WHEN BACKING COMPANIES, GOVERNMENTS SHOULD THINK LIKE INVESTORS

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EVEN BEFORE THE COVID-19 pandemic, rising protectionism and economic nationalism were altering the rules of global competition. In response, governments were looking for ways to bolster the international competitiveness of domestic companies, including through direct government support. Now as the fallout from COVID-19 continues, governments are likely to consider directing some of the stimulus and aid they are providing toward individual companies, particularly those with critical roles in their economies or large workforces. But what are the pitfalls in providing direct support to companies? And what steps must governments take to ensure optimal results from such actions?

BCG set out to understand the dynamics and impact of government policies to support individual companies. We conducted an in-depth study of companies that are dominant in their home market, including many that have received government support such as government ownership or subsidies. While that analysis, which assessed the financial performance of 469 publicly traded companies from the G-20 countries, was conducted before the COVID-19 outbreak, the insights it yields can inform government actions in the months ahead. Among our findings: government support of individual companies is prevalent, however companies that receive support tend to underperform those that do not—an indicator that governments often fail to bring a disciplined, investor lens to those efforts.

Such evidence aligns with the view of BCG and many others that government support to individual companies can only be successful if executed well and as part of a broader economic development approach. Our research zeroed in on what defines successful government support—and what leads to failure. Based on that work we have identified four key guidelines for governments aiming to support the global ambitions of local companies:

- Use objective criteria to select companies for support.

- Be clear on the goals for providing support—and the levers to be used.
- Limit the time period for intervention and gear support toward international competition.
- Adapt quickly to changes or new developments.

As governments grapple with where and how to provide companies with direct support during and after the COVID-19 pandemic, they must adopt an investor mindset. This will enable them to develop a flexible and adaptive approach that maximizes financial returns and minimizes distortions in the domestic market.

How Support For Companies Fits Into a Broad Development Strategy

Government has long played a central role in supporting the development and globalization of industries—as well as individual companies. And for almost as long the optimal nature and extent of that role has been controversial and hotly debated.

As far back as the 18th and 19th centuries, interventionist policies proposed by Friedrich List were heavily denounced by Adam Smith in his work advocating a laissez-faire economic landscape. Today the debate continues. Former World Bank Chief Economist Justin Yifu Lin and University of Cambridge economist Ha-Joon Chang, for example, disagree over whether governments, through heavy support for companies, can enable industries to leap ahead in development.

In general, there are two government approaches to driving economic development. The first, often dubbed "traditional growth theory," advocates "horizontal" policies aimed at improving the general business environment. Under this approach, the role of the government is to ensure an environment in which businesses can thrive, without providing support for specific sectors or companies. Horizontal policies aim to create well-functioning markets in which companies operate by fostering competition and building strong institutions that provide, among other things, education and easy access to capital.

The second approach involves more direct and focused "vertical" policies, typically aimed at supporting specific sectors, industries, or companies. The theory of structural transformation, for example, holds that certain industries—those that offer high value-added products or services—are more desirable than others and therefore should be supported and promoted by vertical policies.

At BCG, we believe countries should build economic development strategies that are a deliberate blend of both approaches, with enhancement of the nation's competitiveness as the ultimate objective. Such efforts must, of course, take into account specifics of the location. And there is clearly not one way to reach a successful blend of horizontal and vertical policies. There are a host of policies that, depending on their design, can be horizontal or vertical in nature, including schemes to attract foreign direct investment, cluster development efforts, trade facilitation programs, urban and regional development initiatives, and innovation strategies. And vertical policies aimed at supporting individual companies can also be part of the mix.

