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Raising capital in emerging markets with restricted Global Depositary Receipts

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ABSTRACT

Despite serious governance concerns revealed in Rule 144A and/or Regulation S Global Depositary Receipt (GDR) circulars, institutional investors voluntarily purchase these illiquid securities. Like issuers of Level III American Depositary Receipts (ADRs), GDR issuers exhibit strong pre-offer performance, with higher average Tobin's q ratios, sales growth rates, sales levels, returns on equity, and dividend payout ratios than their home-market counterparts. However, GDRs are issued predominantly by firms in emerging markets, while ADRs are issued mostly by firms in developed markets. After controlling for country and industry effects, we find that ADR issuers are larger and that they employ more reputable underwriters than GDR issuers do, but no other significant differences emerge. Notwithstanding their similarities, GDRs have larger discounts than ADRs, suggesting that legal bonding provides benefits that reputational bonding cannot fully replicate. However, within the sample of GDRs, pre-offer performance attributes also influence pricing. Specifically, discounts vary inversely with issue size but directly with firm size, suggesting that economies of scale exist in the GDR issue process and that potential agency costs are higher in larger firms. GDR discounts also vary inversely with incremental returns on equity in all partitions of the data, indicating the importance of pre-offer profitability in establishing the reputation of the issuing firm and in increasing the GDR offer price.

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1. Introduction

Between 1990 and 2005, foreign firms raised more than $65 billion in US private equity with the SEC's Rule 144A and/or Regulation S Global Depositary Receipts (hereafter Rule 144A/Reg S GDRs). This amount represents 30% of the dollar volume of equity funds raised by foreign firms outside their own markets during that period.[1] Firms from emerging markets have been dominant players in this market, with Indian, Korean, and Taiwanese firms accounting for more than 26% of the total number of issues and more than 52% of the total dollar volume of capital raised with Rule 144A/Reg S issues. Because GDRs do not require SEC registration, severe restrictions limit their resale. Consequently, they are popularly referred to as "restricted GDRs." This paper focuses on these restricted private equity issues.

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[1] These estimates come from the *Citibank* data base. One indication of the significance of these numbers comes from comparing private and public issues among US firms. Between 1990 and 1997 the percent of funds raised by US firms from private equity was only 21.3% of the amount raised through public equity offerings. Over the same time period, the percent of funds raised through Rule 144A/Reg S equity offerings amounted to 49.4% of the funds raised by exchange-traded ADRs (See Bethel and Sirri, 1998).

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Unlike the more popular American Depositary Receipts (ADRs), Rule 144A/Reg S GDRs do not provide legal bonding.[2] However, we argue that reputational bonding plays a crucial role in the Rule 144A/Reg S market. Other papers make similar arguments. Pinegar and Ravichandran (2002) argue, for example, that Rule 144A/Reg S issues help Indian firms resolve local and global information asymmetries, and Siegel (2005) shows that foreign firms reputed for fair treatment of minority shareholders secure privileged long-term access to outside finance, even when legal bonding fails.[3,4] We extend these papers in three ways.

First, we describe the home-market legal environment of GDR issuers based on information contained in 84 offering circulars purchased from *Global Securities Information, Inc.* Though not exhaustive, this representative sample allows us to detail interesting features about GDR issues that (to our knowledge) are not found elsewhere in the literature. Because these features reveal serious governance concerns, we argue that GDR issuers must have strong home-market performance reputations that are augmented by the willingness of reputable underwriters to sponsor the issues to attract institutional buyers in the US and elsewhere to purchase their illiquid securities.

Second, we test this hypothesis with data on 412 ADR/GDR issues made by firms from 38 countries. With these data, we compare the attributes of 219 GDR issuers to the attributes of 193 ADR issuers. In each case, we measure pre-offer performance incrementally, i.e., relative to the performance of firms in their respective markets.

Finally, we examine the joint influence of the incremental home-market performance attributes of the issuing firms and of their underwriters' reputations on ADR and GDR pricing. [5] Specifically, we measure how the reputations of the issuing firms and their underwriters relate to the discount attached to ADR and GDR issues.

Our findings can be summarized as follows. Corporate governance features in the offering circulars give cause for concern. Though Rule 144A/Reg S contract disputes may be settled in US or UK courts, GDRs derive their value from the underlying shares whose disclosure and monitoring requirements are governed by weak home-market legal regimes. Therefore, the ability of US or UK courts to remedy potential wrongs is severely limited. Moreover, average ownership concentrations are high for Rule 144A/Reg S issuers and voting rights for GDR holders are restricted or non-existent. Board representation is possible for minority shareholders if their rights are violated, but enforcement of those rights may be weak. Even if minority representatives are installed, they may exert little influence on large boards.

