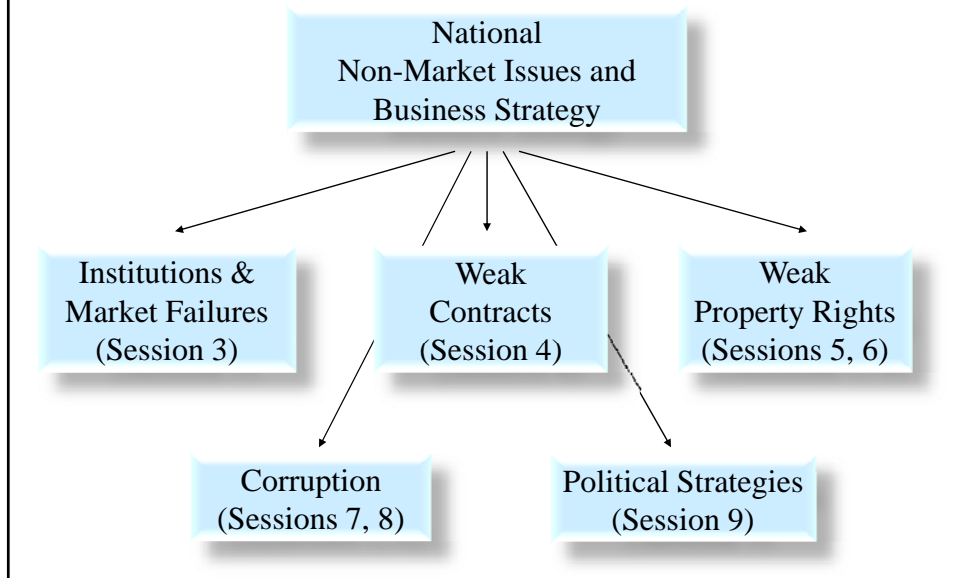
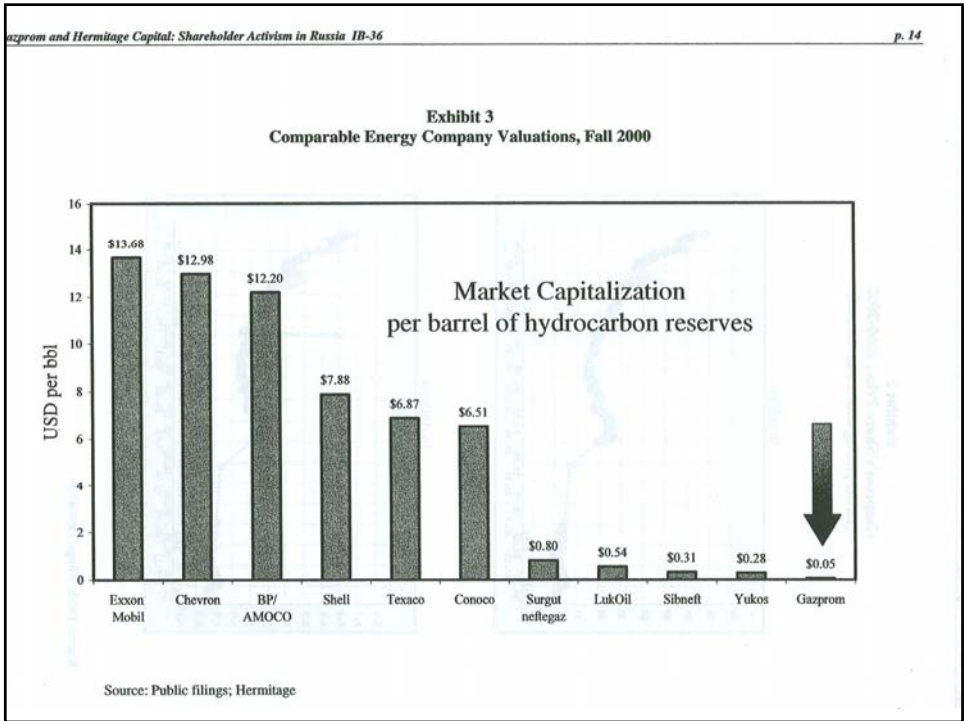


