

Financing in the Global Capital Market

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Zusammenfassung:

Dieser Beitrag untersucht die Finanzierungsmöglichkeiten, die einem Aktien ausgebenden Unternehmen auf dem internationalen Kapitalmarkt zur Verfügung stehen. Die wichtigsten Komponenten des globalen Kapitalmarktes werden untersucht, wobei speziell den Möglichkeiten und Schwierigkeiten, die sich dabei für Erstemittenten ergeben, besondere Beachtung geschenkt wird. Die untersuchten Märkte umfassen die wesentlichen Börsenanlagenbereiche (Bonds, equity und hybrid securities) in Europa und den USA wie auch Handels- und Projektfinanzierung. Der Beitrag schließt mit einem Abriss über Eintrittsstrategien für Erstemittenten auf Basis der Erfahrungen erfolgreicher, weltweit tätiger Emittenten.

1. Business Strategy and Global Financing

This paper surveys the financing opportunities available in the international capital markets to corporate issuers. It is addressed to top management and financial officers responsible for designing and implementing business strategy. In particular, it focuses on the possibility of accessing the capital markets for general purpose financing or the financing of specific projects by first-time issuers. Large companies in countries with well developed capital markets routinely take advantage of financing opportunities in the global market. For example, General Electric, Toyota, Grand Metropolitan, Philips and Hoffman-La Roche raised \$12 billion in the global bond market during 1994. On October 5, 1993 Daimler-Benz became the first German company to obtain listing in the NY Stock Exchange. In addition to Germany and Switzerland, Daimler has listed its shares in Tokyo, London, Paris, Vienna and Singapore, and it plans to list them in Shanghai. In June 1994, Daimler-Benz issued DM3 billion of new equity, 73 percent of which were sold outside Germany. But access to the global market is feasible and even more important for middle-size companies that traditionally rely on local bank financing, and for companies operating in countries with less-developed capital markets.

Many world-class companies face financial constraint to their growth because of the small size of their home capital markets. The mismatch between the managerial and technological capabilities of these companies and the limited ability of their home market to supply the capital they require limits their possibilities to undertake profitable investment projects and puts them at a disadvantage when competing with better endowed foreign competitors.

The opportunities for financing available in the international capital market offer these companies the possibility of implementing the financial policy necessary to support their business strategy and thus realize their value creation potential. Even for a company not subject to capital rationing within its home capital market, a better exploitation of the financing opportunities available in the global market can reduce its cost of capital and increase shareholder value. In fact, a reduction of the cost of capital of 0.2% can increase the value of equity by more than 10% (this is shown in the Appendix).

The last decade has witnessed the extraordinary growth of capital markets around the globe. For example, in 1992, U.S. corporations raised \$744 billion in debt and \$102 billion in equity in the U.S. public markets. \$38 billion were for unrated ("junk") debt issues. In addition, global issues involving issuers and investors in more than one country amounted to \$282 billion in spite of a rather dormant European market. While many of these issues involved refinancing of outstanding issues, the volume of transactions provides a measure of the deepness of today's capital markets. However, while domestic markets have become more sophisticated and flexible, most of them still remain dominated by government debt and their internal supply of funds is insufficient to accommodate the needs of large corporate borrowers. Some countries, such as Denmark, Brazil, Indonesia and Spain, have world-class enterprises with financing needs that exceed the capacity of their capital markets. This has led firms from such countries to issue debt and equity in the international capital market centered in New York and London.

In order to establish a reputation as an international issuer a company must have certain attributes and follow a number of steps directed to communicate in a credible fashion those attributes to international investors. Its management must be truly committed to the goal of becoming an international issuer and needs to devote considerable effort to developing relationships with international investors (the steps to follow in order to access the international capital market are discussed in Section 3.). A classic case of financing growth via the global capital market is that of Novo-Nordisk, the

Danish pharmaceutical company. In the early eighties Novo tapped the Euro-equity and the US markets and was able to compete against much larger competitors such as Eli Lilly (see Stonehill/Dullum 1982).

Section 2. of this paper examines the main components of the global capital market: the bond, equity and hybrid security markets of Europe and the U.S. The characteristics and interrelation of these markets and the opportunities and difficulties that they present to first-time issuers are discussed with reference to the recent experience of a variety of issuers. The discussion is limited to instruments for medium and long-term financing rather than the instruments and transactions associated with short-term and seasonal financing. In addition to the regular exchange and over-the-counter markets, a number of other markets and credit arrangement of particular significance to issuers from emerging capital markets are examined, including trade financing via the capital market and project financing. Hybrid securities such as convertible bonds are shown to be particularly suitable for new issuers and able to pave the way for other issues. Other financing practices discussed include the use of commodity hybrids for attaining hedged hard-currency debt financing, and several securitization practices such as pre-export financing that can be used as a substitute for regular debt financing when market conditions make it difficult to get the latter.

Section 3. concludes the paper with a discussion of the approaches followed by successful international issuers with particular emphasis in the access strategy for first-time issuers. The steps to follow starting from listing in the home market, accessing the Euromarket and finally issuing equity in the global market, and how these steps relate to each other are discussed.

2. The Global Capital Market

The main components of the global capital market are examined in this section. The backbone of the global market are the bond and equity markets of the U.S. and Europe. In addition, trade financing and project financing are many times available to newcomers into the global market and should be part of the overall financing strategy.

2.1. Debt Markets

2.1.1. The US Bond Market

The bond market in which companies and governments issue medium and long-term bonds in the U.S. can be divided into two main segments: the public market and the private placement market. A **public issue** is registered with the U.S. Securities and Exchange Commission and is a "marketable" instrument sold mainly to institutional investors. Public utilities and other large corporations issuing investment-grade debt (Aaa, Aa, A or Baa by Moody's or equivalent rating by Standard & Poor's) have access to this market. Issues are usually listed on an exchange in order to permit their acquisition by those institutional investors required by law to buy only listed securities but most trading normally takes place over-the-counter rather than on the exchange.

A relatively recent development in the publicly traded market is the growth of the **high-yield** ("junk") sector which is made up of noninvestment-grade debt (Ba or below) and certain unrated debt issued by U.S. borrowers. These securities are highly speculative and sell with yield spreads of between 250 and 500 basis points over the yields of same-maturity Treasury securities. The development of this market has allowed less-known, more leveraged corporations to raise large amounts of money in the public market. Companies such as MCI owe their growth to the ability of the high-yield market to accommodate their financing needs during the critical phase of intensive investment for market share acquisition. The high-yield market had a temporary setback as a consequence of a number of defaults associated with large leveraged buyouts and the collapse of Drexel Burnham Lambert which in the eighties acted as the main market-maker in high-yield securities. However, by 1992 \$38 billion in high-yield securities were placed, more than three times the level of 1991.

