Raising Capital in Global Financial Markets

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What are Capital Markets?

• Capital markets facilitate the issuance and subsequent trade of financial securities.
  • The financial securities are generally stocks and bonds.
  • They are used by companies and governments to raise funds and pension funds, hedge funds etc. to invest funds.

• Financial regulators (e.g., the SEC in the U.S., CSA or OSC in Canada, SFC in Hong Kong etc.) ensure investors are protected when buying/selling financial securities.
  • Most regulations require disclosure to ensure investors have the information they require when making decisions.

How Important Are Capital Markets?

• Firms need money to implement their business strategies.
  • Any other reasons to require capital?
  • What is important to the firm when raising capital?
  • What are the rights and responsibilities of firms? Regulators? Governments?

• Recent headlines:
  • “Time for Plan Z: Blackberry is set to go private”
  • “Greenwash: Ontario transit bond is just clever marketing”
  • “Beating Earnings is Good. Beating Sales is Better.”
Capital Market Development

• Although firms have raised capital globally for centuries, until the 1980’s the majority was debt.

• Some exceptions …
  • During Roman times, the empire contracted out services to private groups who sold shares traded throughout the empire.
  • The Dutch East India Company was the first multinational and the first to issue stock as we know it in 1602.

• The demand for international equities changed when British institutional investors (among others) were allowed to have more foreign content in their portfolios in the early 1980’s.

Why Do Stock Exchanges Develop?

• Using Canada as an example, until the mid-1800s, businesses and governments in Canada primarily accessed capital from European markets.

• By 1852, several Toronto businessmen were periodically meeting to exchange shares, mortgages and other loans.

• In 1861, twenty-four businessmen created the Toronto Stock Exchange.
  • To trade individuals had to be members.
  • Fewer than two dozen companies were listed. Trading was limited to half-hour sessions and only two or three transactions occurred per day.

• In 1878 it was growing so it moved to a permanent location and started to expand its membership.
Why Raise Funds Globally?

• Diversification
  • Smoothes out non-systematic risks.
  • Overcomes differences in valuation (i.e., market saturation, market segmentation).

• Types of diversification
  • Location: Domestic, International
  • Asset classes: Bonds, Commodities, Equities, Real Estate
  • Others: Financial innovation

• Risks / Returns
  • Volatility – from information arrival (or not).
  • Liquidity.

Why Go Global? An Example

Bell Canada Enterprises

• Since 1975 its shares traded in Canada and abroad.
  • It established an international reputation by listing on the NYSE and six European stock exchanges.

• In 1983 it issued new shares on the TSE, NYSE and European exchanges: a "trailblazing new concept". It used three underwriting syndicates (Canada, US and Europe)

• Why do this, it had access to sufficient capital in Canada?
  • It heightened Bell Canada’s visibility in Europe as the firm’s largest subsidiary, Northern Telecom, was pushing into the British telephone switching market.
Summary: Why Go Global?

- Increased size of potential capital.
- Lower costs due to the potential segmentation across markets and saturation of domestic markets.
- Diversification and management of country risk (and associated economic risks).
- Modify foreign exchange risk.
- Increased global recognition.
- Tax reduction/avoidance.

Financing Strategies: General Rules

Choose the corporate financing strategy that:
1. Minimizes the expected after-tax cost of financing, and
2. Maintains the level of different types of risk within acceptable levels.

These effects may be more difficult to assess in an international setting, but there are also more opportunities. Some of the issues:
- Institutional and regulatory differences
- Tax laws differ across countries
- Political risks, cultural risks, etc.
Global Financing Options

Equity Financing:
- Cross-listing – e.g. an Israeli firm on the NYSE
- Global Depositary Receipts – e.g. ADR’s
- Euro-equity market

Debt Financing:
- Foreign bank loans
- Foreign bonds – e.g. Yankee Bonds and GDN’s (like ADRs)
- Euromarket bonds – e.g. EuroYen bonds

Derivatives:
- Using futures, options or swaps to change cashflows and thus economic exposure.