Insights from the Study of Government Support

Given the shift toward a more interventionist posture in many large countries, we decided to dig into the issue of company-level support in helping companies compete globally. We conducted a financial analysis of 469 publicly traded companies from G-20 countries, including those that had received government support and those that had not. Although private companies also clearly receive government support, our analysis was focused on publicly traded companies mainly because more information is readily available for those entities. To meet our definition of government support, the assistance needed to be significant: government ownership of 10% or more or a direct grant or subsidy higher than $100 million. It also had to be company-specific, rather than a sector or economy-wide measure. Support could come in a variety of forms:

- Financial support, such as ownership, subsidies, and subsidized loans
- Access to assets, such as government procurement opportunities and construction of specific infrastructure
- Operational support, in areas such as research and development
- Nonmarket-based support, including the granting of a monopoly and diplomatic lobbying for international contracts

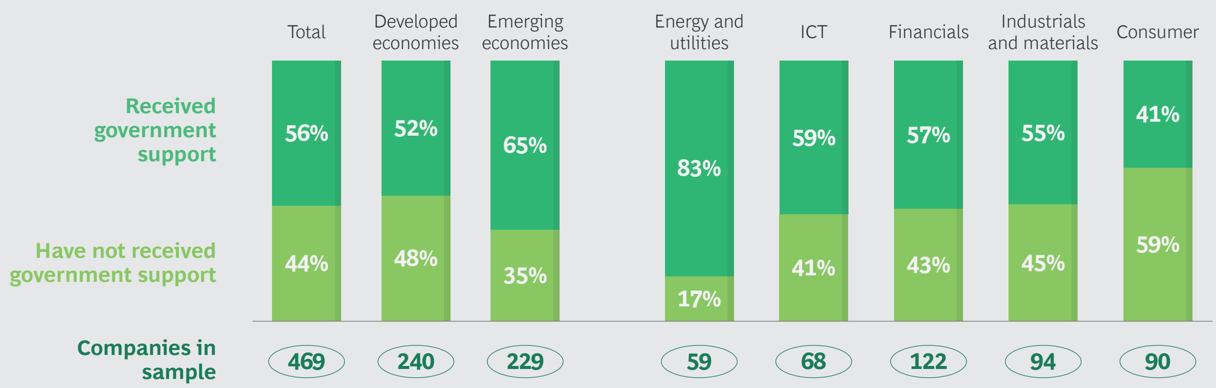
Government support for companies is prevalent. It is clear that government support is omnipresent with more than half of the companies in our sample receiving targeted support. The share is higher in emerging economies and varies by industry. (See Exhibit 1.)

Our view is that government support is most effective when it is invested at a sector or industry level to create enabling environments with well-designed regulations, reliable infrastructure, open market access, and the requisite skilled workers. This approach establishes a level playing field from which winners—players with sound strategies and the right competencies—naturally emerge.

Still, it is clear that some governments will choose to support companies for a number of reasons. First, governments may act because they believe that the growth of a particular company, and that of its direct suppliers, will boost GDP and national jobs growth. Under this scenario, governments are prone to support companies in industries that may face difficulty accessing sufficient capital, for example, companies with large capital expenditure needs or with a very long time horizon for generating returns.

Second, governments may support individual companies with the objective of driving the development of specific industries and ecosystems. For example, governments have supported airlines for a host of reasons, including national pride, or because they want to foster the development of cities as regional or global commercial hubs, promote trade growth, or strengthen tourism. That support can come in the form of fuel subsidies, discounted airport user charges, interest-free loans, subsidies for opening new routes, and exclusive access to world-class terminals built by the government.

EXHIBIT 1 | Government Support of Large Companies Is Widespread and Varies Among Industries



Sources: Capital IQ; BCG analysis.
Note: Analysis of 469 publicly traded companies, each among the top 25 companies in G-20 economies. Developed and emerging economy designations based on International Monetary Fund classification. Industries with insufficient sample size are not shown. ICT = information and communications technology.

