

## emerging markets

# The miracle that became a problem

Comparing new capital mobilisation in Asia and Latin America in the 1990s, it is clear that Asian corporate managers exacerbated the crisis. **David Smith** reports



The recent financial crisis in Asia has greatly changed the world's perception of this region. Asian economies have gone from "miraculous" to "problematic". As the wealth and relative incomes of these economies diminished, many observers came to the conclusion that international and Asian capital markets failed.

*The Asian Bet*, the latest study from Duke University, seeks to assess the claim that capital markets failed to perform their primary duties during the 1990s. The results indicate a significant proportion of the growth in market capitalisation of Asian markets during the 1990s resulted from new capital mobilisation. Asian and international capital markets provided the funds required to sustain the high investment rates that characterised the region.

The research considers the following example of new capital mobilisation: the total number of listed companies on the exchanges in China, Indonesia, Korea, Malaysia, the Philippines, Taiwan, and Thailand increased from 1642 to 3766 between 1990 and 1996.

This increase constituted a significant amount of new capital mobilisation. In Latin America, on the other hand, only 108 initial public offerings (IPOs) found their way on to the major exchanges. Asia issued more than three times as much seasoned equity than Latin America in the 1990s.

The total value of seasoned equity offerings by International Finance Commission (IFC) constituents in Asia

between 1990 and 1996 was \$120bn, while in Latin America the total issuance amounted to slightly more than \$32bn.

Legislating for the size of these regional markets, Asian equity markets were well ahead of Latin America not only in the total amount of seasoned equity issuance, but also in the ratio of total value of seasoned equity issuance to market capitalisation (cap).

In order to get some indication of the contribution of new capital mobilisation to the change in market cap, the research considered the ratio of total value of seasoned equity offerings to the total change in market cap.

Within Asia, new share issuance accounted for 15 per cent of the change in market cap of the region between 1990 and 1996. Only 8 per cent of the growth in the market cap of Latin American stock markets could be attributed to new capital mobilisation.

Throughout the 1990s Asian corporations also made extensive use of international equity markets to raise capital. Comparing the international equity issuance record of Asia to that of Latin America, there is little difference at the aggregate level.

Between 1992 and 1995, 209 Asian and 180 Latin American equity placements were made in international equity markets. The total value of international equity placements during the same time period was \$17.6bn for Asia and \$16.9bn for Latin America. At least one subtle but important distinction should be men-

tioned. Latin American firms tended to prefer publicly issued international equity to private placements.

While American depository receipts and global depository receipts provided Asian firms with an attractive means of raising international capital, it was not the only way that these firms could tap into the bond markets. Throughout the 1990s, the Eurobond market and foreign bond markets served as alternative sources of capital for Asian corporations.

Between 1990 and 1997, East Asian firms managed to float more than \$126bn in these markets (estimated debt issuance by Capital Markets Bondware). More than two-thirds of this amount, \$83bn, was denominated in dollars.

The ability of East Asian companies to tap into this international market can be judged in relation to their Latin American counterparts. Between 1990 and 1997, Latin American companies succeeded in issuing more than \$181bn in Eurobonds. The fact that Latin American companies surpassed their East Asian counterparts in total international bond issuance is astounding, considering the Latin American debt crisis remains a recent memory for most investors. The resurgence in international bond flows to Latin America during the late 1990s overwhelms the flows into Asia.

Despite the significant new capital mobilisation, Asian stock markets remained heavily concentrated in terms

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of market cap of individual firms, industry base, and equity ownership. This high degree of concentration contributed to a lack of cross-sectional variation in returns across firms.

In general, individual corporations listed on Asian exchanges tended to move together to a much larger extent than would be expected in more diversified stock markets. For the region as a

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whole, 70 per cent of the individual stocks exhibited price movements in the same direction each month.

The study also provides a micro-level analysis of Asian financial markets with a systematic evaluation of the performance and financial risk of Asian corporations. It finds Asian corporate managers increasingly leveraged their companies despite declining profitability. Consider the following examples of deteriorating corporate performance and increased financial risk of Asian firms: In Indonesia

the median return on equity (ROE) drops steadily, falling from 15 per cent in 1992 to 12.5 per cent in 1996. In Thailand this pattern is more pronounced. In 1992, the median ROE falls from 19.4 per cent to 7.7 per cent in 1996.

The return on invested capital provides another convenient indication of a firm's performance. The changes in Asian returns on invested capital (ROIC) during the 1990s parallel the changes in the ROE. As far as increased financial risk is concerned, consider the following summary statistic. In 1992 the median leverage ratio across Thai firms was 68.6 per cent. By 1996 the median firm's leverage ratio had almost doubled to 114 per cent.

While the median firm in Korea managed to decrease its leverage ratio, the financial risk across all Korean companies was substantially higher compared with other Asian firms.

While the causes of the Asian crisis are complex, this micro-level analysis suggests that individual firms greatly increased their risk exposure. The paper refers to the higher leverage at a time of declining profitability as a "bet".

A shock to the economy could have a greatly magnified and a potentially catastrophic effect because of the high-risk exposure induced by corporate managers. While Asian corporate managers did not initiate the crisis, their deficiencies in standard risk management practices greatly exacerbated the crisis. The decline of many corporations can be directly tied to a failure in corporate governance with respect to risk management and control.