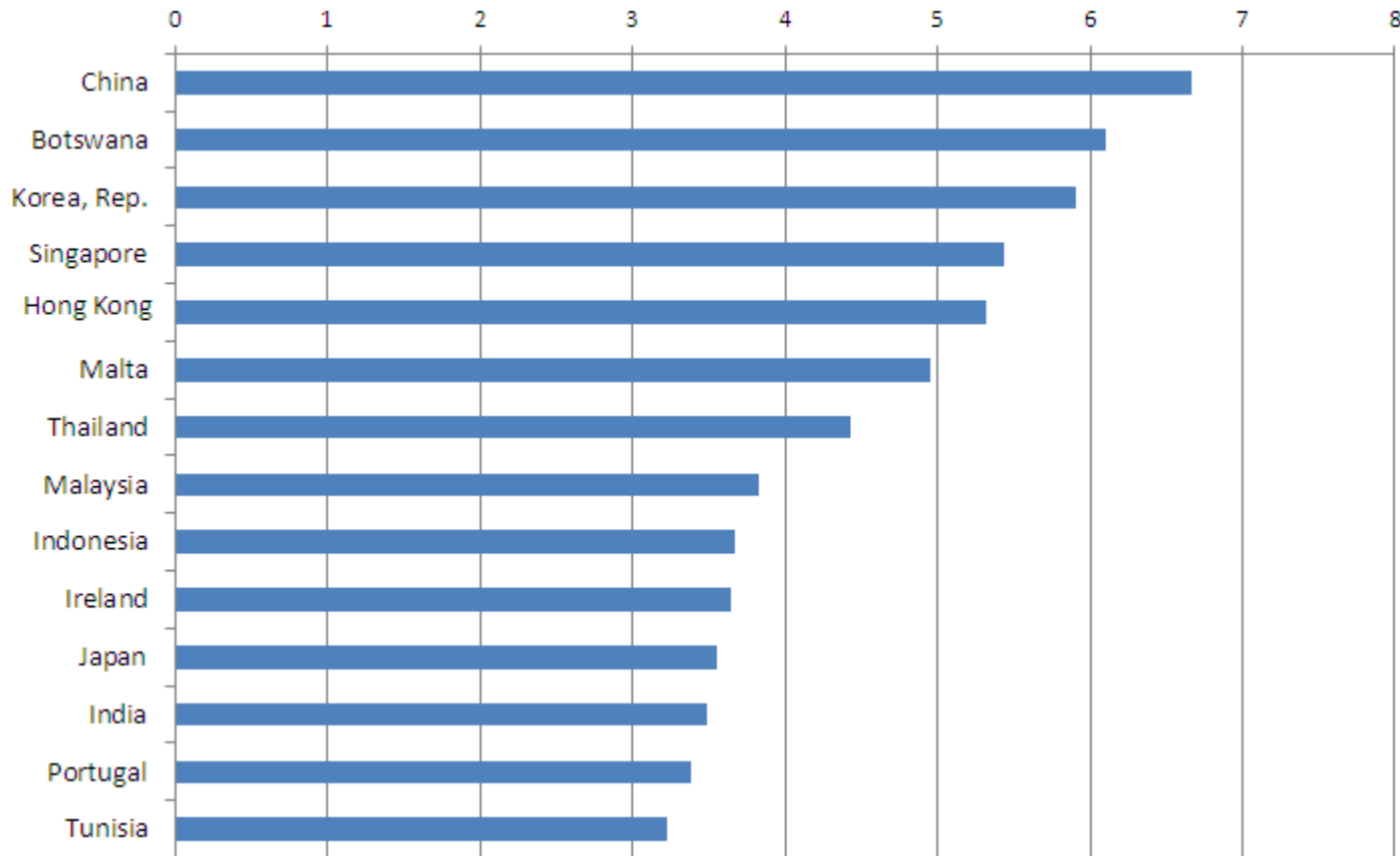
- The role and principles of industrial policy;
- Private equity/Venture capital funds - vehicle for Industrial policy;
- IP macro and micro teams, communication with the market;
- An illustrative example;
- Conclusion.

The importance of industrial policy

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- Rapidly-growing countries for the last 50 years had an industrial policy (Nadaraia et al. 2013)

Average annual percentile growth of GDP per capita (1960-2010)



Necessary but not sufficient condition

- Having an industrial policy does not always guarantees success.
- However, achievement of high growth is unlikely without industrial policy.