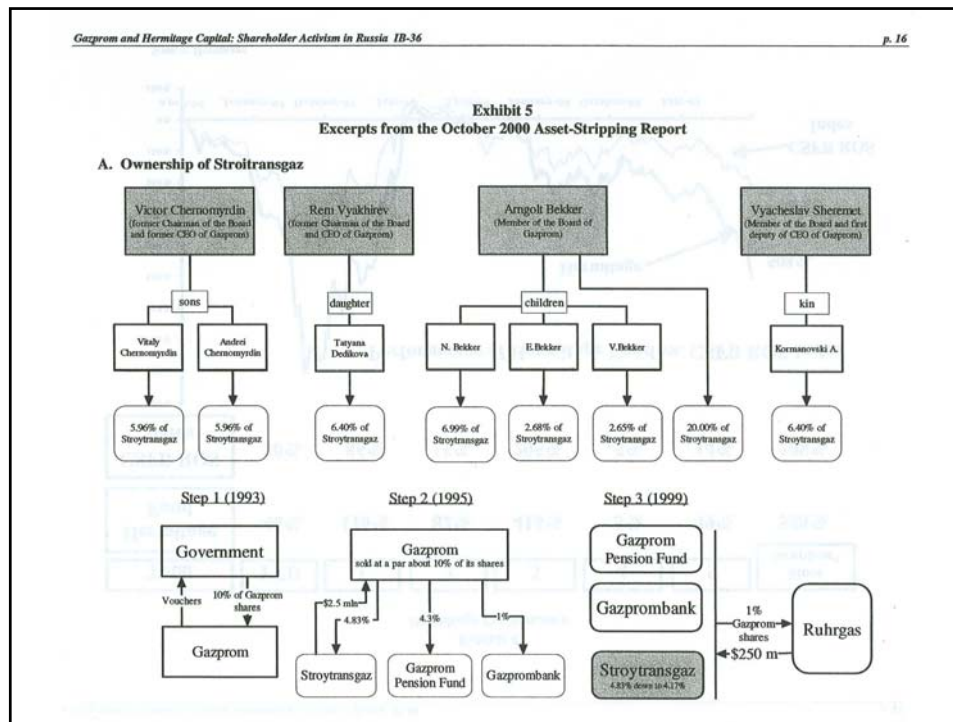
Part I (Session 3 – 9)



Gazprom Case

- The Setting & the Players
- Why is Gazprom's Stock Price so Low?
- Browder's Strategy





Where is Hermitage Capital Now?

- Browder's Russian visa revoked in November 2005
- Hermitage Capital's offices in Moscow raided as part of a "tax investigation" in June 2007
 - Three companies stolen from Hermitage Capital, used to generate \$230 million payment to thieves
 - Hermitage charged with underpaying taxes
- Sergei Magnitsky, Hermitage Capital's lawyer, arrested and held without bail. Dies in jail two months ago (he was 37)
- Medvedev fires 20 senior (mostly prison) officials last month

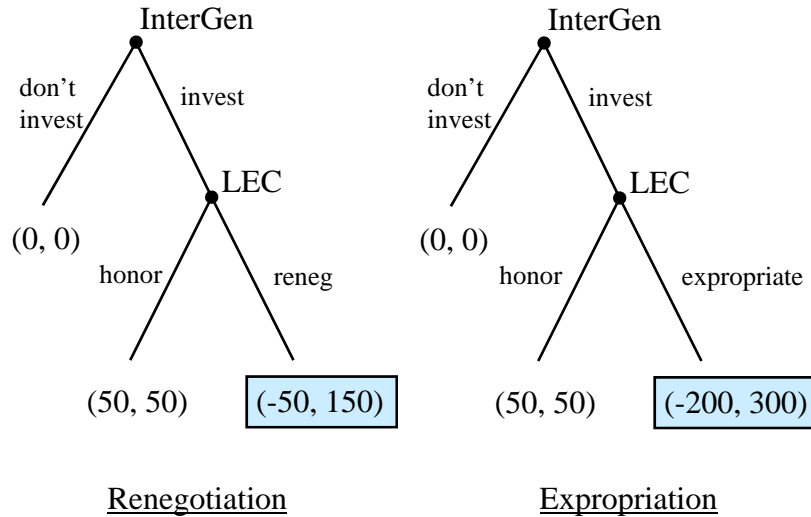
Property Rights I: Weak Investor Protections