A **private placement** issue is generally sold to a small number of financial institutions (mainly insurance companies). It needs not be registered with the SEC and is not marketable. Private placements are usually smaller (less than \$100 million) and are likely to pay higher interest rates but have lower issue expenses. Private placements are subject to more restrictive covenants than their public counterpart. However, since the investors are sophisticated financial institutions able to appraise the risks of an individual company, the private placement market is opened to smaller less-established companies and can handle the more complicated financing terms that are necessary in order to finance newcomers or special situations. Private placements are usually not rated and account for more than 30 percent of all corporate

borrowing in the U.S. Since private placements require close interaction between lenders and companies, this market is not readily available to foreign issuers. However, in 1993-1994 a number of Scandinavian financial institutions have raised subordinated debt through simultaneous private placements in Europe, Japan and the US (see Euromoney 1994). The enactment of Rule 144A has opened a related market to foreign issuers.

Rule 144A was enacted in April of 1990. This modification of the Securities Act of 1933 deals with private resales of securities to institutions. It removes restrictions on trading private placement securities without SEC registration by providing an exemption from the registration requirements of the Securities Act for resales to eligible institutional buyers of securities that were originally issued in private placements. In addition, the rule gives institutional investors greater access to securities sold outside the U.S. in offerings that are exempt from registration under the U.S. securities laws. Institutional investors qualified under Rule 144A are entities acting for their own account or the account of other qualified institutional buyers, that on the aggregate own and invest on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity. The qualified institutions include insurance companies, registered investment companies, pension plans, and banks.

The significance of Rule 144A is that, by allowing U.S. institutional investors to trade in nonregistered issues, specially Euro-issues and other global issues, it has greatly expanded the liquidity of the global market and therefore expanded the financing possibilities of smaller and less well-known foreign firms that were before effectively barred from the U.S. debt market. The 144A market should not be confused with the traditional private placement market discussed above in which one or a few lenders (insurance companies, banks) lend money to a small but closely monitored company. The securities issued under Rule 144A are essentially public issues traded over-the-counter among institutions without the registration requirements of the SEC.

2.1.2. The Euro-debt Market

The Euro-market is an international money and capital market in which currencies are traded outside their country of origin. Euro-DMs for example are marks deposited at banks outside Germany which are reinvested with or without converting them into other currencies. US dollars, Deutsche marks, Canadian dollars, pounds, Dutch guilders, Swiss francs, yens and ECUs are the major currencies used for transactions. In recent years, the boundaries

of the original Eurobond market have been expanded by the growth of foreign borrowing in the national markets of the U.S. (Yankee bonds), Japan (Samurai bonds), Hong Kong and Singapore (Dragon bonds), Germany and Switzerland.

A typical Eurobond issue is managed and underwritten by a syndicate of London-based international investment banks from such countries as Germany, Switzerland, Luxembourg, United States and Japan. The bonds are issued in bearer form (the registered form is prevalent in the U.S.), usually pay interest once a year and are sold to individual investors and institutional investors throughout Europe and the U.S.

Public bond issues are listed on the exchanges (mainly Luxembourg or London). As in the U.S., issues are usually listed to satisfy legal requirements on the portfolios of some institutional investors but most trading takes place between banks and brokers over-the-counter. **Private Euro-placements** are arranged by banks for placement with their own investment clientele or through a syndicate.

Examples of Euro-market and Rule 144A issues are given in the Table 1. The yield to maturity of the issue measures depends on the credit rating of the issuer as well as on the expected performance of the currency of issuance. This explains the difference in the cost of financing between Telebras and AT&T, for example. Convertible securities and bond plus warrants, such as the issues of Nafinsa, Roche, Kobe and Sapporo, pay a lower yield because of the capital gain they offer. However, the cost of these issues is higher than the reported yield because they can result in dilution to the existing shareholders (see section 3).

2.1.3. Trade Financing

Trade financing is a method of providing funds to the buyer so he/she can make immediate payment to the seller upon shipment. It involves banks, other investors and government agencies. The latter subsidize the lenders and/or provide funds and insurance in order to promote exports. Buyers benefit from lower interest rates, grace repayment periods and long-term repayment schedules. Medium-term trade financing is provided by the unregulated **forfeit** markets of London and Zürich. Normally, forfeiting provides fixed-rate supplier credit for up to several years for capital goods exports or project financing. The exporter receives a promissory note from the importer. The note is guaranteed via an irrevocable aval by a bank typically in the importer's country. The exporter discounts the note on a nonrecourse

Issuer	Date	Due	Amount	Yield
Tintas Corral	Jun 92	1994	\$ 40	12 %
Telebras	Aug 92	1997	\$ 100	11 %
Banco do Brasil	Apr 93	1998	\$ 100	10.54 %
Cemex	Oct 92	1999	\$ 280	10.75 %
Gemex	Nov 92	1997	\$ 110	10.76 %
Nafinsa	Jul 92	2002	\$ 100	9.41 %
Nafinsa	Feb 93	1998	\$ 100	5.875 %
Celulosa Arauco	Jun 93	1998	\$ 150	7.284 %
Osaka Gas	May 93	1998	\$ 250	5.776 %
AT & T	Jun 93	1998	\$ 400	5.553 %
Roche Holdings	Mar 93	2000	\$ 1,000	2.75 %
Rhône-Poulenc	Apr 93	2000	SFr 250	4.914 %
Fuji Oil	May 93	1998	SFr 100	4.742 %
Kobe Electric	May 93	1997	SFr 90	.5 % ¹
Hung For Trd Bk	Jun 93	1998	DM 100	9.5 %
McDonald's	Apr 93	1998	DM 200	6.15 %
McDonald's	Apr 93	2003	FF 1,000	7.619 %
British Gas	May 93	2003	Lt 150,000	10.466 %
Daido Steel	May 93	1997	¥ 20,000	4.781 %
Sapporo Brewer	Jun 93	2000	¥ 40,000	1.375 % ²

¹ With warrants
² Convertible

Table 1: International Bond Issues in the Euro-market under U.S. Rule 144 A (Millions)

basis (not liable for the importer's default) with a forfeiter (normally a subsidiary of a large bank). The discount being determined by the credit ratings of the importer and the guaranteeing bank and the prevailing interest rate. Forfeiting is usually expensive and can exceed 5% over LIBOR (the London Interbank Offered Rate), plus the fees and cost of credit lines charged by the guaranteeing bank. In addition, exporters are sometimes reluctant to use forfeiting because of the liabilities they may incur in case of legal defects in the instrument documentation.