Third, governments often base support of individual companies on national security priorities. This was the case in 2014 when the French government intervened in the sale of Alstom's power and grid divisions to General Electric. The French government opposed GE's bid, citing issues related to national technological independence in the civil nuclear field, and the potential impact on French jobs. Ultimately France issued a decree, dubbed "*décret* Alstom", giving the state power to veto the takeover of "strategic interests." The acquisition was finalized in late 2015, with conditions such as a set of commitments from GE that included creating jobs in France and maintaining some headquarters, industrial footprint, and nuclear activities in the country.

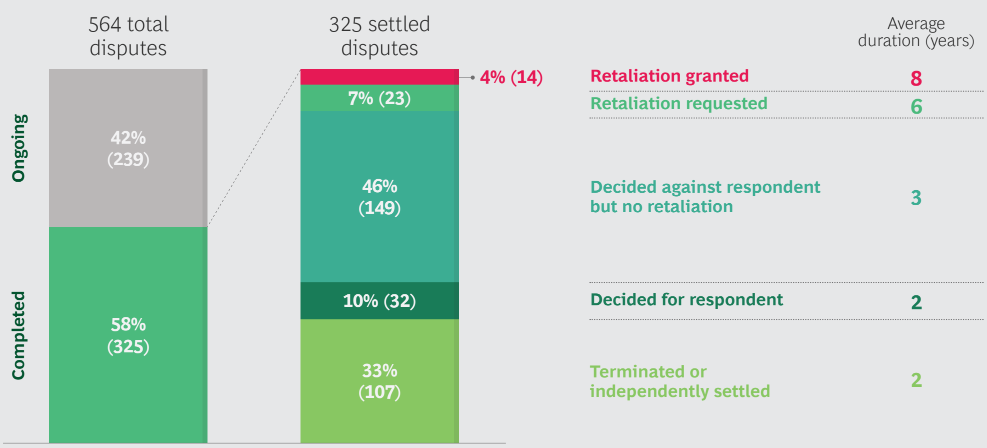
The future will be marked by more government intervention. Although the reasons behind government support of individual companies may not change significantly, the global environment is evolving. A new globalization is taking root, one that is giving rise to new political, economic, and business models. And all three are driving government action to support individual companies.

- **New Political Model.** Increasingly governments are embracing economic nationalism and protectionism, turning away from multilateral collaboration in favor of bilateralism. A natural outgrowth of this shift is increasing government support of leading domestic companies. This is evident in the way that governments–which in the past typically played by the rules outlined by multilateral organizations such as the WTO—now frequently use those rules when they benefit their companies and sidestep them when they do not.

Consider trade dynamics in the steel industry. The US increased tariffs on steel and aluminum imports on the grounds that overreliance on foreign steel manufacturers would pose a threat to national security. The action reflected a novel interpretation of WTO rules. At the same time, 515 steel industry antidumping cases were filed with the WTO in 2018, up from 301 in 2005, reflecting a greater tendency by some countries to ignore altogether the rules imposed by the WTO.

Such disregard for WTO rules overall is hardly surprising. Disputes take a long time to resolve (eight years on average for cases involving retaliation) and economic penalties for violations are authorized in only 4% of cases. (See Exhibit 2.) At the same time, even

Exhibit 2 | WTO Disputes Take Years to Resolve and Rarely Result in Retaliation



Sources: WTO; expert interviews; BCG analysis.
Note: All outcomes included from 1995 through mid-2018.

in those cases where economic retaliation is granted, action is not always implemented.

- **New Economic Model.** Today emerging economies are playing a more substantial role in driving global economic growth, and trade growth is flatter than in the past. In emerging economies, this new economic model has resulted in the adoption of policies to support rapidly growing companies as they go global, policies similar to those embraced in developed markets for decades. Governments in developed nations, meanwhile, have often responded to the new economic model by protecting their own domestic companies at home from inroads by large emerging market competitors. Investment screening, often used by governments to protect strategic interests and intellectual property, can be a lever for providing such protection. (See the sidebar "Increased Investment Scrutiny in Europe.")

