Overseas Capital Market Issues

Topics

- Introduction to International Financial and Capital Markets
- The International Bond Market and Products of Overseas Capital Markets
- Depository Receipt Mechanism of Equity offers
- Indian Regulatory Regime for Global Market Floats
- Process Flow of International Offering

International Financial Markets

- International Financial Markets consist of International Banking Services and International Money Market
- Banking Services
  - Trade Financing
  - Foreign Exchange
  - Foreign Investment
  - Hedging Instruments (Forwards/Options etc)

International Financial Markets

- Money Market
  - Eurocurrency Markets
  - Euro credits
  - Euro notes
  - Euro Commercial Paper etc

International Capital Markets

- A capital market is basically a system in which people, companies and governments with an excess of funds transfer those fund to people, companies and governments that have a shortage of funds.
- International capital markets are the same mechanism but in the global sphere.
- Benefits
  - Higher Returns and Cheaper Borrowing costs
  - Diversifying Risk

Components of International Capital Markets

- International Equity Markets
- International Bond Markets

International Equity Markets-Growth Factors

- Key factors for the increased growth in the international equity markets are
  - Growth of developing markets
  - Drive to privatize
  - Investment Banks
  - Technology Advancements

International Bond Markets

- Bonds are the most common form of debt instrument, which is basically a loan from the holder to the issuer of the bond
- Companies that do not want to issue more equity shares and dilute the ownership of existing shareholders prefer using bonds or debt to raise capital
- The international bond market consists of all the bonds sold by an issuing company, government or entity outside their home country.
- Several types of International Bonds
  - Foreign Bond
  - Eurobond
  - Global Bond

International Bond Markets- Categories

- Three categories of International Bonds
  - Foreign
    - It is a bond sold by a company, government or entity in another country and issued in the currency of the country in which it is being sold.
    - Generally risky (Forex, Economic and Political risks)
  - Euro
    - It is a bond issued outside the country in whose currency it is denominated.
    - They are not regulated by the countries in which they are sold.
  - Global
    - It is sold simultaneously in several global financial centres, generally denominated in a single currency i.e. dollars or euros

Euro Currency Markets

- Originated in 1950s, when the communist governments in eastern Europe became concerned that any deposits of their dollars in US banks might be blocked.
- These governments addressed their concerns by depositing their dollars into European banks , which are known as Eurodollars.
- Banks in other countries too began to hold US dollar deposits and now Eurodollars are any dollar deposits in bank outside US. Half of worlds deposits are in this form.
- Extension of Eurodollar is Eurocurrency, which is a currency on deposit outside its country of issue.
- Euro-loan market is a growing part of the Eurocurrency market. These loans are quoted on the basis of LIBOR.
- The charm of Eurocurrency market is that there are no regulations, which results in lower costs.

International Bond Market

- International bonds are issued by a country or company that is not domestic for the investor
- Three categories
  - Domestic
  - Euro
  - Foreign
- Dollar Denominated
  - Euro Dollar bonds
  - Yankee Bonds
- Non Dollar Denominated

Products of overseas capital markets

- Top four international capital market instruments
  - Global Depository receipts
  - Foreign Currency Convertible bonds
  - American Depository Receipts
  - External Commercial Borrowing

Global Depository Receipt

- Global Depository Receipt (GDR) is an instrument which allows Indian Corporate, Banks, Non- banking Financial Companies etc. to raise funds through equity issues abroad to augment their resources for domestic operations.
- As per the recent guidelines on issue of GDR, a corporate entity can issue any number of GDR issues in a year and the corporate involved in infrastructure projects need not have a past track record of financial performance.
- A GDR is a dollar denominated instrument of a company, traded in stock exchanges outside the country of origin i.e., in European and South Asian Markets. It represents a certain number of underlying equity shares.
- Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees only. Instead of issuing in the names of individual shareholders, the shares are issued by the company to an intermediary called the ‘depository’, usually in Overseas Depository Bank, in whose name the shares are registered.

Foreign Currency Convertible Bonds

- Foreign Currency Convertible Bonds (FCCBs) are issued in accordance with the scheme and subscribed by a non-resident in foreign currency and convertible into ordinary share of the issuing company in any manner, either in whole or in part on the basis of only equity related warrants attached to debt instrument. The FCCB is almost like the convertible debentures issued in India.
- The Bond has a fixed interest or coupon rate and is convertible into certain number of shares at a prefixed price. The bonds are listed and traded on one or more stock exchanges abroad.
- Till conversion the company has to pay interest on FCCBs in dollars (or in some other foreign currency) and if the conversion option is not exercised, the redemption also has to be done in foreign currency. The bonds are generally unsecured.