In many cases the government of the exporter subsidizes trade financing via agencies that supply insurance facilities and/or "make-up" interest subsidies to lenders and direct five to ten year financing to foreign buyers for the acquisition of capital goods. The subsidies provided by OECD countries are governed by the "Arrangement on Guidelines for Officially Supported

Export Credit". In particular, these guidelines require a minimum buyer cash down-payment of 15 percent, a maximum 10-year repayment period, and minimum interest rates (the "consensus rates") that depend on the economic status of the buyer's country and the maturity of the loan. However, OECD members sometimes circumvent these restrictions by offering **mixed credits** made of a bundle of commercial bank credit and government export credit, plus additional financing at concessional (foreign-aid) rates. The OECD Arrangement attempts to regulate the use of mixed credits in order to limit evasion of the consensus rates. The U.S. agency providing trade financing is the Export-Import Bank (ExIm Bank). Its direct lending program provides 5-10 year fixed-rate financing for U.S. capital good exports. It requires 15% down payment and it provides up to 65% of the total contract with the balance financed by a commercial bank. In addition, the Private Export Finance Company (PEFCO), jointly owned by U.S. banks and industrial firms, provides between 20% and 25% of the total financing in participation with the ExIm bank and commercial banks, and the Foreign Credit Insurance Association (FCIA) provides commercial and political risk insurance for export credits. FCIA is jointly owned by the ExIm bank and a number of insurance companies. In most cases, the exporter is required to provide 10% coinsurance. Other OECD countries have trade financing and insurance agencies which provide similar subsidies to those of the U.S. agencies. For example, the Export Development Corporation (EDC) in Canada; the Compagnie Francaise d'Assurance pour le Commerce Exterieur (CoFACE) and the Banque Francaise du Commerce Exterieur in France; HERMES (a private insurance consortium) and the Kreditanstalt für Wiederaufbau in Germany; Mediocredito Centrale and the Sezione Speciale per l'Assicurazione del Credito all'Esportazione in Italy; and the Japanese Export-Import Bank, the Export Insurance Division of the Ministry of International Trade and the Overseas Economic Cooperation Fund in Japan.

One interesting development in trade financing is the use of the capital market to further export financing. For example, government agencies (U.S. Ex-Im Bank, France CoFACE) sometimes guarantee bonds issued by foreign companies to finance their imports. These bonds may be denominated in currencies other than that of the agency's country and can be issued in foreign capital markets as well. This type of arrangement provides a stepping stone to a foreign company attempting to make a name for itself as an issuer in the international capital market as the following summary of an issue by the Czechoslovak Airlines illustrates. Another possible but costlier mechanism would be for the importer to issue notes guaranteed by its bank (as in forfeiting) and the exporter to purchase insurance on the foreign bank's guarantee. These enhanced export credit notes would then be sold in the capital market of the exporter.

Czechoslovak Airlines 12 Year Bond Issue

On July 1992 Citicorp (through Citicorp Investment Bank-London) arranged for \$141 million financing for Czechoslovak Airlines (CSA) for the acquisition of five Boeing 737s. The financial package included commercial bank and Ex-Im bank bridge financing with partial Ex-Im financing. In a second stage, on October 1992, 81% of the financing (\$113.74 million) was raised via a bond issue in the U.S. market. The bonds (Guaranteed Trade Certificates) have a maturity of 12 years (due September 1, 2004) and pay 7.02% interest. The notes are guaranteed by the U.S. Export-Import Bank. The underwriters were Citicorp Securities Markets, Merrill Lynch and J.P. Morgan. J.P. Morgan advised CSA. This issue is particularly significant because it permitted CSA to enter for the first time the US capital markets and start to build its reputation as an international issuer.

2.1.4. Project Financing

Project financing is a financial arrangement under which the assets and cash flows associated with a specific project are separated from the parent company(s) and the creditors get repaid solely from the cash flow and the assets of the project itself. Projects financed in this way often have more than one equity owner with each owning no more than 50% of the equity in order to avoid consolidation with the parent company accounts and therefore qualify as "off balance sheet" financing. The project is commonly set up as a corporation or a joint venture partnership.

In principle, creditors have no recourse to the assets of the parent company(s) other than those of the project. Hence, the name "nonrecourse" project financing often given to this type of financing. However, few lenders are willing to extend pure nonrecourse financing and, in practice, most project financing are "limited recourse" in which the equity holders have some contingent liability with respect to loan repayment. For example, in projects in which the equity owners provide a completion guarantee, the loan becomes full-recourse in case of completion failure.

A business financed by project financing is regulated by tight rules. Project financing can be seen as a project governance system which provides incentives, safeguards and mechanisms of control and dispute resolution, all designed to align the interest of the parties and maximize the probability of timely completion of the project (the rate of return of a project decreases by 5 to 10 percent per year of completion delay). By reducing moral hazard, the cost of financing the project is reduced and the project can be made

economically feasible and be financed with less equity. In particular, (i) lenders have the right to receive detailed reports on the progress of the project and to inspect the project on site; (ii) cash disbursements by lenders are graduated to the project progress and the use of the cash provided is supervised by the lenders; and (iii) the borrower has not discretion over the use of the cash flow generated by the project until repayment of the loan(s) has taken place.

Project financing has staged a resurgence in recent years. In the U.S. it amounts to more than \$15 billion per year via public placements plus an unknown amount of private placements. Project financing is being used in the U.S. to fund power generation projects, oil and gas development, and even plant construction. It has been used to finance a large number of hydroelectric and geothermal projects in which the projects sell electricity to utility companies under long-term contracts, the proceeds of which provide the basis for non-recourse project financing. The worldwide size of the market is about \$50 billion per year. Project financing has also been used to finance large projects in developing countries, an example of which is the financing of the An Tai Bao project described below (for additional details on the AnTai Bao project see Euromoney Corporate Finance 1986; Wall Street Journal, 1991a and 1991b). Many project financings undertaken in developing countries during the seventies and early eighties defaulted on their payments because of the inability of central banks to provide the necessary hard currency to the project sponsors. These projects, being mostly for infrastructure development, generated local currency not the hard currency required for repaying the loans. As a consequence, the present availability of project financing for developing countries is limited mainly to export projects generating definite hard currency cash flows or to companies with hard currency exports which can be pledged as collateral for the loans (examples of this type of export supported financing are provided in section 2.3.).

As a way around the foreign exchange availability problem, the so-called BOT (Build, Operate, Transfer) form of project financing has been used in a number of cases. Under a BOT arrangement, a consortium of service and equipment vendors build, own and operate a power project, a water project, a transportation system, or other infrastructure projects, taking equity risk and receiving equity returns for a predetermined period of time. At the end of a certain ownership period, the project is sold back to the host country or, alternatively, the project can be incorporated and its shares sold to investors in the domestic or international capital markets providing an exit to the original investors. The feasibility of this financial arrangement depends on the credibility of the assurances given by the host country government con-

The An Tai Bao Mine Project Financing

In 1986 a syndicate of 39 banks led by Credit Lyonnais, Bank of America, Industrial Bank of Japan, the Royal Bank of Canada and the Bank of China arranged for a \$475 million project financing of the An Tai Bao Mine in China's Shanxi province. The lead banks agreed to lend \$130 million, the U.S. Ex-Im Bank and Canada's EDC provided \$110 million in export credits, the Bank of China provided \$75 million, and the rest was supplied by a syndicate of 34 banks. The equity ownership of the project was as follows: 50% owned by a Bermuda based 50-50% joint venture between a subsidiary of Occidental Petroleum and a subsidiary of the Bank of China, and the other 50% owned by PSF, an agency of China's Ministry of Coal Industry and by China International Trust and Investment Corporation. Occidental and the Bank of China were jointly and severally responsible for the loans prior to satisfaction of certain completion requirements, afterwards the loans were to become nonrecourse. Occidental was responsible for the operation of the mine and PSF for developing the infrastructure to support the mine. Eighty percent of the coal was to be exported mainly to Japan, North Korea and Hong Kong. The project had no long-term sale contract but part of the loans would become full recourse if the average price of coal delivered to a Chinese port fell below a certain level. Financing was structured into several tranches with maturities of at least nine years. The several loans were to be activated depending on the progress of the project and were priced at ½% to 1% over LIBOR pre-completion and 1¼% to 1% over LIBOR post-completion. In 1991 the Bank of China acquired Occidental's 25% stake in the mine and prepaid the \$200 million already drawn down under the project financing loan agreement.

