Euro Issues

A.R.Barwe
Managing Director
SBI Capital Markets Limited

The globalisation of capital markets has encouraged issuers the world over to increasingly look beyond the borders of their home markets to expand their investor base and raise funds by way of equity and debt. Simultaneously, investors have increasingly sought to diversify their holdings and increase yields. This has led to the emergence of a vast global financial market transcending national boundaries and enabling massive cross-border capital flows from those who have funds and are in search of high returns to those seeking low cost funding.

While Indian companies have been tapping the foreign currency loan market since long, they were allowed to access the international equity market only after 1991, consequent upon the introduction of economic reforms and New Economic Policy (NEP). Although there have been issuances by Indian companies in the international debt capital markets by way Floating Rate Notes (FRNs) and Fixed Rate Bonds (e.g., Yankee Bonds), in the Indian context , issues in the international capital markets through the mechanism of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs) are commonly referred to as Euro Issues.

Global Depository Receipts (GDRs)

Depository Receipts (DRs) were created in 1927 to aid US investors who wished to purchase shares of non-US Corporations. Since that time, the depository receipt has grown into a popular and flexible structure which enables issuers to access investors worldwide and raise equity outside their home market.

Depository Receipts are frequently identified by the markets in which they are available :

American Depository Receipts (ADRs) - DRs that are publicly available to US investors.

Rule 144A ADRs - DRs that are privately placed to a select group of institutional investors in the US market under Rule 144A of the Securities Act,1933.

Global Depository Receipts (GDRs) - DRs that are offered to investors in two or more markets outside the issuer's home country through a global offering.

DRs can be publicly offered or privately placed - the method of sale defines the segment of investors who can purchase the securities. In the US, publicly traded securities are sold to the broadest spectrum of investors and trade in either the over-the-counter (OTC) market or on a national exchange. Privately placed securities are sold to Qualified Institutional Buyers (QIBs), including institutions that own or invest at least US$ 100 million in securities and registered broker-dealers that own or invest on a discretionary basis US$ 10 million in securities of non-affiliates. Offerings using GDRs are frequently structured as a Rule 144A private placement in the US and an offering outside the US in reliance on Regulation S under the Securities Act.

The following chart describes the various types of depository receipts, the placement options and the type of investor who can purchase them.

Type	Where Available	Market	How Traded	Investor Segment
ADR	US	Public	OTC	All investors
		Public	Listed : NYSE NASDAQ	All investors
RADR	US	Private	PORTAL	QIBs
GDR	Europe/Asia/ Latin America	Public	Exchange in Europe/ Asia/Latin America	Reg S investors
	US	Public	US Exchanges	All investors
		Private	PORTAL	QIBs

The GDR issuing mechanism

A global depository receipt (GDR) is a negotiable certificate evidencing ownership of shares in a foreign corporation from a country outside the market in which the GDRs are traded. In essence, a GDR is nothing more than a means of re-packaging a share to make it available and more attractive to international investors. GDRs are created when the issuing company delivers ordinary equity shares issued in the name of an overseas Depository Bank (the Depository) to a domestic custodian (who holds the shares as an agent of the Depository). The Depository then issues receipts called Global Depository Receipts representing the shares to the foreign investors.

Each GDR represents a certain number of underlying equity shares of the issuing company.

GDRs are quoted and traded in the currency of the country in which they trade and are governed by the trading and settlement procedures of that market. Generally, they are denominated in US dollars, but may be denominated in any currency. GDRs are eligible for book entry settlement through the Depository Trust Company ("DTC") in the US as well as through the European settlement systems, Euroclear and Cedel. Settlement of international trades of GDRs are faster compared to the settlement of trades in the Indian market. The ease of trading and settling GDRs makes them attractive investment options for investors willing to purchase shares in foreign companies.

Advantages of GDRs for Issuers :

A Global Depository Receipt issue offers the following advantages to the issuer :

- Enables issuers to access broader and deeper markets outside the home market and raise more capital, sometimes at better price
- Creates price tension between the overseas and home market
- Enhances company visibility
- Expands shareholder base
- Increases potential liquidity by enlarging the market for the company's shares
- Makes administration simpler than would be the case if investors held shares since dividends etc. are paid to a single entity (Depository).

Advantages of owning GDRs to Investors:

- Facilitates diversification into foreign securities
- GDRs trade, clear and settle in accordance with requirements of the market in which they trade. An investment in GDRs avoids local clearing and settlement procedures which are often unfamiliar to international investors and more cumbersome than international procedures.
- Eliminates custody charges
- If GDRs are exchange-listed, investors also benefit from accessibility of price and trading information and research. Whereas the underlying shares may be listed on a number of stock exchanges in the home market, the GDRs are listed on a stock exchange that the foreign investors are more familiar with such as Luxembourg or, more recently, London.
- The price of the GDRs are normally quoted in US dollars and dividends are converted from local currency by the Depository and paid in US dollars to the investors. Foreign investors find it convenient to deal in US dollars.