Major Global Financial Centres

<table>
<thead>
<tr>
<th>PRIMARY:</th>
<th>SECONDARY:</th>
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<tr>
<td>NEW YORK</td>
<td>FRANKFURT</td>
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<td>LONDON</td>
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<td>SINGAPORE</td>
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<td>TORONTO</td>
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World Market Capitalization

1970
- USA: 66%
- Europe: 22%
- Asia: 5%
- Other: 7%

2000
- USA: 43%
- Europe: 30%
- Asia: 20%
- Other: 7%

Stock Market Capitalizations 1990-2012

- New York
- Toronto
- Hong Kong
- Japan
- China
- Frankfurt
- London
- Euronext

Source: World Federation of Exchanges
International Equity Issues (billions USD)

Source: Bank for International Settlements

International Debt Issues (billions USD)

Source: Bank for International Settlements
International Capital Issues (trillions USD)

Global financial stock has surpassed pre-crisis heights, totaling $212 trillion in 2010
Global stock of debt and equity outstanding1
5 trillion, end of period, constant 2010 exchange rates

International Equity: Cross-listing

To list shares on a foreign exchange companies must:

1. Qualify for listing according to the standards set for overseas companies by the exchanges.
   - For the NYSE foreign firms must have a pre-tax income of over $25M (for domestic firms it is only $2.5M), and a market value of publicly held shares of over $100M ($40M for US).
   - Arrange same settlement facilities as domestic issuers.

2. Register with the local securities commission therefore they must conform to local GAAP etc. and pay the necessary fees.
   - Note: Canadian and Israeli companies can list their shares on the US exchanges “like” US companies.
Why Crosslist?

1. Improves the liquidity of your shares.
2. Helps overcome mispricings due to illiquid capital markets, governance concerns or market segmentation.
3. Increases visibility in foreign markets.
4. Establishes a market for shares to perform transactions such as acquisitions in the host market.
5. Establishes a secondary market to compensate management and employees of subsidiaries in the foreign country.

International Equity: Depositary Receipts

An alternative to overseas listings
- DR’s are certificates representing ownership of shares
  - They represent ownership of a specific number of underlying shares held in trust at a custodian bank.
- American Depositary Receipts (ADR’s) were developed by JP Morgan in 1927 so Americans could invest in the British retailer Selfridge & Co.
- Since it was conceived and initially only used in the US, ADRs are the best known. They allow non-U.S. companies to offer and trade their shares in the U.S.
  - Increasing use of Global Depositary Receipts (GDR’s).
  - Indian firms represent the largest number of DRs. There are now also Hong Kong Depositary Receipts, Indian Depositary Receipts.
Trading of (American) Depositary Receipts

- Shares held on deposit at custodial bank
- Receipts
- Shares traded on local stock exchange
- Receipts traded by US investors

Publicly traded firm outside of US

Shares held on deposit at custodial bank
Receipts
Shares traded on local stock exchange
Receipts traded by US investors
Shares or receipts traded by US investors (arbitragers)

International Equity: ADR (cont’d)

- Depositary banks hold the securities in the country of origin and convert all dividends and other payments into US dollars.
- US investors bear all of the currency risk and pay fees to the depositary bank for their services.
- Usually pre-existing shares that are just held at the depositary bank and the ADR trades as its “proxy” on the US exchange.

Advantages:
- Cost efficiency, trade execution in US, avoids foreign investor exclusion laws, avoids unusual foreign market practices, visibility in the US …

Disadvantages:
- “Information risk” – foreign firms may be less transparent and may have less or no US analyst coverage.
- Currency risk, political risk.
International Equity: ADR (cont’d)

- *Unsponsored ADR’s* – the non-US shares are offered to US investors without the firm’s active participation (e.g., Selfridge). Rule amendments in October 2008 renewed interest in setting these up.

- *Sponsored ADR’s* – the firm approaches a depositary bank to manage their shares in the U.S. They have to, at least partially, reconcile to US GAAP.

- *Sponsored ADR’s* can range from:
  - Level 1: trade OTC with limited disclosure (over 75% in quantity)
  - Level 2 & 3: trade on exchanges. More disclosure required.
  - Rule 144A

Number of DR programs

[Bar chart showing the number of DR programs from 1996 to 2009, divided into ADR - Sponsored, ADR - Unsponsored, and GDR categories.]
New Capital Raised by DR’s (billions of USD)

Source: Citi DR Annual Report 2012
Trading Activity in DR’s 2012

Example: Indian Depositary Receipt

- Standard Chartered plc was the first foreign company to have expressed interest in an IDR issue. The company is already listed in London and Hong Kong.

- Neeraj Swaroop, CEO - South Asia at Standard Chartered Bank, said that the decision to list in India through an Indian depository receipts (IDR) issue, was not about raising capital but rather about sending a message of commitment to India.