cerning the rates the utility will be able to charge to its customers, and the assurances that the company will be able to make hard currency remittances to its foreign investors. Examples of BOT project financing include those undertaken by the Hong Kong engineering firm Hopewell in the power sector. One in South China for the development of 350 megawatt coal fired power plant. The project was financed in yen under an export credit from the Japanese government for the acquisition of Japanese equipment. The payment received by the project from the utility buying its power was to be half in renminbi and half in yen. Another project was for a \$41 million 200 megawatt gas turbine plant in the Philippines which used refurbished used U.S. turbines. Financing for this project came from the Asia Development Bank and the International Finance Corporation. More recently, Thames Water, the UK privatized water authority, negotiated with the government of Turkey a \$700 million dam project plus pumping stations and water

mains. Thames arranged financing including its own equity participation, will repay debt, operate the project for 15 years and sell water to Turkey's water authorities for hard currency.

2.1.5. Foreign Exchange and Interest Rate Hedging

A borrower may find attractive to borrow in a currency such as Swiss francs or Deutsche marks while its revenues are linked to U.S. dollars, for example. In that case, the borrower can exploit its borrowing advantage in Swiss francs and hedge its exposure by buying Swiss francs forward or swapping the loan payments into dollars. For example, Nafinsa, the Mexican state-owned credit and development agency, issued SFr150 million three-year Eurobonds in August 1995 and swapped the proceeds into fixed-rate dollars. Similarly, a borrower may find advantageous to borrow at a floating (Libor plus) rate and swap the loan into a fixed rate via an interest rate swap. The swap market matches the needs of several counterparties to foreign exchange and interest rate transactions.

The all-inclusive cost of a hedged transaction includes the cost of the foreign exchange forward contracts or the swap. For example, a cash flow of a Swiss francs loan after fees and commissions is translated into dollars at the dollar spot ask rate for the funds received and at the dollar forward bid rate for the payments. The borrower enters into a forward contract specifying the exchange rate to pay at each future date in which the coupon and repayments of the loan take place. The yield to maturity of the dollar cash flow thus computed is a measure of the all-inclusive borrowing cost. In a swap transaction, the borrower agrees to exchange the Swiss franc cash flow associated with its loan for an equivalent cash flow in dollars, for example. The bank providing the swap agrees to pay the Swiss franc loan and charges the company a dollar rate based upon the quotes in the swap market plus or minus an adjustment depending on how high or low is the Swiss franc rate of the original loan. This adjusted dollar rate is the all-inclusive cost of the loan to the borrower. It should be compared to the cost of direct borrowing in the currency or at the terms desired. Long-term hedging is available in the market only for hedging across hard currencies. Issuers from weak-currency countries can hedge their foreign exchange borrowing by linking the terms of the debt to the issuing company export commodity prices. In 1992 the World Bank created the Commodity Risk Management and Finance Unit to assist developing countries with strategies to hedge commodity price risk and link debt service to commodity prices. For example, the World Bank has assisted coffee producers and exporters of Costa Rica in developing hedging strategies for coffee exports (other

examples of commodity-linked borrowing and hedging are discussed below in section 3.).

2.2. Equity Markets

2.2.1. Common Equity

Shares of common equity are **traded** on stock exchanges around the world (such as the Frankfurt, London, New York and Zürich exchanges) or over-the-counter (such as Nasdaq market in the U.S.). Nasdaq is by far the most effective over-the-counter market in terms of the liquidity it offers investors and its ability to attract fast growing companies. About 30 per cent of the value of all shares traded in the U.S. are traded on Nasdaq (comparable figures for the NYSE and AMEX are 67% and 2%, respectively). It currently trades some 200 foreign stocks out of a total of 5,000 listed on its market. Nasdaq stocks are dealt in by about twelve market makers on the average and 98 percent of its top 2,200 companies are regularly reported by financial analysts. Smaller European companies are increasingly using Nasdaq. Over-the-counter markets also operate in Paris, Frankfurt, Amsterdam and Stockholm. Secondary markets, created to complement the main exchanges, also operate in Brussels, Paris, Amsterdam, Frankfurt, Rome, Madrid, London and Dublin. These secondary markets have not succeeded in creating viable volumes. The possibility of linking Nasdaq with European exchanges and establishing an Europe-wide over-the-counter market (Easdaq) are presently under consideration. In addition, equity is also **privately placed** and can be privately traded the same as bonds on the Euro-markets or under Rule 144A in the United States.

The global market for common equity has experienced a very significant development in recent years as fund managers and other investors in the U.S., Europe and Japan have added foreign stock to their portfolios. Trading volume of foreign shares in the U.S. exchanges is estimated to exceed \$100 million per day at the present time and close to \$200 million including over-the-counter volume. Capital raised through new issues in the U.S. market has varied between \$2 and \$5 billion in recent years. While Western European (mainly UK, Netherlands and Spain) companies continue to dominate the U.S. market, companies from several other countries have recently entered it. With Mexico's ADRs recently surpassing Spain for the second place (behind the U.K.) in trading volume.

2.2.2. Depository Shares

While U.S. investors can acquire shares in foreign exchanges, foreign companies desiring to establish themselves in the U.S. equity market usually issue American Depository Shares (ADS). For example, a depository bank acquires shares of a Finnish company in the Helsinki Stock Exchange and deposit them with a custodian bank in Helsinki. Then, the depository bank issues American Depository Receipts (ADRs) to U.S. investors. ADRs are certificates of ownership of the securities in deposit in Finland. ADRs trade on a U.S. stock exchange or over-the-counter. Publicly traded shares need to be registered with the Security and Exchange Commission and companies issuing them must publish quarterly earnings reports and annual financial statements in English with adjustments to conform to U.S. GAAP (Generally Accepted Accounting Principles). The ADRs are quoted and transacted in dollars and receive dividends in dollars (translated by the depository bank at the exchange rate on the date the company pays its dividends in its own currency). Another possibility for raising equity in the U.S. market is via a direct public offering of common stock in the U.S. This approach was followed in 1992 by Brilliance China Automotive Holding Limited, a Bermuda holding company established to own a 51% interest in a Sino-foreign equity joint venture which manufactures, assembles and sells minibuses in the People's Republic of China. The issue raised \$90.6 million for 5 million shares representing 28.75% ownership of Brilliance China, the rest being owned by a number of Chinese government agencies including the Bank of China and, indirectly, by Chinese public shareholders. The issue price was \$16 at a price-earnings multiple of 23 times 1992 projected pro-forma earnings. The valuation of Brilliance China is discussed below (see Table 3). Foreign companies also issue equity in London. For example, some years ago small American companies (Mrs Field's Cookies and Borland among them) decided to by-pass U.S. registration and reporting requirements by launching their IPOs in London's Unlisted Stock Market. This trend has reversed itself, with small European and other foreign companies opting for Nasdaq in preference to London.