Arguments for government intervention (Rodrik, 2004)

Cost Discovery

- Uncertainty of cost structure – an important barrier for investing in innovative activities;
- Solid expenses related to identification of cost structure;
- “a small gain” or “a great loss” for investors;
- Normally, private sector does not have sufficient incentives to invest in innovation because the expense is private, while the benefit is public (in contrast with banking industry).

Coordination Failures

- Implementation of a business initiative depends on the procurement of several interdependent conditions within the business activity;
- Need for guarantees from the government;
- Government support is particularly important for industries with the scale or agglomeration (cluster) effect.

Experimentation, Diversification and Development (Rodrik, 2004)

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Trend of sectoral concentration in time for rapidly-growing countries



Had South Korea not chosen the road of diversification and followed its traditional competitive advantage, today it would still be a rice-producing country, and not the world leader in the production of smartphones. (Stiglitz, 2012)

- During the preliminary stages of development, economy encompasses only a short list of industries. As economy develops, diversification increases and then, decreases again.
- The latter is the result of experimenting with different industries with the goal of identifying competitive advantages. After discovering competitive fields, countries tend to specialize again.

Rate of failure

- The scarcity of mistakes points at the lack of intensity of industrial policy (Rodrik, 2004).
- “What distinguishes a good industrial policy is not the ability to pick winners, but the guts to let losers go”. (Hausmann, 2010)
- On a micro level every project, when taken separately, cannot be profitable.
- If we are dealing neither with very large-scale products (including co-financing), nor with the coordination problem, then we can conclude that industrial policy without high rate of failure is competing with the private sector.

What new activity means?

- New to the firm – something existing already in the market.
- **New to the country** - Any activity in which a country does not have prior experience can be considered innovative.
- New to the world – Activities which support innovations in the world
- It is obvious, that in Georgian context, it is better to emphasize on **new to the country**.

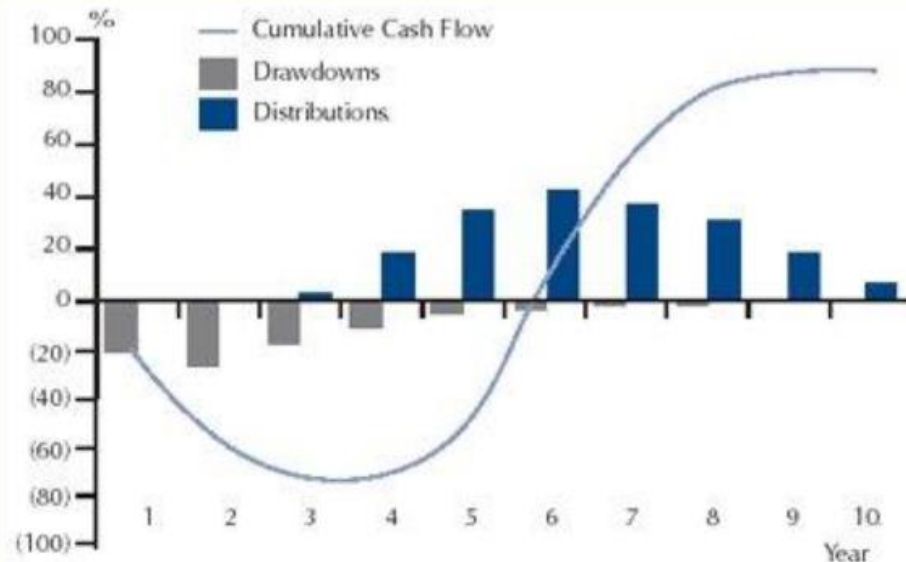
Private equity/Venture capital – Best vehicle for Industrial Policy?

- Rodrick (2004) discussed various instruments of industrial policy:
 - Development Banks
 - Tax heavens
 - Private equity/venture capital funds
- For the reasons below Private equity/venture capital fits best to the industrial policy.

Private equity / Venture capital

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- Given the portfolio approach and the deal structure VCs use, only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate of **25% to 30%**;
- **J curve:** Private equity (especially venture capital) funds tend to demonstrate a decline in value during the early years of existence, before beginning to show positive returns in later years;
- High cost of capital constraint and the “right industry” selection problem can be addressed by the state subsidy.