- **New Business Model.** Cross-border digital trade is increasing, complexity is growing as companies move to establish digital ecosystems, and the cost of acquiring or developing new technologies, including AI, genetic engineering, nanotechnology, and smart materials, are on the rise. In response, governments are increasingly establishing regulations aimed at ensuring a level playing field for all players operating in their country, a step that should ultimately help domestic companies adapt effectively to these shifts.

Some governments have taken steps to protect domestic companies from rising competition in digital trade. In the past few years, the US government, citing national security concerns, has taken a more activist approach on mergers and acquisitions in the technology industry. The Committee on Foreign Investment in the United States (CFIUS) recently blocked several acquisitions by Chinese players of US companies in the technology industry or in businesses with access to large amounts of personal data.

Government can also play a role in supporting digital ecosystems. Development of these increasingly critical networks hinges on a number of factors including a strong user base and a deep bench of partners across numerous industries and countries. Governments, particularly in Southeast Asia, are designing policies that encourage the cultivation of these ecosystems. Such approaches can include creating an environment that is conducive to digital experimentation, fostering the development of startups (critical elements of robust ecosystems), crafting intellectual property laws suited to the digital age, and ensuring regulations for data sharing that encourages collaboration while still protecting consumer privacy.

INCREASED INVESTMENT SCRUTINY IN EUROPE

In April of 2019 the European Union instituted an investment screening framework to "safeguard Europe's security, public order and strategic interests."

Under the framework when a non-EU company plans to invest in EU companies with critical infrastructure, technologies or raw materials, or sensitive information or media assets, a review process can be initiated by any member state or by the European Commission. That review includes an assessment of whether the investment is likely to pose a threat. Both the European Commission and other member states can provide comments and opinions. The final decision to approve or block the deal is made by the member state where the investment is to take place, taking into account comments from both the European Commission and other member states.

Measuring the impact of government support. Amid the likelihood of more government intervention, we wanted to understand how company-level support impacts market performance. We analyzed the 20 to 25 largest companies in each of the G-20 economies and found that companies receiving individual support are on average faring worse than those that receive no support. This does not, of course, prove that government support causes underperformance. However, it does show that government support is often not sufficient to make a company successful. (See Exhibit 3.) We observed this trend in both emerging economies and advanced economies, across all geographies and almost all sectors.

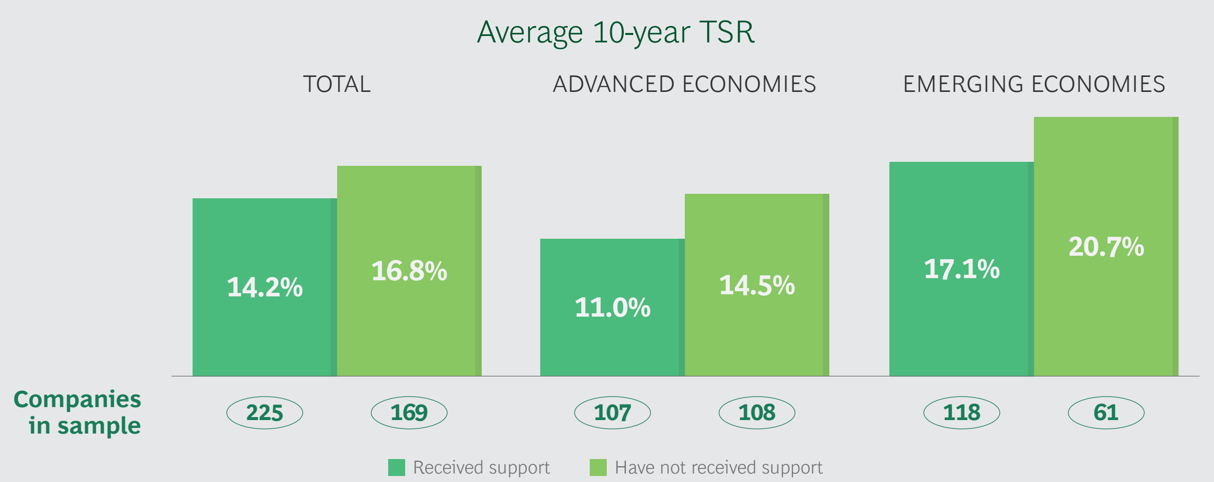
What explains these results? Our research has identified a number of clear pitfalls for governments providing company-level support.