The non-U.S. counterpart to ADS are the Global Depository Shares (GDS) traded in European and Asian exchanges. For example, in October 1992 the Philippine Long Distance Telephone Company issued \$316 million in GDS representing convertible preferred stock (the role of convertible securities is discussed in sections 2.3. and 3.). The issue was distributed as follows: \$57 million via an European offering (London, Frankfurt and Paris); \$138 million in a U.S. offering under Rule 144A; and \$121 million in Asia (Hong Kong and Singapore).

2.2.3. Euroequity

The Euroequity market is an outgrowth of the Eurobond market. Shares are distributed through the over-the-counter market that was originally developed for Eurobonds. During the last few years, American companies and, most recently, European, Asian and Latin American companies have made global issues consisting of simultaneous U.S. and Euroequity issues. By mid-1980 U.S. companies discovered that simultaneous issues in the U.S. and Euromarket permitted them to obtain better pricing for the shares. The key to the development of joint U.S.-Euroequity issues was the U.S. Tax Reform Act of 1984 which introduced targeted registered offerings. Prior to 1984, bearer shares (the preferred form by Euromarket investors) could not be resold in the U.S. where SEC regulations require traded shares to be registered. Thus, shares issued abroad were deprived of the liquidity provided by trading in the U.S. In a targeted registered offering, a U.S. company can issue shares abroad to non-U.S. financial institutions. These shares are exempt from U.S. tax withholding and can be resold by the financial institutions to their non-U.S. clients as bearer shares. The bearer shares revert to registered shares when sold to American investors. Now-a-days, U.S. companies routinely make Euroequity offerings without listing their shares on any of the European exchanges. Liquidity to Euroequity bearer shares is imparted by the deeper U.S. equity market. Foreign companies usually access the U.S. market via ADRs which satisfy the registration requirement of U.S. law and issue bearer shares in the Euromarket. Similarly, a number of new issuers from Asia and Latin America have simultaneously issued ADRs in the U.S. and GDRs on the Euroequity market. Details about some recent global issues are given in Table 2.

The last column of Table 2 contains the fees and expenses of the issue, including underwriting fees. Issue costs depend on if the issue is an initial public offering or a first-time global issue such as those of Natuzzi, RGA, Brilliance China, Nine West, Dr. Pepper, Tocor and Tribasa or a seasoned issue, such as those of Novo, Dina, Turner and Intel. The fees and expenses of the first averaged 7.4 percent while those of the latter averaged 4.2 percent.

The pricing of global issues of US and Western Europe companies is done using similar valuation parameters (comparable price earnings (P/E) multiples and discounted cash flow (DCF) rates). For example, when British Telecom went public in December of 1984 it was priced at 130 pence per share or 8.6 times its 1985 projected earnings per share (EPS) of 15.1 pence. This valuation was equivalent to a P/E multiple of 11 times the EPS restated to conform with American accounting standards (11.8 pence) (the

Company		Home	USA ¹	Eu- rope ¹	Rest ²	Fees + Exp
Repsol (Sp)	Mar 93	\$ 98	\$ 333	\$ 331	\$ 41	3.5 %
Ind. Natuzzi (It) ³	May 93		\$ 126		\$ 25	7.4 %
Novo-Nordisk (Den)	Apr 92				\$ 104	4.3 %
Dina (Mx)	Mar 93	\$ 292	\$ 173		\$ 49	5.5 %
Brill. China (Ch) ³	Oct 92		\$ 91			8.9 %
RGA (US) ³	May 93	\$ 120			\$ 30	6.9 %
Turner Broad. (US)	Sep 92	\$ 147			\$ 37	3.2 %
DrPepper/Up (US) ³	Jan 93	\$ 247			\$ 60	6.0 %
Nine West (US) ³	Feb 93	\$ 112			\$ 28	8.5 %
Tocor/Centocor (US) ⁴	Jan 92	\$ 81			\$ 23	7.7 %
Intel (US) ⁵	Mar 93	\$ 240			\$ 60	4.3 %
Tribasa (Mx)	Sep 93	\$ 53	\$ 132		\$ 79	6.7 %

¹ Excludes home issue for US and European companies
² May include Europe and US in specific cases
³ Initial public offerings
⁴ With warrants
⁵ Warrant issue

Table 2: Global Equity Issues (US \$ millions)

main adjustment had to do with the treatment of deferred taxes). On the other hand, ATT's P/E was 13.7 and the average of the Bell local companies P/E was 8.0 which implied a P/E multiple of 10.85 for a company such as British Telecom with earnings evenly split between local and long-distance telecommunication.

The pricing of issues from emerging market companies is complicated by the lack of data on comparable multiples and risk-adjusted discount rates. The value parameters for these issues need to account for their higher risk and illiquidity. Table 3 presents data on three of such issues. The high multiple at which Brilliance China went public, well in excess to the multiple of US auto companies, is due to the high growth assumed to for the company at the time of the issue. A better gauge of the pricing of the issue is attained by computing the rate of discount which equates the issue price to the present value of the company's projected free cash flow to equity holders. In the case of Brilliance China this rate exceeded the cost of equity of small capitalization companies in the U.S. auto industry by 14.7 percent. This premium can be interpreted as compensation for the country risk and lower liquidity of the issue. On the other hand, the additional premium paid

Company	Country/ Industry	Issue date	Issue P/E	Com- para- ble P/E	DCF Issue Rate	US Small Cap Cost of Equity	Country and Liquidity Premium
Brilliance China	China Auto	Oct 92	22.8	13.3	28.7 %	14.0 %	14.7 %
President Enterprises	Taiwan Food	Mar 93	16.8	17.3	16.2 %	12.0 %	4.2 %
Petofi	Hungary Printing	Oct 92	10.8	18.8	19.8 %	14.5 %	5.3 %

Table 3: Pricing of Equity Issues from Emerging Markets

by President Enterprises, a well known Taiwanese company, was only 4.2 percent in spite of the private placement nature of the issue. The premium paid by Petofi was also lower but that was due to it having World Bank and EBRD financing.

2.2.4. Equity participations

Sometimes, a foreign company with a complex structure may not offer a transparent enough business to satisfy far-away investors, or its owners may want to preserve private ownership over some parts of the business. However, a privately owned holding company does not need to go public itself in order to tap the global equity market. The holding company can incorporate one or more of its subsidiaries and sell a non-controlling fraction of the equity to public stockholders.