- The IDRs opened at the Bombay Stock Exchange and National Stock Exchange on June 11, 2010.
International Equity: Euroequity

- Euro-equity are shares issued outside the firm’s home country.
- The shares are distributed to investors by a syndicate of international banks (i.e., not traded on an exchange).
- Usually a portion issued in the home country. The Euro portion is not subject to regulatory approval.
- Because of the domestic component, the issue is still regulated (home market rules).
- Most shares are eventually sold back in the home market after the mandatory holding period ("flowback").
International Bond Markets

Total Bonds Outstanding

- Japan
- United States
- Euro Area
- Other markets

Issuers of Outstanding Bonds

- International
- Corporate
- Financial Institutions
- Government

Source: IMF

International Debt: Foreign Bonds

International or foreign bonds are:
1. Issued under the regulations of a specific country.
2. Denominated in the currency of that country, **but**
3. The issuer is a non-resident.

Examples:
- USD obligations of non-US firms that are underwritten and issued in the US are called **Yankee bonds**.
- Yen obligations of non-Japanese firms underwritten and issued in Japan are called **Samurai bonds**.
- British Pound Sterling obligations of non-UK firms that are underwritten and issued in the UK are called **Bulldog bonds**.
Eurobonds and the Euromarket

• Developed after World War II based on the need to hold deposits in foreign currencies, especially U.S. dollars, in different locations (e.g. outside the US).
  • These deposits are free from domestic regulations such as interest rate ceilings, reserve requirements and deposit-insurance requirements since the currency is held outside its home country.

• This market really took off with the floating of exchange rates in the early 1970’s.

• Investors can choose from overnight Eurocurrency deposits to 50 year Eurobonds.

Euromarket Tools

• Eurobonds and Euronotes
  • Bonds that are similar to a domestic-bond issue except that they are issued outside the jurisdiction of the country of the currency of the bond.

• Eurocommercial paper
  • Similar to domestic commercial paper (short-term unsecured notes issued by corporations), except that it is only sold outside the jurisdiction of the country of the currency of issue. Issuers are generally large American or European organizations.
Euromarket Attractions

- Large capital base (arguably the largest in the world).
- *May be* lower cost for some firms - fewer registration and disclosure requirements, fewer fees.
- Can issue in different currencies to hedge foreign exchange exposure.
- Fewer restrictions because not issued in a specific market:
  - Foreign bonds listed on a specific market must meet that market’s restrictions.
  - Bonds in US need to be rated, not always the case in the Euromarkets. However, this imposes other restrictions.

Derivatives

- As global investment has increased, the market has developed tools to increase access to capital and mitigate the associated risks that not all investors and firms want to be exposed to:
  - Interest rate risk
    - Currency and interest rate swaps (credit default swaps?)
  - Foreign Exchange Risk
    - Currency forwards, options and swaps
  - Political risk
    - Political risk insurance
## Euromarket: Examples

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<th>US$</th>
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<td>Domestic</td>
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<td>BIS General Guidelines</td>
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## Euronote Spreads vs Domestic Spreads

Eurodollar deposit rates are higher and Eurodollar loan rates are lower than their corresponding domestic deposit and loan rates due to the absence of banking restrictions such as reserve requirements and deposit insurance fees, and the wholesale nature of the market.
Occasions Requiring Foreign Capital

• Cross-border ventures
• International joint ventures
• International mergers or acquisitions
• Foreign spin-offs or divestitures

Where to Raise Capital

- Firm’s securities appeal only to domestic investors
- Firm’s securities appeal to international portfolio investors

- Illiquid domestic securities market and limited international liquidity
- Highly liquid domestic market and broad international participation

- Segmented domestic securities market that prices shares according to domestic standards
- Access to global securities market that prices shares according to international standards
Other Factors: Country Risk Ratings

Summary

- Global markets offer CFO a wide range of funding opportunities:
  - Usual funding issues:
    - Availability
    - Cost
    - Degree of leverage
    - Interest coverage
    - Control considerations
  - Added considerations:
    - Political risk
    - Choice of currency
    - Hedging requirements
    - Institutional differences

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<th>Risk Ratings</th>
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Economy:
- Rank: 88
- Score: 56.4
- Trend: Positive

Political:
- Score: 42.0
- Trend: Positive

Economic:
- Score: 18.0
- Trend: Positive

International Country Risk Guide:
- Score: 37.8
- Quantity: 54.6
- Risk measures: 26.3

Overseas Private Investment:
- Corporation: Yes
- Yes
- Yes
- No