IP vs PE/VC

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	IP	PE/VC
Business model		
Innovation, discovery process: shaping and creating new technologies, firms and sectors	Yes	Yes
Risk&uncertainty		
high risk, high uncertainty: high rate of failure, but high return in case of success	Yes	Yes
Return		
J curve (when potential gains materialize at later stage, after inception)	Yes	Yes
Business process		
Selection (investment opportunity evaluation negotiation) and post-selection (no time spent on losers);	Yes	Yes
Exit		
Prescribed exit strategy	Yes	Yes
Development orientation		
Address to social imbalance, employment, economic growth, productivity	Yes	Not necessarily
Spillover/externalities	Yes	Not necessarily

Are IFIs private equity IP investors?

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- IFIs should be development oriented and profitable as well – difficult task.
- Lower required return on equity is difficult to justify as an argument. Idea of IP is not low, but high return on equity with high losses for trial.
- One efficient way of private, IFIs and public sectors co-operation should be:

Loss taking order:

- First – Public
- Second – IFIs
- Last - Private

The roles of government macro and micro teams

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Macro Team (Development Economists)

- Growth diagnostics to identify constraining factors
- Tradeoff between employment and productivity.
- Potential spillover effects
- Urbanization strategy
- ...

Micro Team (PE/VC specialists)

- Comparative advantages
- Feasibility study
- Management capability
- Project monitoring
- ...

Communication with the market

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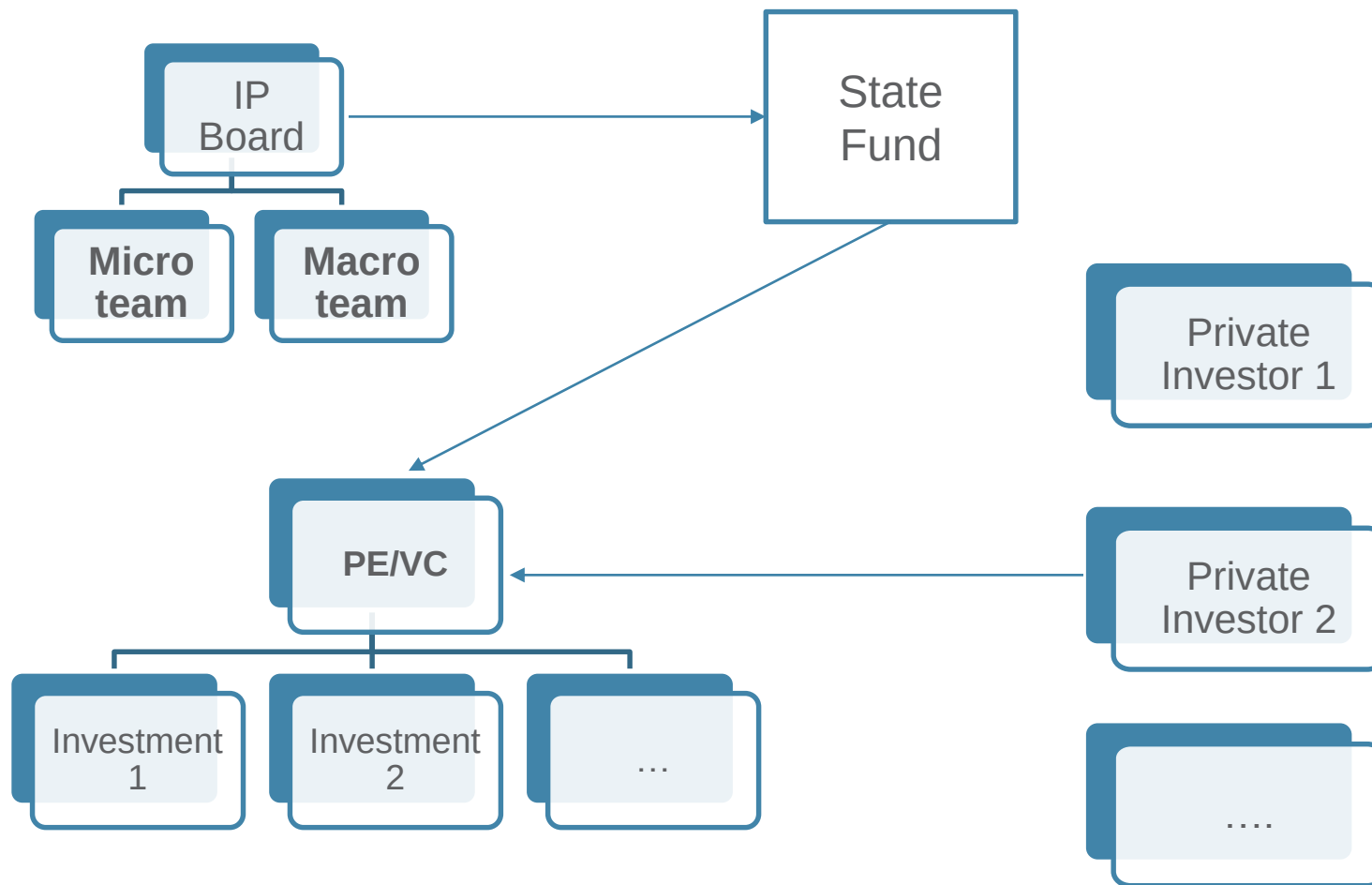
Market communication strategy is important for successful industrial policy.