This approach is not limited to private companies. Public holding companies can also issue shares of subsidiaries. For example, in 1989 Pirelli S.p.a. the cable and tire Italian company, spun off its tire business by creating Pirelli Tyre Holdings N.V. (PTH) as a company registered and headquartered in the Netherlands. It then sold 24% of the equity of PTH to public stockholders in Amsterdam and other European markets. Pirelli used the proceeds from this issue to finance the acquisition of the Armstrong Tire Co. in the U.S.

Another approach is the issue of participating notes. For example, in October 1992 Walt Disney made a global \$400 million (Eurobond and

144A) issue due 1999 of a new type of equity hybrid. The instrument pays 7½% interest during the first 18 months and 1½% thereafter. In addition, a contingent interest will be paid based upon the revenues of a \$400 million portfolio of films, if the revenue exceeds \$800 over the life of the notes, plus a supplemental interest if the company fails to develop the \$400 million portfolio. The cumulative contingent and supplemental interests are subject to a cap of \$240 million. Besides reducing the interest rate below the level that Disney would have had to pay on straight debt financing, this structure links its interest payments to the revenues of the project and smoothens Disney's earnings. Disney is expected to be able to deduct the full interest on the notes (fixed and contingent and original issue discount amortization) for income tax determination. Complicated financial structures such as this one may not be available to a newcomer to the public market, but they can be proposed to sophisticated lending institutions in a private placement.

2.3. Hybrid securities

Equity-linked securities, also called equity derivatives, combine the characteristics of bonds and equity. The most common examples of these hybrids are convertibles bonds and bonds with warrants. These securities have experienced a resurgence in recent years in both the U.S. and the Euromarket, and are often used by first-time issuers to break into the global market.

2.3.1. Convertibles and bond plus warrants

A **convertible bond** is a bond that can be exchanged for shares at the option of the holder at a predetermined price during a specified period of time. The shares need not be those of the borrower but can correspond to another company and can be denominated in a currency other than the currency of the bond. An alternative to the convertible bond is the convertible preferred stock which pays a cumulative dividend instead of interest.

A **bond plus warrant** unit is a bond with a warrant that entitles the holder to purchase shares of a company at a specified price during a certain period. Payment of the exercise price of the warrants can be made in cash or, often, by surrendering the bond. In this latter case the bond plus warrant unit is effectively a synthetic convertible. The difference being that the holder can usually detach the warrant from the bond and sell the bond or the warrant separately. In the U.S., issuers of bond plus warrants can make use of original issue discount amortization for tax purposes while issuers of regular

convertibles cannot. Equity-linked issues are particularly attractive to investors from countries such as Switzerland and Germany where capital gains are tax exempt or taxed at a lower rate.

Equity-linked securities are attractive to investors because, in addition to coupon interest, they provide a participation on the upside of the company by giving investors the opportunity to acquire stock. This is why hybrids are more attractive when the shares of the company trade in some public market such as the market of the issuer's country. Warrants are also attached to private placement financing of private companies and are then called **equity-kickers**. Usually, these warrants are puttable (the holder can sell them back to the company) at some price in order to compensate for their lack of liquidity. Investors also get downside protection as opposed to straight ownership of stock since they keep their bondholder status if the stock of the company does not do well. The largest equity-linked issue ever was the April 1995 \$2.15 billion Liquid Yield Option Notes (LYONS) by Roche, simultaneously sold in Europe and, under Rule 144A, in U.S. LYONS are zero coupon, convertible, callable and puttable bonds (they are analyzed in McConnell/Schwartz 1992). In September 1995 Mitsubishi Bank issue 3 percent \$2 billion notes due 2002. This notes are exchangeable for Mitsubishi ADS at a 10 percent conversion premium. However, the conversion price is reset down each year if the fall in the price of the underlying ADS.

Since investors get part of their return from their option to acquire stock, they demand a lower interest than on a straight bond with no equity link. Hence, companies can reduce the amount of cash they assign to interest or debt repayment by issuing hybrid securities. The possibility to attain a large capital gain via the equity kicker may induce an otherwise reluctant investor to acquire low-coupon securities from a less known issuer. On the other hand, the conversion feature or warrant is not free to the company since it can result in the issuance of new shares with dilution of ownership to the current owners. For this reason the implications of conversion or the warrant terms have to be evaluated and compared to the cost of other alternative forms of raising capital. The all-inclusive cost of an equity-linked issue can be computed by subtracting from the proceeds of the issue the fees and expenses **and** the value of the warrant. These net proceeds are then matched with the coupon and principal payments in order to compute the yield to maturity of the stripped loan. Companies planning to enter the global market may start by issuing convertibles. As mentioned before, convertibles pay less interest than straight debt and can be more appealing to investors willing to take additional risk in exchange for the possibility of equity returns. In addition, convertibles pave the way for a subsequent global

equity issue. This is so for several reasons: Analysts report on the firm issuing convertibles in a more comprehensive form than when only straight debt is floated, thus contributing to the better knowledge of the company. Also, if the shares of the company perform well in the company's home market, foreign investors will opt to convert (or exercise their warrants) and become shareholders, paving the way for a global equity issue. Furthermore, because Euromarket convertibles are settled through the network of the Eurobond clearing houses, the convertibles can often offer more liquidity than regular equity, particularly if the equity issue does not trade in the U.S. market. Companies that have used convertibles to better access the global capital market include Novo-Nordisk, the Danish pharmaceutical; Astra, the diversified Indonesian group; and Banamex, the banking subsidiary of the Mexican holding company Banacci. Novo followed its issue of convertibles in the Euromarket with an issue of ADRs in the U.S. Astra, after launching an international issue of common equity in 1990, placed \$100 convertible Eurobond with a 15 year maturity and a 7% coupon (this issue is convertible into shares at a premium of 20% and is noncallable for three years). In December 1992, Banamex made a global issue of \$565 million of seven-year subordinated debentures exchangeable into shares of Banacci. In September 1995, Lukoil, the Russian oil company, issued \$70 million convertible into depository receipts. Convertibles or the components of bonds plus warrants are often callable at a premium by the issuer as a way of limiting the upside benefit offered to investors. The call feature usually results in a somewhat higher coupon. Straight bonds are often callable as well.

2.3.2. Commodity-linked hybrids

In 1973, PEMEX, the Mexican oil company, issued bonds with principal repayment linked to the price of oil. By doing so, it linked its debt to its oil revenues and hedged its overall risk. It also provided investors with the upside of an oil price surge for their taking the risk of a fall in oil prices. Essentially, this commodity-linked bond was a combination of a bond and a forward contract on oil. Commodity-linked hybrids have become more common in recent years as a tool for risk management. For example, in 1986 Pegasus Gold Corporation issued Eurobonds with detachable gold warrants as a way of reducing the coupon on its bonds and its financial risk; and Ghana's Ashanti Goldfields Corporation issued \$140 million denominated in U.S. dollars or gold, and hedged the equivalent of \$100 of its gold sales to guarantee the issue. Ashanti's financing as well as its hedging facility was arranged by the International Financial Corporation. Other companies which have in recent years issued commodity linked debt include the Algerian oil company Sonatrach (oil-linked Eurobonds), and Mexicana de Cobre S.A. (copper-linked project financing).