Rights of a GDR holder

A GDR holder, like the holder of the underlying equity share has the right to receive dividends and bonus when declared , and also participate in rights issue when announced. While a GDR does not entitle its holder any direct voting rights, under a number of GDR facilities in other countries the GDR holders have the right to direct the Depository on how to vote. In India, normally the Depository , in whose name the underlying shares are issued relinquishes its right to vote as a part of the agreement with the issuing company, and votes only if required to do so by law. However, there are instances where the Depository has agreed to exercise votes in accordance with the directions of the issuer's board of directors.

GDR holders can cancel the GDR and convert it into equity shares after a cooling period of normally 45 days. In India, however, the fungibility of the GDRs i.e. the extent to which the GDRs and the underlying shares are interchangeable, is partial. This means that the company does not have the right to reconvert the released equity shares into GDRs for sale to international investors. However, it appears that the Indian Government is now considering the issue of permitting limited two way fungibility of Depository Receipts. This would enhance the liquidity of the GDRs in the international markets and lead to the integration of the domestic market with the global capital markets.

Pricing of GDRs

A common and effective method of offering securities in the international markets which has also been utilised by Indian issuers is the bookbuilding method. This method involves the production of a preliminary offering document known as "red herring" by the issuer which marks the commencement of the bookbuilding period. At this stage the offer price of the securities is not determined. The marketing of the securities precedes the determination of the offer price and the finalisation of the offer document. On the basis of this document, the investment bank managing the issue, often known in international offerings as the "global coordinator" or "bookrunner", acting through a network of managers called syndicate members, assesses the level of interest in or the demand for the GDRs to be offered. This is done by asking prospective investors to indicate, on a non-binding basis, whether they would be interested in acquiring the GDRs and, if so, at what price. In this way the investment bank builds the "book of demand". The book is built over a period of 1 to 2 weeks during which the marketing of the issue (popularly known as "roadshows") takes place. The "roadshows" include group presentations to investors by the company's management as well as one-on-one meetings with investors expected to have high interest in the transaction. At the end of the bookbuilding period the price is determined with reference to the level of demand. Orders for the shares are then confirmed. In GDR issues the "bookrunner", in consultation with the issuer, decides how many shares should be allocated to investors based on a variety of criteria. The allocation of shares is extremely important to ensuring an orderly and lively aftermarket. The outcome of a properly syndicated and well marketed offering is to arrive at an offer price that achieves the company's pricing objectives and an allocation methodology that ensures that investor appetite is not completely satisfied. One of the principal advantages of bookbuilding is that the price that is ultimately set for the offer at the end of the bookbuilding period should represent fairly accurately the demand for the shares in the market. Other advantage for the issuer is that it serves to create competition among investors who are required to bid on a competitive basis for shares, which ensures that the true demand is generated.

Price discovery through the bookbuilding method has the effect of reducing the likelihood of large movements in the company's share price immediately following the offer period. However, the process can never be an exact science and there is a risk that the post offer demand for the GDRs can exceed supply or vice versa leading to volatility in the share price. Aftermarket stabilisation is a common practice in international offerings. An effective means of ensuring good aftermarket stabilisation is the granting of the "greenshoe" option by the issuer to the Lead Manager. This option allows the bookrunning Lead Manager to overallot and create a "short" position by allotting more shares than are available to be sold and subsequently cover the full or a portion of the short position by either buying GDRs from the secondary market thereby providing support to the share price or purchasing additional GDRs from the issuer at the offer price.

The Indian scenario

India has provided exciting investment opportunities for international investors since long. Continued commitment to economic reforms has resulted in a surge in foreign investment in India and many Indian companies have firmly established themselves as issuers in the international capital markets. A significant proportion of the investment of foreign investors has, so far, been through GDRs. Overseas equity investors find GDRs an attractive route to invest in India as there are regulatory restrictions and limits of investments in Indian companies by foreign institutional investors ("FIIs"). Euro-issues are treated as direct foreign investment in the issuing company and are subject to extant policies governing direct foreign investments.

In India, the issue of GDRs is governed by the guidelines issued by the Ministry of Finance, Government of India. The Department of Economic Affairs, Ministry of Finance, gives permission to companies to float GDRs if they have a consistent track record of good performance for 3 years. This criteria, however, has been relaxed for infrastructure projects like power generation, telecommunication, petroleum exploration, ports, roads etc. Recently, the Government has allowed unlisted companies to issue GDRs. Companies raising capital through GDRs are allowed full flexibility in deploying issue proceeds with the restriction that investments in stock markets and real estate will not be permitted.

