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The long-term performance of privatization-related ADR issues

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Abstract

American depository receipts (ADRs) have been increasingly used in the share issue privatization process (SIP) by privatizing governments, both in developed and developing countries. In this study, long-term performance of 143 privatization-related ADR programs were analyzed. The ADR programs covered in the study were initiated between 1984 and 1999 and included a diverse mix of companies from 29 different industries across 31 developed and emerging markets. The analysis of the long-run performance of these programs revealed interesting patterns. In all cases, average cumulative returns and average cumulative abnormal returns of developed country privatization-related ADRs exceeded emerging market privatization returns. The same conclusion was reached using an alternative return calculation methodology. While sample companies generally outperformed their respective country indices and the FT World Index, they under performed the S & P 500 Index. In addition, findings indicate that Level I issues traded in over-the-counter (OTC) markets outperform the Level II and Level III ADRs traded in the NYSE, as well as 144A private placements. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Privatizations through share issues accounted for approximately 70% of the privatization revenues generated by governments in the last two decades. These issues collectively represent a significant portion of the global equity supply. In 2000, share issue privatizations accounted for $90bn of the $200bn global initial public offerings (IPOs) (Hill, 2002). Although share issue privatizations (SIPs) proved to be an effective method in divestment of large state-owned enterprises (SOEs), their use was constrained by the size and sophistication of the local equity markets. Domestic absorption of multi-billion-dollar issues stumbled upon serious obstacles, even in relatively developed equity markets.[1] The limitations imposed by the size of individual transactions and the equity market infrastructures forced government issuers to search for cross-border venues for the sale of SOE shares.[2] The globalization of financial markets enabled governments to sell equity in foreign markets through cross-listings and private placements, and international offerings reached approximately 47% of total share-issue privatizations (Bortolotti et al., 2000; Megginson et al., 2000).

Among competing financial centers, the government issuers were particularly attracted to US equity markets due to its sophisticated market infrastructure and the availability of a diverse institutional and individual investor pool. The center of gravity further shifted toward US equity markets when the introduction of a new regulatory framework by the US Securities and Exchange Commission (SEC) energized the American Depository Receipt (ADR) market in 1985. The ADRs denote shares that represent equity issued in a foreign country. These negotiable certificates, which represent a non-US company's publicly traded equity, are quoted, traded and pay dividends in accordance with US clearing and settlement standards. As the new regulatory regime relaxed stringent disclosure requirements and offered flexibility, a range of ADR tools emerged. The variations of generic ADRs facilitated access to US equity markets for a large number of non-US companies, including the state-owned enterprises. These ADR tools proved to be particularly attractive and effective for privatization agencies in search of cross-border placement opportunities. Consequently, ADRs were increasingly used in privatization-related equity issues.

The increasing internationalization of privatization-related share issues, and particularly the use of ADRs by both developed and emerging market governments, produces at least two readily observable outcomes. First, privatization-related ADR issues create new investment opportunities for institutional and individual investors around the globe. Secondly, they facilitate internationalization of the cost of capital for the newly privatized firms. An immediately relevant

[1] For instance, Germany, France and Italy had to combine domestic offerings with international tranches in large-scale privatizations.

[2] This motivation was compounded by factors such as external account conditions, company characteristics and conditions related to managerial control in the post-privatization period. In addition to these, an increasing number of government issuers started to target foreign investors to attract foreign capital flows.