2.3.3. Securitization

Another variant that has been used to enhance the quality of debt issues is linking interest and principal repayment to the issuer's dollar receivables. For example, AT&T pays Telmex a significant balance for calls from the U.S. to Mexico. By an agreement between ATT and Telmex, ATT pays these charges to a special account that goes to pay investors for funds provided to Telmex. A similar arrangement is the \$235 million issue of receivable trust certificates arranged by Salomon Brothers for Mexico's Comisión Federal de Electricidad which is backed by the proceeds from a power export contract with two California utilities. A further extension of this practice is the \$33 million Eurobond issue arranged by Bankers Trust for Tamsa, the Mexican manufacturer of steel tubing and pipes. Tamsa deposited the proceeds from the issue with the London branch of Bancomer and pledged these funds as security for the issue. In return, Bancomer lent Tamsa dollars in Mexico. Bancomer is in effect extending the credit to Tamsa but the funds are being provided by Euromarket investors. A similar arrangement supported a \$92 million Eurobond issue by Grupo San Luis in September of 1990.

Brazilian companies have often used securitization and **pre-export financing** to obtain dollar loans and raise funds in the Euro-commercial paper. For example, in June of 1992 Aracruz Cellulose raised \$150 million at Libor plus 300 basis points via the following arrangement: Aracruz directs a percentage of its export revenues to an export account in order for an Aracruz offshore subsidiary to obtain \$150 bank financing guaranteed by the funds on the offshore account. In addition, Aracruz issued \$150 million in notes to its subsidiary in exchange for the \$150 million. Aracruz has also obtained dollar loans via pre-export financing using seven to ten year export contracts as collateral. In March and April of 1992 Sambra issued \$120 million 3-year Euronotes secured with commodity export contracts for soybean meal exports (\$70 million were priced to yield 12.3% and \$50 million priced to yield 11.8%). Varig used a sort of pre-export financing in borrowing from Citibank \$46 million against the planned sale of a DC10. Varig has also raised \$50 million against its U.S. revenue from credit-card sales.

3. Conclusion: How to access the global capital market

3.1. Investors

The investors in the international capital market are mainly institutions (such as pension funds, mutual funds, insurance companies and trust

accounts managed by banks). Institutions do the bulk of the investment in the U.S. market and, even in the Euromarket, a market until recently dominated by individual investors, institutions are estimated make almost one-half of the market.

Institutions are sophisticated investors which often have "buy-side" analysts capable of analyzing the solvency and growth prospects of issuers and pricing their securities. In addition, institutional investors follow portfolio diversification strategies that allows and, in the case of large funds, encourages cross-border diversification and the taking of higher risks in search for higher returns. On the other hand, many institutions (mutual funds in particular) are restricted to invest in securities that trade in a established market.

Institutional investors follow rather uniform criteria for fundamental valuation of companies and the securities issued. To be considered for investment, a company must be expected to be profitable on an operating basis after a transitory developmental phase; it should produce quality products or services and have a solid reputation in its markets; and it must operate in an industry with growth potential. In addition, the company has to have competent management with an established track record.

3.2. Role of the home stock market

Many institutional investors can not invest in illiquid securities. The market for the securities does not need to be public since, for example, most institutions are allowed to invest in Eurobonds and U.S. 144A securities which only trade over-the-counter. However, companies that have stock listed on their own home stock market can more easily access the international capital market. This is particularly so for global equity issues or issues of convertible securities (because the value of the latter depends in part on the price assigned to the underlying stock). Listing stock on the home stock market is also beneficial for first-time issuers of straight Eurobonds. The reputation acquired in the home market is taken into account by Eurobond investors.

In summary, a solid **reputation** is essential in order to gain access to the international capital market, and it is in the home capital market where it is easier for the company to begin to acquire such a reputation. The local market performs a monitoring function by following and evaluating the performance of the company and its management. In turn, this is reflected in the interest created in the home market for the company's shares and in

the performance of its share price. This process of reputation acquisition needs not to extend over several years. A private company with a well-known history in the local banking and commercial market can float a fraction of its shares in its home stock market in order to create the appropriate investment profile, and tap the global market shortly thereafter.

3.3. Transfer risk

The transfer risk is the risk faced by lenders that the borrower will be prevented by government restrictions on currency and capital transactions from making interest and principal payments. This means that, in addition to evaluating the credit risk and reputation of the company, international lenders consider the country in which the borrower is based. Such factors as the economic policies followed by the country, how the government deficit is financed, the stability of its currency and inflation trends, its political stability and labor relations situation, its aggregate level of foreign indebtedness and debt service requirements in relation to its foreign trade and balance of payment, are all given weight in the decision on whether or not to lend to or invest in a particular company.

Large companies facing the unfavorable effect of unstable economic conditions at home, can get around the problem if they are significant exporters or have other sources of foreign exchange earnings such as profitable operations abroad, as they can then borrow or issue equity securities against the cash flows generated outside their home country.

3.4. Sequential strategies

Companies from countries with small capital markets which have successfully accessed the global capital market cover a wide range of countries and industries. From the Danish pharmaceutical company Novo-Nordisk and the Spanish electric utility Endesa, to Indonesia industrial group Astra and several Mexican firms including Vitro (glass) and Cemex (cement). An analysis of the experiences of these companies does not reveal a single strategy but their approaches have certain common characteristics which are discussed below.

Strategy (1): Share listing in the home stock market

Listing common stock on the company's home stock market is a highly desirable first step to be undertaken by a company planning to access the global capital market. Listing can also have side benefits such as providing liquidity to family members in family controlled firms as they can sell part of their holdings in the public market by attaching them to the initial public offering, or by selling them later on after following appropriate registration procedures where shares need to be registered (as opposed to bearer shares). International investors are distrustful of companies that do not have an established listing on their own home stock market.

Going public in the home market is sometimes done by instituting two classes of shares each with different voting power. The shares with higher voting power are retained by the founders and the shares with less voting power, but otherwise the same rights concerning ownership and dividends, are issued to public stockholders. This approach is quite common in Europe and other countries outside the U.S. It should be noted, however, that strong forces toward the elimination of dual classes of shares are at work in Europe. Institutional investors are increasingly expressing their displeasure with dual voting power shares, in particular, in the case of German companies. In addition, the price attained by shares with reduced voting power may be lower. For example, the average difference in price between Class A and Class B shares for a sample of Swedish firms was between 1.4 and 6.1 percent during 1975-1985 (see Rydqvist 1987). Sometimes, in order to protect existing shareholders against dilution of their control on the company, it is established in the corporate charter that issues of new shares have to be done only through **preemptive stock rights** - which give the right to existing shareholders to buy new shares in proportion to their current shareholdings and thus preserve their ownership participation in the company. Those shareholders not desiring to buy additional shares can sell their rights to other shareholders. If the issue is underwritten with a **stand-by agreement**, the investment banker would buy the unexercised rights and their associated shares and resale the latter in the open market. Rights issues are common in Europe.