Till date, Indian companies have raised over US$ 6 billion in the form of GDRs. The first GDR issue by an Indian company was launched in 1992 by Reliance Industries. The year wise break-up of the issuances are as under :

Year	No.	Amount (US$ m)
FY 1993	2	240
FY 1994	17	1586
FY 1995	30	2113
FY 1996	7	616
FY 1997	8	1438

As may be observed from the above table, after the initial enthusiasm in the first three years after liberalisation, the Indian GDR market exhibited a marked slowdown since FY 1996. This change can be attributed to various factors including oversupply of Indian paper, political uncertainty, rising US interest rates, change in international sentiment towards emerging markets following the Mexican crisis and relative illiquidity of the GDR market overseas. But perhaps the most compelling factor triggering the slowdown has been the dismal performance of the Indian GDRs in the aftermarket. Of the 64 GDRs trading today, 49 are quoting at a discount to the issue price, Even worse, 40 of the GDRs are currently trading at a discount of over 50 percent to their issue price. One of the reasons for this is that in the three years immediately following the opening up of the Indian economy in 1991, there was unprecedented enthusiasm by foreign investors to invest in India and many Indian companies with weak credentials exploited this eagerness with overpriced issues. Analysis of these companies both by the investment banks lead managing the GDR issues as well as the investors were not of the highest quality and many of the obvious weaknesses were overlooked. The restructuring process set in train in the Indian industry has since exposed some of the inherent weaknesses of these companies, pushing many of them to the brink.

However, starting around 1996, following the collapse of the aftermarket of most of these companies, foreign investors had wisened up to the market place and had begun to take a realistic view of the Indian companies. Since August 1996 only five Indian companies could successfully raise equity from the global capital markets by way of GDRs. And all five of them were Indian blue chips. This trend is expected to continue in future and only quality issues from well managed companies are likely to succeed. Although India continues to remain a favoured investment destination, foreign investors are now more aware of the Indian story and are likely to examine the investment proposals more critically. The recent successes of the SBI, VSNL and MTNL GDRs clearly demonstrate that there is appetite for well run and focused companies with clear competitive strengths. Foreign investors have become more discerning and would only be attracted by companies with compelling investment stories and clear definitions of future plans and utilisation of issue proceeds. Indian companies will have to have realistic expectations of the price and can no longer expect fancy premiums for their stocks. Normally, for listed companies the reference price for GDRs is the ruling market price of the underlying scrip. This is fraught with some risk as market prices, especially for relatively less liquid stocks are vulnerable to price manipulations in the run up to the GDR issue. Pricing, therefore, has to be done based on a proper valuation of the company's share, taking into account the fundamentals of the company and evaluating its performance against other comparable companies, the market price of the share as well as the company's expected future performance. Price fixation has to be done in a manner such that there is value for the investor in the transaction.

Till date no Indian company has successfully made a public offering of ADRs in the US markets, although quite a few are in the pipeline. An international equity offering through ADRs requires to be registered with the SEC in US. For SEC registration, an issuer is required to reconcile its accounts to US GAAP which is time consuming. SEC registration allows a company to offer shares to individual or "retail" investors in US who cannot purchase in Rule 144A offerings or other private placements. Thus an international equity offering of ADRs maximizes the shareholder base and enables companies to raise the largest amount of funds at the best possible price. Once registered with SEC, ADRs can be listed in US stock exchanges like NASDAQ or New York Stock Exchange. These exchanges provide better liquidity compared to other exchanges. In future we may well see a few ADR offerings from India.

Foreign Currency Convertible Bonds (FCCBs)

A Foreign Currency Convertible Bond (FCCB) is an equity linked unsecured debt instrument carrying a fixed rate of interest and an option of conversion into fixed number of equity shares or GDRs of the issuer company. FCCBs are listed and traded on one or more stock exchanges abroad. Till conversion, the interest on FCCBs is paid in dollars or any other freely convertible currency and if the conversion option is not exercised , payment of redemption is also in foreign currency.

Raising funds through FCCBs helps in deferring the dilution of capital until conversion. Further, the company can also stipulate conversion at a premium to current market price. Normally , FCCBs are structured with a call option to the issuer to "call" the bond after a specified period of time subject to the domestic share price exceeding a certain percentage of the conversion price.

In India, FCCBs were quite popular in the second half of 1993 and the first half of 1994 when a total of about US $ 1.1 billion was raised. Since then, the Indian Government had adopted a restrictive policy towards FCCBs since the bonds formed part of the country's external debt till their conversion into equity. Since interest as well as redemption of the non converted part would be in foreign currency, Indian issuers have also not been very keen because of the exposure to the foreign exchange risk.

The performance of the FCCBs by Indian issuers has been quite disappointing. Out of the 9 scrips that are being quoted today, 7 are at a discount to the issue price. The conversion prices of all the FCCBs are substantially higher than their current market prices making conversions unattractive for the investors. Consequently, most of these FCCBs are trading as straight debt instruments.

Conclusion

For a growing economy like India where there is an increasing need for capital, Euro Issues offer an attractive source of funds. The performance of the offerings from India notwithstanding, it is expected that due to the numerous advantages they offer, Euro Issues are going to form a crucial source of funding for the years to come. Post liberalisation, with the opening up of the Indian economy, the maturing of the Indian capital market and improved disclosure standards adopted by Indian companies, one can well expect continued international investor interest in India. However, only quality offerings from strong corporates are expected to attract investments from the international markets. The global investment community mainly comprise sophisticated and informed institutional investors who look favourably at companies having relatively large market capitalisation, strong management, clear business focus, good track record and global competitiveness. There are several Indian companies, both in the private and public sector, who possess these qualifications and are geared to tap the global markets to raise capital. With the Indian Government also accessing the international capital markets for disinvestments, the Euro Issue market is expected to witness heightened activity in the years to come.