Raising Capital in Global Financial Markets

Advanced Corporate Finance

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Stephen Sapp

Introduction

- Capital markets facilitate the issuance and subsequent trade of financial securities.
  - The financial securities are generally stock and bonds used by companies and the government to raise funds and pension funds, hedge funds etc. to invest funds.
- Financial regulators, such as the SEC in the U.S. or CSA, OSC, etc. in Canada oversee the capital markets in their jurisdictions to ensure that investors are protected against fraud with the financial securities they are buying/selling.
  - Most regulations require disclosure to ensure investors have the information they require about the security.

History: Development of the TSX

- Until the mid-1800s, businesses and governments in Canada primarily accessed capital from European capital markets.
- In 1852, several Toronto businessmen periodically met to exchange shares, bonds, mortgages and other loans.
- In 1861, twenty-four business men met at the Masonic Hall to create 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 usually occurred per day.
- In 1878 it moved to its first permanent location.

More Recent Market Developments

- Although firms have raised capital from markets for centuries, until the 1980's the majority of international investment capital was debt.
  - International equity investments can be traced back to, at least, the founding of international trading entities such as the Hudson's Bay Company.
- The change occurred as British institutional investors were allowed to take advantage of international portfolio diversification in the early 1980's.
  - US and Japanese investors followed shortly thereafter.
- This diversification in global corporate investments and trade resulted in significant growth in all financial markets (stocks, bonds, FX, derivatives, …).

Why Go Global? Investing

- The value of diversification
  - Smooth out unsystematic risk events in a portfolio so that the value of one asset is decreasing while another is increasing.
- Types of diversification
  - Asset classes: Bonds, Commodities, Equities, Real Estate, other types of Hard Assets (e.g., lumber?)
  - Location: Domestic, International (developed and emerging markets)
- Risks / Returns
  - Volatility. Information availability and reliability.
  - Liquidity.

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Why Go Global? Raising Capital

Bell Canada Enterprises

- Since 1975 shares have traded on both Canadian and non-Canadian exchanges.
  - 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"
  - BCE used three underwriting syndicates - one each in Canada, the US and Europe - to ensure worldwide sales for its offering.
  - Why? It heightened Bell Canada's visibility in Europe as the firm's largest subsidiary, Northern Telecom, was pushing into the British telephone switching market.

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Why Go Global?

- Larger pool of capital.
- Lower costs due to the potential segmentation and saturation of domestic markets.
- Diversification 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 the project, 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:

- Institutional and regulatory differences
- Tax laws differ across countries
- Political risks, different market risks, etc.

Global Financing Options

Equity Financing:
- Cross-listing – e.g. a Canadian firm on the NYSE
- Global Depositary Receipts – e.g. ADR's
- Euro-equity market

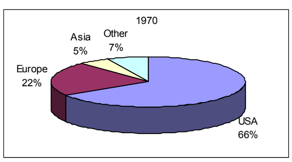
Debt Financing:
- Foreign bank loans
- Foreign bonds – e.g. Yankee Bonds
- Euromarket bonds – e.g. EuroCanadianDollar bonds

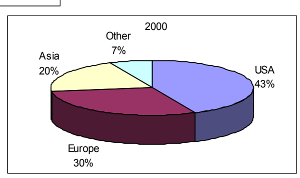
Derivatives:
- Using futures, options or swaps to change cashflows and thus economic exposure.

Major Global Financial Centres

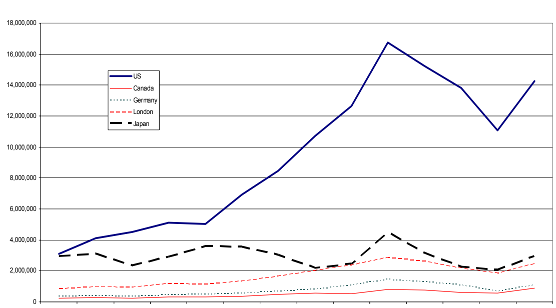
PRIMARY:	SECONDARY:
NEW YORK	FRANKFURT
LONDON	ZURICH
TOKYO	LUXEMBURG
	HONG KONG
	PARIS
	SINGAPORE
	TORONTO