Within the confines of their home markets, GDR issuers exhibit strong pre-offer performance, with incremental performance attributes that are remarkably similar to the incremental attributes of firms that issue Level III ADRs. Both groups have significantly higher average Tobin's q ratios, sales growth rates, sales levels, and returns on equity than do their home-market counterparts. GDR issuers also have higher average dividend payout ratios.[6] When we control for country and industry effects, ADR issuers are larger and they employ more reputable underwriters than GDR issuers do, but no other significant differences emerge.

Despite these similarities, differences in pricing remain. Discounts are larger for GDRs than for ADRs, even after we control for pre-offer performance and underwriter reputation, for country and industry effects, and for the effects of signaling (Hertzel and Smith, 1993), overvaluation (Hertzel et al., 2002), and potential diversification and liquidity benefits. Thus, legal bonding provides some benefits that reputational bonding cannot fully replicate. Nevertheless, the effects of reputational bonding are evident in the pricing of GDRs. *Within* that sample, discounts vary inversely with issue size but directly with firm size, suggesting that economies of scale exist in the GDR issue process and that potential agency costs are higher in larger firms. GDR discounts also vary inversely with incremental returns on equity in all partitions of the data, indicating that the pre-offer profitability of private issuers is important in establishing the reputation of the issuing firm and in increasing the GDR offer price.

[2] ADRs are listed on the New York Stock Exchange or on NASDAQ, which requires that foreign firms initially register their securities with and subsequently file annual reports to the SEC using US Generally Accepted Accounting Principles (US GAAP). Because issuing firms are required to abide by US securities laws, foreign investors in these firms receive greater legal protection than they would if firms did not issue ADRs. Evidence consistent with legal bonding is reported in Doidge (2004), Doidge et al. (2002, 2009), Lel and Miller (2008), and Reese and Weisbach (2002). Though Rule 144A/Reg S GDRs cannot provide legal bonding, the effects of GDR issues on home-market share prices and trading volume are similar to the effects of ADR issues that do provide legal protection. Both have similar mean announcement period returns (compare Pinegar and Ravichandran, 2002 with Miller, 1999), similar cross-sectional determinants of issue period returns (compare Pinegar and Ravichandran, 2002 with Foerster and Karolyi, 1999), and similar post-issue declines in home-market trading volume (See Karolyi, 2004).

[3] Licht (2001, 2002) argues that cross-listing preserves and frequently enhances private benefits of control because of informational and cultural distances between the issuing firm and US shareholders.

[4] We do not argue that firms would invest in reputational capital in the absence of financial incentives. Like legal bonding, reputational bonding may be motivated by enhanced markets values. Goswami (2001, p. 29) illustrates this point in his discussion of firms that built strong reputations in India even before they were legally required to do so. Specifically, he states: "[Infosys] discloses its accounts in keeping with GAAP requirements of India, US and six other countries. It follows the CII code and the Cadbury committee recommendations on corporate governance, has a highly acclaimed and independent board with Audit, Remuneration and Nomination Committees. From 1996 onwards — *three years before it issued an ADR and got listed on NASDAQ* — Infosys has been making full-fledged disclosures under section 10-K of the SEC. Its annual reports contain an exhaustive management discussion and analysis as well as other financial disclosures that go beyond best international practices. Other highly acclaimed companies in terms of disclosure include NIIT, Bajaj Auto, Hindalco, Nicholas Piramal, Wipro, BSES, Housing Development Finance Corporation and Dr. Reddy's Laboratory. *All of them have voluntarily gone well beyond the mandated disclosures of the Companies Act, and have done so in their self-interest. They have also been amply rewarded by the market for their transparency*." (Emphasis added) Of the nine firms mentioned by Goswami, four have publicly-traded ADRs, three have Rule 144A/Reg S GDRs, and two are not traded publicly or privately in US markets. Thus, reputational bonding may apply more broadly than legal bonding.

[5] Recent papers that show that underwriter reputation is important in the issuance process include Brau and Fawcett (2006) and Ljundqvist et al. (2006).

[6] These findings are consistent with Mitton's (2006) evidence that shows that increased openness by foreign firms to investment by outside buyers is associated with increased growth, increased investment, and increased profitability.

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