- Property Rights & Expropriation
- Expropriation in practice
- Firm Strategy

Expropriation

- Protecting the right to private property is probably the most fundamental of all market institutions
- If people fear *expropriation* – the abrogation of their property rights – they will not invest
- Expropriation is like the hold-up problem, but worse
 - You invest in first stage
 - Instead of renegotiation your counterparty (or 3rd party) simply takes your investment from you
 - You get nothing but the cost of your investment
- Societies which do not respect private property rights will see very little investment

Compare Renegotiation and Expropriation



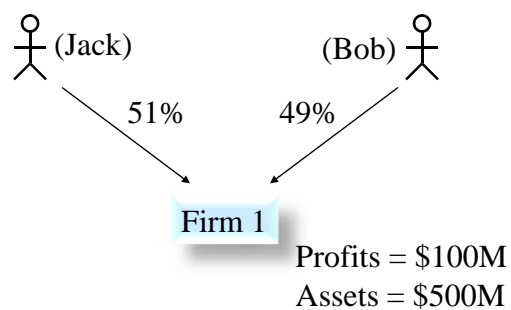
Expropriation in Practice: Government

- Historically, the most dramatic type of expropriation has been *nationalization*
 - A government takes your property
 - Common when Marxist parties come to power
 - Examples: USSR, Cuba, China, Mozambique, Guinea
- Nationalization less common after end of Cold War
 - Pro-market ideology mostly triumphant
 - Nationalization does still exist (e.g. Venezuela, Zimbabwe)
- Subtler forms more common than outright stealing
 - “Creeping expropriation” through taxation, tariffs, etc

Expropriation in Practice: Private Parties

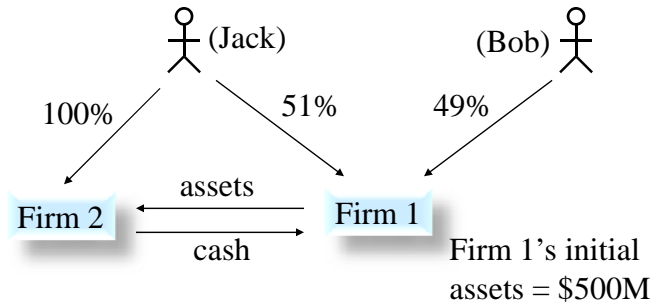
- Common forms of expropriation occurs between parties sharing equity in the same firm
 - Joint venture partners
 - Portfolio investors
- Party with greater control rights can use subtler means to steal money from other party
- Types of expropriation
 - Asset stripping
 - Transfer pricing
 - Equity dilution

Ownership Structure & Control Structure



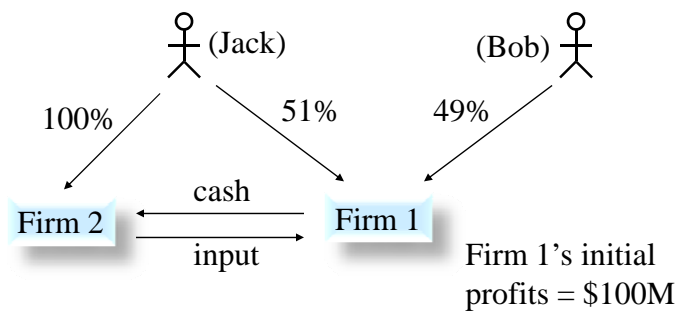
- Jack has *ownership rights* to 51% of the profits and assets of firm
- Jack has complete *control rights* through his majority stake
- Jack can use his *control rights* to steal from Bob