World Stock Market Capitalization



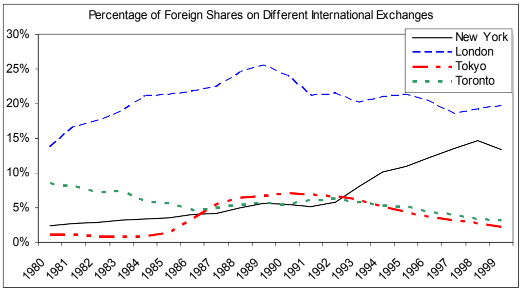


Stock Market Capitalization 1990-2003

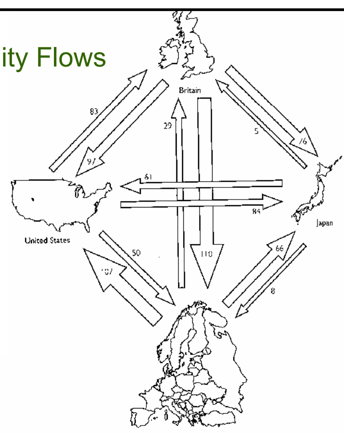


Source: World Federation of Exchanges

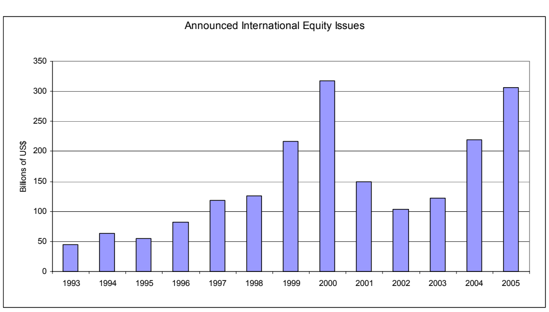
Non-Domestic Equity



Global Equity Flows



Announced International Equity Issues



Source: Bank for International Settlements

International Equity: Cross-listing

To list shares on a foreign stock 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 companies can list their shares on the US exchanges “like” US companies.

Why Crosslist?

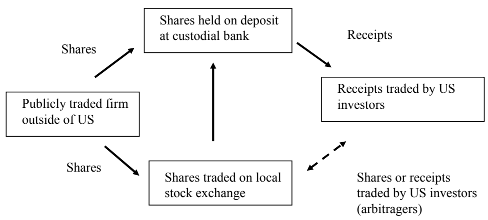
1. Improves the liquidity of your shares.
2. Helps overcome mispricings due to illiquid capital markets, governance concerns or market segmentation.
3. Increases visibility in foreign markets.
4. Establishes a market for shares to perform transactions such as acquisitions in the host market.
5. Establishes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

International Equity: Depositary Receipts

An alternative to overseas listings are Depositary Receipts (DR).

- DR’s are negotiable certificates indirectly representing ownership of shares.
  - They represent a specific number of underlying shares held in trust at a custodian bank.
- ADR’s were first developed by JP Morgan in 1927 to allow Americans to invest in the British retailer Selfridge & Co.
- Since it was conceived and primarily used in the US, American Depositary Receipts (ADR’s) 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) by firms such as Daimler-Chrysler (Note: India has the largest number of DRs and they are traded in the U.S. and Europe).

Trading of American Depositary Receipts



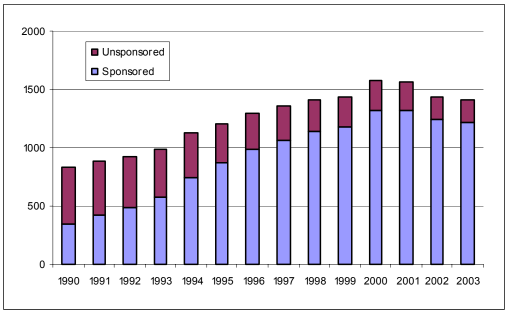
International Equity: ADR (cont'd)

- 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 are less transparent and have less or no analyst coverage.
  - currency risk, political risk

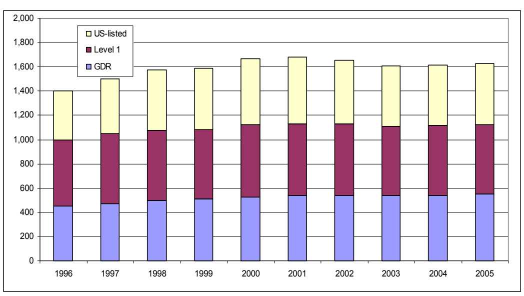
International Equity: ADR (cont'd)

- *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.
- *Unsponsored ADR's* – the non-US shares are offered to US investors without the firm's active participation.
- 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

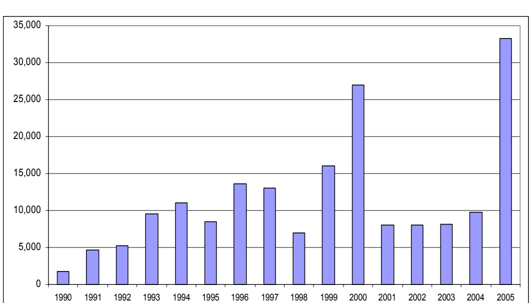
Number of Depositary Receipt programs



Total Sponsored DR's (in millions of US$)



New Capital Raised by DR's (in Millions of USD)



International Equity: Euroequity

- Euro-equity are shares issued outside the firm's home country and distributed to investors by a syndicate of international banks (i.e., not traded on an exchange).
- Usually there is a portion issued in the home country simultaneously. 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.

