Capital Controls & Private Equity

December 2007

Sanjeev Sanyal
Chief Economist
Global Markets Economics Research

Deutsche Bank

What really is Private Equity ?

•It covers a wide range of finance ranging from “venture capital” that funds start-ups to funding mergers, acquisition, leveraged buy-outs of exiting companies.

•The main distinguishing characteristic is that the transactions are done in Private rather than Public markets. Typically private equity investors also play an active role in managing the investee companies.

•They play a very important role in providing finance in situations where the open market is inefficient, illiquid or unable to price an asset.

Private Equity in India

• Private Equity inflows have grown exponentially in the last few years

•Most of the capital has gone to fund “growth” and capacity building, especially in first generation enterprises.

•Ajay Shah has estimated that there are 250 PE firms with 1500 investments. Approximately 20% went through small stakes in listed companies, 20% as large stakes in listed companies and 60% went to unlisted companies.

•It is likely that inflows could rise sharply in the next few years.

Volatility & Capital Controls

•It is a source of "growth" capital that typically takes a long term view and injects funds to innovations and first-generation entrepreneurs. Hence PE has FDI characteristics.

•It does not suffer from a "mark-to-market" pressures like other forms of portfolio capital. If anything, the money become more sticky during periods of financial stress.

• Even if private equity enters into "undesirable" transactions, the question is whether or nor capital controls hold the answer. There are many other forms of regulation that may be far more effective that capital controls.

Private Equity in the rest of Asia

- Few rules specifically targeting private equity in Asia. However, large PE investments have sometimes created problems – for instance, the Lone Star – Korea Exchange Bank episode.
- The rise of sovereign wealth funds will now cause added problems. Singapore's Temasek has already had problems in Thailand with Shin Corp and more recently in Indonesia with ownership of telecom companies.
- However, its unclear how to deal with these funds. As the recent experience of Thailand and Indonesia shows, targeting them can have serious reputation risk to the host country.
- Furthermore, sovereign private equity can take many forms. Should we consider Blackstone a front for Chinese investment?

Capital Controls should be Light & General

•Capital controls cause distortions and they should used very sparingly. At most they should be used to add a bit of friction to international capital flows.

• Inefficient to target a specific form of capital flow – such as PE – as capital can take many forms. End use restrictions are difficult to monitor and, in any case, undesirable. Even a simple debt-versus-equity distinction can be circumvented.

•Perhaps, one can look at time-determined taxes – the Chilean tax or mandatory forward hedging.

•In the medium term, the Impossible Trinity problem requires a macroeconomic solution that combines monetary policy, exchange rate policy and fiscal policy.

•Long term, supply-side reforms are needed to allow the economy to “absorb’ the capital

Disclaimer

The views expressed in this report accurately reflect the personal views of the undersigned lead analysts about the subject issuer and the securities of the issuer. In addition, the undersigned lead analysts have not and will not receive any compensation for providing a specific recommendation or view in this report. Sanjeev Sanyal

The information and opinions in this report were prepared by Deutsche Bank AG or one of its affiliates (collectively "Deutsche Bank"). The information herein is believed by Deutsche Bank to be reliable, but Deutsche Bank makes no representation as to the accuracy or completeness of such information.

Important Information Regarding Our Independence. The research analyst principally responsible for the preparation of this report receives compensation that is based upon, among other factors, Deutsche Bank's overall investment banking revenues. Deutsche Bank may engage in securities transactions in a manner inconsistent with this research report, and with respect to securities covered by this report, will sell to or buy from customers on a principal basis. Disclosures of conflicts of interest, if any, are discussed at the end of the text of this report or on the Deutsche Bank website at http://equities.research.db.com/cgi-bin/compose?PAGE=HOMEPAGE.

Opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this report. They do not necessarily reflect the opinions of Deutsche Bank and are subject to change without notice. Deutsche Bank has no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate, or if research on the subject company is withdrawn. Prices and availability of financial instruments also are subject to change without notice. This report is provided for informational purposes only. It is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction. The financial instruments discussed in this report may not be suitable for all investors and investors must make their own investment decisions using their own independent advisors as they believe necessary and based upon their specific financial situations and investment objectives. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the price or value of, or the income derived from, the financial instrument, and such investor effectively assumes currency risk. In addition, income from an investment may fluctuate and the price or value of financial instruments described in this report, either directly or indirectly, may rise or fall. Furthermore, past performance is not necessarily indicative of future results.

Unless governing law provides otherwise, all transactions should be executed through the Deutsche Bank entity in the investor's home jurisdiction. In the U.S. this report is approved and/or distributed by Deutsche Bank Securities Inc., a member of the NYSE, the NASD, NFA and SIPC. In the United Kingdom this report is approved and/or communicated by Deutsche Bank AG London, a member of the London Stock Exchange. This report is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Singapore by Deutsche Bank AG, Singapore Branch, and in Japan by Deutsche Bank AG Tokyo. Additional information relative to securities, other financial products or issuers discussed in this report is available upon request. This report may not be reproduced, distributed or published by any person for any purpose without Deutsche Bank's prior written consent. Please cite source when quoting.