Asset Stripping



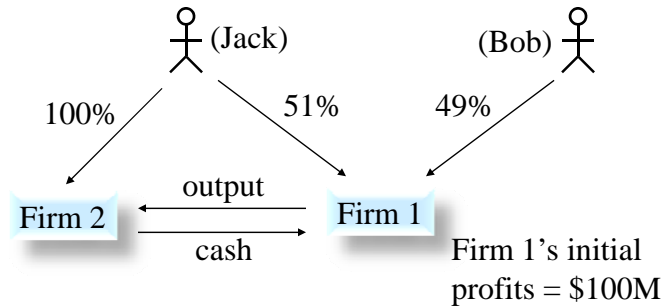
- Jack uses his control rights to sell Firm 1's assets to Firm 2
- Jack decides on very low price to be paid for assets
- Example: Jack transfers a factory worth \$200M, pays \$0M for it
 - Jack gains $(100\% - 51\%) * (\$200M - \$0M) = \$98M$
 - Bob loses $(49\% - 0\%) * (\$200M - \$0M) = \$98M$

Transfer Pricing I: Transfer Profits Upstream



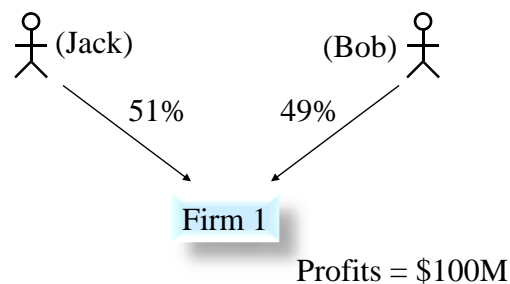
- Firm 1 buys a critical input from Firm 2
- Jack uses his control rights to raise the price Firm 1 pays Firm 2
- Example: Jack sets price so high that Firm 1 profits are now \$0M
 - Jack gains $(100\% - 51\%) * (\$100M) = \$49M$
 - Bob loses $(49\% - 0\%) * (\$100M) = \$49M$

Transfer Pricing I: Transfer Profits Downstream



- Firm 1 sells its output to Firm 2
- Jack uses his control rights to lower the price Firm 2 pays Firm 1
- Example: Jack sets price so low that Firm 1 profits are \$0M
 - Jack gains $(100\% - 51\%) * (\$100\text{M}) = \49M
 - Bob loses $(49\% - 0\%) * (\$100\text{M}) = \49M

Equity Dilution



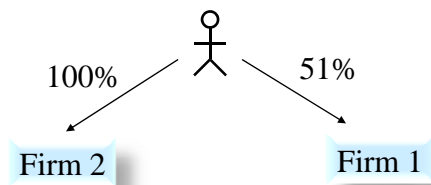
- Jack announces new equity issue that doubles number of shares
- Jack buys the shares at insider price of \$0
- Afterwards, Jack owns 75.5% of company, Bob owns 24.5%
 - Jack gains $24.5\% * \$100\text{M} = \24.5M
 - Bob loses $24.5\% * \$100\text{M} = \24.5M

Summary

- Minority shareholders' ownership rights are weak when others can control firm actions
- Asset stripping: steal *assets* from partner
- Transfer pricing: steal *profits* from partner
- Equity dilution: steal *ownership share* from partner
- Well-functioning market institutions protect minority shareholders by making these practices illegal and enforcing the law
- Business environments with weak protections
 - present special risks to minority owners
 - reduce investment by reducing supply of capital