Government IP team should have accountability, but flexibility also.

- IP could have signaling effect.
- Some innovation happens anyway even without IP. Important not to hinder such innovations.
- In case of profitability target, all this relates not only innovative projects, but traditional activities also.

PE/VC based IP illustrative structure

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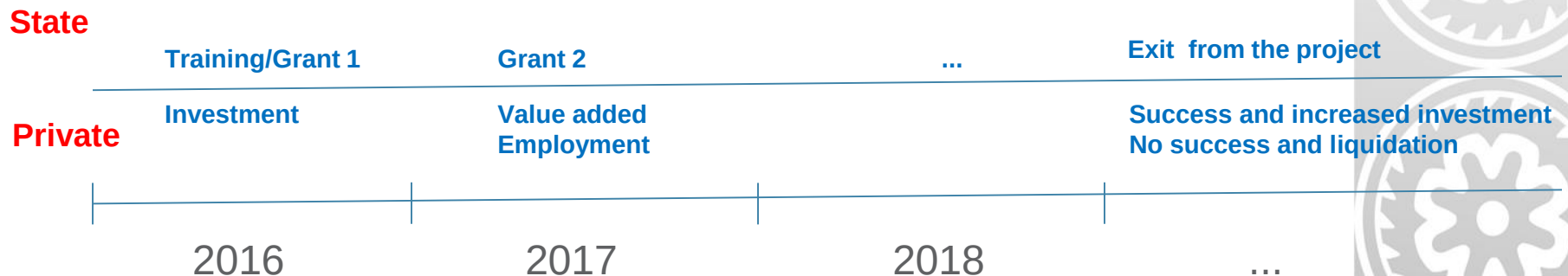
An illustrative example (bespoke tailoring)

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- Interested parties:
 - Public
 - Macro Team
 - Employment priorities
 - Currency inflow from tourism
 - Positive effect on tourism
 - High growth potential in case of success
 - ...
 - Micro Team
 - Analysis of comparative advantages
 - Feasibility study
 - Positive externalities with other sectors - develop tourist services
 - High growth potential in case of success
 - New activity/innovation (test), respectively high risk & high ROE
 - Monitoring of the projects
 - ...
 - Private (Domestic & international)
 - Interesting, but high risk (innovation), need for high initial capital (inventories, equipment)
 - Lack of qualified work force
 - Initial coordination problem between private parties.
 - ...
- Principles:
 - No competition with private sector, transparency
 - Defining of new activities
 - Focus on positive externalities
 - Clear exit criteria in case of success/failure

An illustrative example (continued)

- State offer
 - Grant, Cheap loan, Guarantee, Mezzanine, Equity
 - Training
 -
- Private offer
 - Number of employees
 - Size of provided services
 -



Conclusion

- Among principles of good IP, necessity of loss-making on a micro level is most difficult to accept in practice.
- PE/VC is probably the best vehicle for industrial policy.
- IP governance must have micro and macro teams.
- Micro and macro team must be accountable, but sufficiently flexibility as well.
- It would be beneficial to study worldwide IP practice of using PE/VC vehicle and discuss benefits of such vehicle in Georgian context.

Special thanks to Georgian Industrial Development Group for this event and developing IP framework in Georgia!

**Thank you
for your attention!**

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