The floatation of shares in the home market has to be sufficiently large to provide enough liquidity to the market and justify following the stock by security analysts. This does not normally mean that the current owners need to issue a large fraction of their ownership and thus risk losing control. In fact, less developed capital markets normally operate with relatively small floats.

Strategy (2): Accessing the Eurobond market

A straight **Eurodollar** issue, if feasible, is a good entry into the global market. The maturity of these issues can go up to 10 years but a first-time issuer will most likely be limited to a shorter maturity, perhaps as short as two years and the amount may be limited to \$20 to \$40 million. While the first issue will not satisfy the needs for long-term financing, it will represent an important step toward accrediting the company in the international market. Longer term issues for larger amounts will be possible as the company develops a track record on debt service.

Issuing a **convertible bond** is highly desirable for those companies planning to tap the global equity market. The opportunity may be available for first-time issuers or after issuing straight medium-term notes. The advantage of a convertible issue, which usually is made for a maturity of four to seven years, is that it carries a lower coupon than an alternative straight bond and represents an indirect entry into the global equity market. Euro-convertibles, being channelled through the Eurobond bank network normally have reasonable liquidity. They create interest in the underlying stock of the company and prepare investors for a future equity issue.

A convertible issue should be accompanied by the investment banker commitment to make a continuous market on the security and to initiate reporting on the company. This will start the process of giving an international valuation to the equity. In this connection, it is desirable that the convertible offer attractive conversion terms so that it trades at least in part as stock. Attractive conversion terms exist when the bond is convertible to stock at not too high a premium (25% or less). Such terms would not increase the cost of the issue if the interest coupon can be reduced accordingly. If the issuer has been already active in the Eurobond market, the convertible issue may raise about \$100 million or more, otherwise the amount raised may be significantly less.

A **private placement** is an alternative when public issues are not initially acceptable to Euromarket investors. However, a private placement will not contribute so rapidly to building the reputation of the issuer and can be costlier than a regular Euromarket issue.

Choosing the appropriate financial advisors with the ability to place the issue, make a market, publish research about the company, and have the capacity to arrange for future equity issues is very important. The financial advisor should undertake a thorough analysis of the company, design a suitable first issue and have it ready for whenever the opportunity arises depending on market conditions and company needs. Of course, the decision

about how and when to proceed ultimately rests with the company itself but a good banker can assist the company to better reach this decision. An international financial advisor with a solid reputation lends credibility to first-time issuers in addition to putting its selling power behind the issue.

First-time issuers from developing countries or the transition economies of Eastern Europe can greatly benefit from a guarantee from the IFC, or from export credit guarantees from export support agencies such as the Ex-Im bank. An issue with guarantee has virtual probability of success and can be done at a small spread over the same-maturity U.S. Treasury yield. Such an arrangement, when available, will provide an effective way of initiating the access to the global capital market. While more involved and expensive than straightforward concessional credit, it has the beneficial long-term effect of developing the fund-raising capability of the firm.

Strategie (3): Global equity issues

The ultimate goal of a global equity issue is to remove the capital constraint of the home market and permit the firm to achieve its full potential. One consequence of attaining access to the global equity market is the reduction of the cost of capital. To begin with, a firm attaining international valuation will trade at a price higher than that permitted by its home market. In addition, by increasing its equity, the firm simultaneously adds to its reputation and to its debt capacity and will be able, therefore, to borrow more and/or at more favorable terms. An equity issue also protects the company from financial distress. Because a significant part of the return promised to shareholders is in the form of capital gains rather than cash payments, the firm will be less vulnerable to revenue shortfalls or fluctuations in the exchange rate than when having to service hard-currency debt.

A desirable step prior to a global equity issue is to list the shares of the company on the international equity market. This can best be attained by starting an **sponsored ADR program** in the U.S. with listing on the Nasdaq over-the-counter market (the advantages of Nasdaq listing are discussed in section 2.2.). In an sponsored ADR program, the company arranges for a broker to make a market in its ADRs. For this it is not necessary to issue new shares as the broker arranges for a depository bank to acquire shares in the home market of the company and issue against them American Depositary Shares. The company pays all the expenses associated with listing, SEC registration and other expenses incurred by the broker who will then offer the ADR to its clients. ADR programs are described in section 2.2. above. The brokerage arm of an investment banker will make a market

in the ADRs as a preliminary step leading to a global equity issue. ADR listing will require that the company initiate annual reporting in English showing adjustment to conform to U.S. accounting standards and commit itself to publish quarterly reports within a reasonable period of time. ADR listing can be done at the same time or immediately following the launching of a convertible issue. This will help the pricing of the convertibles as investors see the company moving toward establishing an international valuation for its shares. Several months after initiating the sponsored ADR program the company can follow it with a global equity issue with simultaneous placements in its home market and abroad.

Instead of following the listing and public issue route, the company can begin by making a private placement of equity if it states in the prospectus its commitment to seeking listing within a short period of time, a commitment that is implicitly certified by the investment banker managing the issue. However, a private placement will be usually done at a lower share price than that attainable via the public issue route described above because of its initial illiquidity and the lack of a reliable international valuation.

A floatation in the \$50-\$150 million range is typical of many first-time equity issues. A smaller floatation would not justify the issue expenses and would not provide sufficient liquidity. Financial analysis would not report on the company if the float is too small. How much larger the issue can be depends on the interest of investors at the time of the issue as gauged by the pre-selling efforts of the investment banker.

Appendix: Cost of Capital and Value

Companies create value for their shareholders by investing in projects at a return exceeding their cost of capital. Access to the global market reduces the cost of capital, permits the undertaking of additional profitable projects and increases the present value of the cash flows generated. It is shown in this appendix that a 20 basis points (0.2%) reduction in the cost of financing can increase the value of the company's equity by more than 10 percent. This can be shown as follows: The value of debt plus equity of a firm growing at a rate g is

$$V = \frac{c}{w - g},$$

where c is the first year after-tax free cash flow and w is the cost of capital $w = b(1-t)r + (1-b)k$ for a debt ratio b , a tax rate t , a cost of debt r and a cost of equity k . Let p be the basic point reduction such that $r = r-p$ and $k = k-p$ and consider the percent change in the value of equity resulting from a basic point (on hundredth of a percentage point) reduction p :

$$\frac{1}{(1-b)V} \frac{dV}{dp} dp = \frac{1}{(1-b)V} \frac{c(1-tb)}{(w-g)^2} dp = \frac{1-tb}{(1-b)(w-g)} dp.$$

For example, for typical values such as $t = 40\%$, $b = 45\%$, $w = 10\%$, and $g = 7\%$, the increase in the value of equity per basis point reduction in the cost of debt and equity is 0.5%. This translates into a 10% increase in the value of equity for a permanent 20 basis point reduction in the cost of financing. This calculation does not take into account that a lower cost of financing may allow the firm to undertake additional positive net present value projects and thus increase its growth rate. In that case, the contribution to shareholder value would be higher.

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