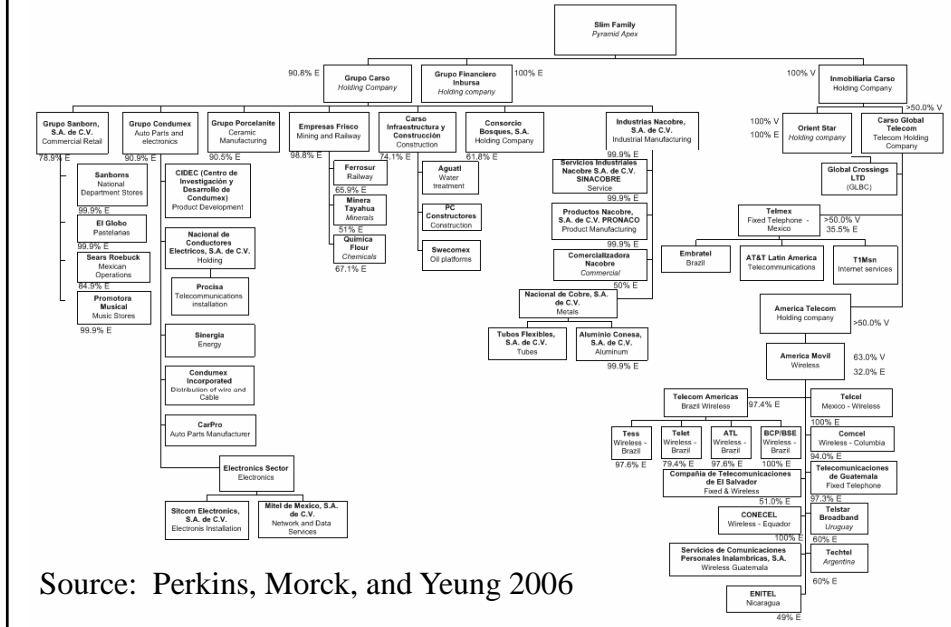
Evidence

- Bertrand et al (2002)
 - Study profit shocks to divisions of conglomerates in India



- If tunneling occurring, positive profit shock to Firm 1's industry will appear relatively weakly in Firm 1 and will also appear in Firm 2
- Positive profit shock to Firm 2's industry will appear relatively strongly in Firm 2 and will *not* appear in Firm 1
- Find evidence consistent with all these predictions
 - Estimate that 25% of profits are tunneled

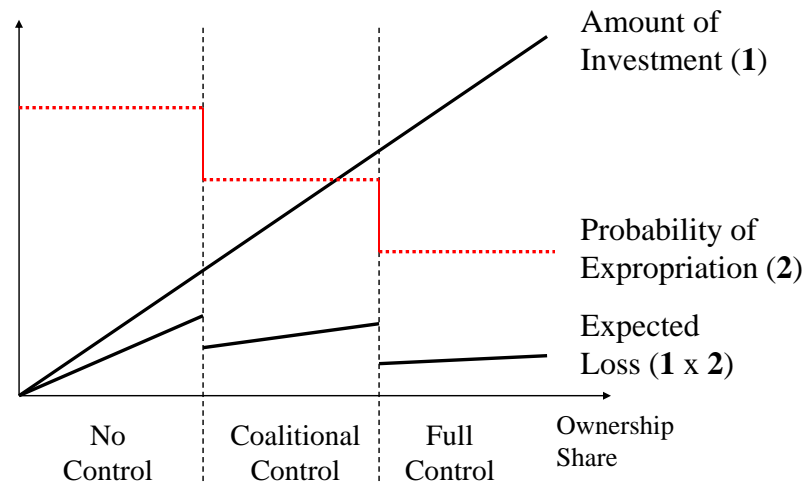
Example: The Slim Helu Group



Source: Perkins, Morck, and Yeung 2006

Strategy I: Control vs. Exposure

- There is a discontinuous tradeoff between control and general exposure. Putting in *more* can mean *less* risk



Strategy II: External Leverage

- If full control is not desirable or feasible, how can you prevent partners from abusing their control rights?
- Identify partners' interests
 - Are their incentives aligned with yours?
 - Is what they want likely to change?
- What points of *external* leverage can you employ – i.e. what leverage can be created outside the bylaws of the firm in which equity is shared?
 - Court system
 - Reputation & Information
 - Political leadership

END