First, in some cases governments are supporting companies that do not have a competitive advantage in the market—a fact that government assistance is unlikely to remedy. A prime example of the above happened in Sweden in the 1970s. While the Swedish shipbuilding industry at that time was at a clear competitive disadvantage globally, the government poured billions of dollars into individual shipbuilding companies. Many of those companies never managed to regain their competitiveness and disappeared.

Second, government support can distort domestic competition, which can negatively affect the performance of individual companies or an entire sector. In the 1970's, South Korea government focused its limited resources on supporting the country's largest companies. These Chaebols have greatly contributed to the industrialization of Korea, but some observers argue this has constrained the development of the small and medium enterprise landscape. Over the last several decades, Korea has been working to find the right balance, which would allow it to support large companies while not distorting competition.

Third, the support of domestic players over foreign competitors can harm bilateral relations. As multilateralism gives way in some areas to bilateralism, this has significant consequences. The trade war between the US and China, for example, stems in large part from the US belief that China is protecting its domestic market from foreign companies, while benefiting from open markets abroad.

Exhibit 3 | Companies That Receive Government Support Underperform on Average



Sources: Capital IQ; BCG analysis.
Note: Analysis of 469 publicly traded companies, each among the top 25 companies in G-20 economies. Companies that have yet to report ten-year TSR are not included. Developed and emerging economy designations based on International Monetary Fund classification.

Fourth, government support, particularly government ownership, can lead to weak corporate governance—which in turn can lead to corruption. Weak corporate governance can also incentivize rent-seeking behavior, introducing major moral-hazard risks.

Adopting an Investor Lens to Support Companies

Given the evidence outlined above, how should governments approach the issue of supporting individual companies as part of their blended economic development strategy?

First, they should make an objective determination about whether the potentially lower financial returns for supported companies are acceptable in light of the potential benefits. The decision will depend on the specifics of the country and the companies considered for support and therefore is not a primary focus of this article.

Second, in those cases where the potential benefits seem to warrant intervention, governments must take steps to ensure they maximize those benefits as well as the returns for their supported companies. Our research revealed key insights on this point, yielding four best practices that governments should follow in supporting companies to become successful global competitors. These four guidelines help governments adopt an investor mindset that can help minimize market distortions and maximize returns. In some cases, sovereign wealth funds may be an effective tool for ensuring governments are bringing a private investor lens to their efforts. (See the sidebar "The Discipline of Sovereign Wealth Funds.")

Set objective criteria for support. The government should have clear criteria for the companies that will receive any direct support. This can include companies with a fundamental and sustainable competitive advantage and ambitions for international growth and those that play a key role in society. The latter criteria is often a factor in support of companies in the transportation industry. In South Korea, where the economy is very dependent on overseas trade, the government is providing a $1 billion capital injection to Hyundai Merchant Marine and has pledged to continue its support in order to avoid disruption to the Korean economy.

Governments may also target support to companies that can have a positive social or environmental impact. They may support companies that can contribute to national job growth, through their own operations or that of their suppliers.

Outline goals and the appropriate levers. Governments need to design their support with a clear goal in mind, and should apply different levers depending on those goals. We have identified three key archetypes of government support and the typical set of levers being applied to each. (See Exhibit 4.) This is not an exhaustive list, but it does capture some of the most common.