Example of Global Equity Offering

ADR

Ordinary Shares

Euro-equity

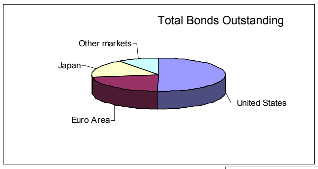
Foreign Bonds

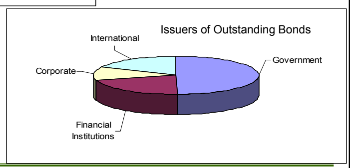
- International or foreign bonds are:

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*.

International Bond Markets





Source: IMF

Eurobonds – History of 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 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.
- The limiting factors are the issuer's needs and investors' demands.

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.

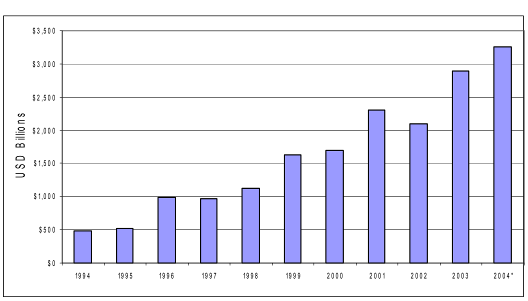
Euromarket: Example

	US$	Yen
Domestic	US Bank Deposit US T-Bills and T-Bonds US Corporate Bonds US Regulation	Japanese Bank Deposit Japanese Government Bonds Japanese Corporate Bonds Japanese Regulation
Offshore	Euro-$ Deposit Euro-$ Bond (corporate and sovereign) BIS General Guidelines	Euro-Yen Deposit Euro-Yen Bond (corporate and sovereign) BIS General Guidelines

Euromarket Attractions

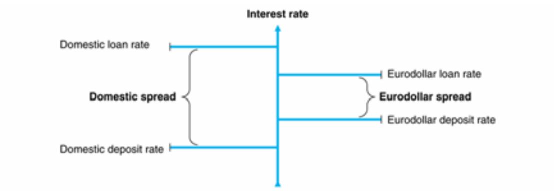
- Large capital base (arguably the largest in the world).
- May be lower cost for some firms - fewer registration requirements and fees.
- Can issue in different currencies to hedge foreign exchange exposure.
- Fewer restrictions because not issued in a specific market:
  - Foreign bonds listed on a 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.

Announced Volume of Eurobond Issues



Source: BIS

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.

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
  - Foreign Exchange Risk
    - Currency forwards, options and swaps
  - Political risk
    - Political risk insurance
  - How does this relate to Asset Backed Securities?

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Occasions Requiring Foreign Capital

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

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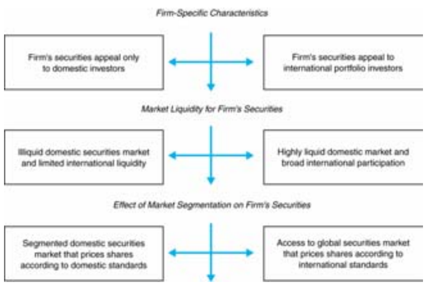
Determining Where to Raise Capital



Country Risk Ratings

Risk Ratings	Indonesia	Finland	Brazil	Russia	Mexico
Currency:					
Unit	rupiah	euro	real	ruble	peso
Arrangement	floating	EMU	floating	managed float	floating
S&P's Rating	CCC+	AA	B+	SD	BB
Moody's Rating	B3	Aaa	B2	B3	B2
Fitch IBCA	B-	AAA	B	CCC	BB
Economist Intelligence Unit:					
Rating	D	B	D	D	C
Score	67	35	62	79	53
Euromoney:					
Rank	88	12	76	161	47
Score	36.4	90.9	41.7	20.9	55.2
Institutional Investor:					
Rank	86	14	65	104	49
Score	27.9	82.2	37.4	20.0	46.0
Trend	Negative	Positive	Negative	Negative	Positive
International Country Risk Guide:					
Political	42.0	90.0	66.0	54.0	69.0
Financial	22.0	39.0	31.5	25.5	31.0
Economic	18.0	45.5	33.0	18.5	35.0
Milken Institute Capital Access Index:					
Score	37.8		61.65	57.81	61.65
Quantitative	56.6		52.38	71.15	52.38
Risk measures	26.3		29.41	43.59	31.25
Qualitative	0.0		36.36	31.03	34.76
Overseas Private Investment Corporation	Yes	No	Yes	Yes	No

Adapted by authors from the sources listed. All values for March 1999.

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