THE DISCIPLINE OF SOVEREIGN WEALTH FUNDS

Sovereign wealth funds often bring the discipline required for smart government investing strategies. First, they typically demand strong corporate governance practices. Second, with board representation—if not outright board control—they can shape company management and strategy. Third, they have a results-driven culture, closely monitoring performance of their portfolio companies. Fourth, they are often able to transfer much needed capabilities through temporary assignments of members of their management team into their portfolio companies. Fifth, they can be strong advocates for companies in need of certain government support such as loan restructuring or help with mergers and acquisitions.

One frequent objective is supporting a company to achieve aggressive growth. Governments can use a variety of levers to this end, including giving the company preference when awarding government procurement contracts or directing or supporting mergers and acquisitions. One European country merged three government-owned companies to form a conglomerate and supported the new company by awarding government procurement contracts.

Another objective is to fuel international expansion using levers such as export finance assistance and lobbying of other governments. One tech company, for example, expanded in Africa with the support of its home country. This included export financing for the company and development loans from the home government to African countries buying the company's equipment.

A third objective is to advance national priorities through actions such as the provision of capex funding, support for innovation, and balancing labor supply and demand. In the 1960s, '70s and '80s, an Asian government advanced its nation's industrialization by supporting a diversified industrial conglomerate, through licensing agreements that limited competition in certain sectors, as well as providing access to government assets and contracts and creating education partnerships.

All three archetypes either directly or indirectly help companies become strong players that can compete effectively in global markets.

Design support to limit market impacts. Governments need to minimize any distortions of the overall market and competition. As a result, they should set a time limit for any company support, a step that can reduce the moral hazard risks. In the case of bailouts, it has been argued that applying punitive measures to executives and shareholders reduces moral hazard distortions as well. The US automotive industry bailout, under which the government required management changes, is a clear example of the latter.

They should also focus their support when possible on a company's international operations. This can include policies to bolster a company's exports or government funding to support a company's investments in its existing or prospective foreign operations. In cases where companies need significant scale to compete globally, however, governments initially may want to support domestic growth.

In all instances, governments need to ensure supported companies emerge as strong competitors. Companies receiving support that are suppliers of government products and services, for example, must be held to global quality standards.

EXHIBIT 4 | Three Key Archetypes of Government Support

Source: BCG analysis.

Be agile in adjusting or ending support. Governments must adapt quickly to new information and developments, in some cases terminating their support when companies are not meeting expectations.

To ensure agility in the face of new opportunities or emerging threats, governments should assess and monitor the market dynamics for the companies they support. Malaysia's sovereign wealth fund Khazanah Nasional Berhad, for example, made several opportunistic investments in hospital organizations from 2005 through 2012, creating IHH Healthcare Berhad which was at one time the second-largest hospital group by market capitalization worldwide. Khazanah's regional healthcare network achieved critical mass with the purchase of 24% of Parkway Pentai, one of South Asia's largest private healthcare providers, at the height of the 2008 financial crisis, followed by the full acquisition of the company in 2010 before markets had fully recovered.

Finally, governments must be willing to acknowledge failure. Academic research has found that productivity growth is driven in large part by the substitution of efficient businesses for inefficient ones. If governments continue to support poor-performing operations, that will limit productivity gains. Despite that evidence, in too many instances governments continue—or even increase—their support of companies despite strong evidence those companies are failing. To avoid this, governments must pay attention to KPIs and milestones and if the company is failing, pull support.

Managing the Risks of Company-Level Support

Governments play a critical role in the development of industries—and companies—within their borders. As the rules of global competition change, they must adapt and develop strategies that reflect the new environment. Creating the right foundation for economic development, including through the establishment of a smart regulatory environment, sound infrastructure, open markets, and a balanced labor market, is more important than ever. But they will increasingly face questions about whether supporting individual companies also makes sense.

If governments decide to provide company support, they must do so with discipline and an investor mindset. This means establishing clear criteria for support, outlining objectives and the levers to achieve them, limiting market distortions, and responding to new developments—including signs of poor company performance. Governments that deploy these guidelines are more likely to succeed in helping their companies thrive globally and produce competitive financial returns.

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