Foreign Currency Convertible Bonds Issued By Indian Companies

- Following the sustained liberalisation programme undertaken by the Indian Government to integrate with the global economy, the foreign currency convertible bond (FCCB) market took a quantum leap during the bull run of 2005– 2008. Reports state that 201 Indian companies raised approximately US$16bn through FCCBs during that period.
- Companies issued FCCBs to reduce their borrowing costs. They issued the bonds at very low coupon rates; some were even zero coupon. However, they fixed the conversion prices between 25 per cent and 150 per cent higher than the prevailing market prices in expectation of an increase in share prices. This theory fell flat with the subsequent crash in global equity markets. It is estimated that two thirds of the FCCBs due to mature before March 2013 will not be converted into equity shares.
- Most of the FCCBs that will mature in 2012 were issued in the years 2007–2008, when the foreign exchange rate was approximately 42 Indian rupees (INR) to a US dollar. The INR has since lost more than 30 per cent against the US dollar. This has added approximately US$2bn to the value of FCCB maturities in 2012.

Foreign Currency Convertible Bonds

- Injecting Equity
- Raising domestic Debt
- Redemption of FCCBs by Refinancing
- Buy-back of FCCBs
- Restructuring the FCCBs
- Enforcement of bond-holders' rights
- Regulation of FCCBs in India

American Depository Receipt

- A foreign company might make issue in U.S. by issuing securities through appointment of Bank as depository. By keeping the securities issued by the foreign company, the U.S. Bank will issue receipts called American Depository Receipts (ADRs) to the investors.
- It is a negotiable instrument recognizing a claim on foreign security. The holder of the ADRs can transfer the instrument as in the case of domestic instrument and also entitled for dividends as and when declared.
- The ADR holder can ask the bank for the original foreign security by exchanging the ADR. The Bank will act as a custodian for the investors. An ADR can be described as a negotiable instrument denominated in US dollars, representing a non-US Company's local currency equity shares or known as depository receipts.
- These are created when the local currency shares of an Indian Company are delivered to an overseas depository bank's domestic custodian bank, against which depository receipts in US dollars are issued. Each depository receipt may represent one or more underlying shares. These depository receipts can be listed and traded as any other dollar denominated security.

External Commercial Borrowing

- ECBs is a borrowing of over 180 days
- ECB is the borrowing by corporate and financial institutions from International markets
- They include commercial bank loans, buyers credit, supplier credit, security insyruments such as floating rate notes and fixed rate bonds, credit from export-credit agencies, borrowings rpm international financial institutions such as IFC etc.
- The incentive available for such loans if relatively low financing cost
- They can be taken in any major currency and for various maturities
- ECBs are approved with Annual ceiling

External Commercial Borrowing- How to avail?

- Funds can be raised using External Commercial Borrowing either through the approval route or the automatic route.
- There are certain eligibility regulations created by the government for availing finance under the automatic route.
- These regulations relate to amounts, industry, the end-use of the funds, etc. Companies that wish to raise finance through ECB will have to meet these eligibility criteria and funds can be raised without the need for approval.
- The approval route, on the other hand, requires companies that fall under certain pre-specified sectors to get the RBI's or the government's explicit permission before raising funds through External Commercial Borrowing.
- Circulars and formal guidelines have been issued by the Reserve Bank of India for the specification of norms for borrowing.

External Commercial Borrowing-Advantages

- The value of funds is generally lower when borrowed from external sources. For instance, there are economies that have a lower interest rate, and Indian firms and organisations can borrow money at lower interest rates from the Eurozone and the United States as the rates are comparatively low.
- Since the markets are larger when raising funds through ECB, companies can meet larger requirements from international players in comparison with what can be achieved through domestic players.
- External Commercial Borrowing is basically just a way to take a loan. It does not necessarily have to be of equity nature, and therefore the company’s stakes will not be diluted. Borrowers can essentially raise funds without relinquishing control as debtors will not have any voting rights in the company.
- The investor base can be diversified by the borrower.
- ECB offers access to global markets so that borrowers have greater exposure to worldwide opportunities.
- ECB offers benefits to the economy as well. Inflows can be directed into the sector by the government of India, thereby increasing its potential for growth. For instance, a greater percentage of funding through ECB can be allowed by the government for the SME and infrastructure industry. This aids significantly in the overall growth of the country.
- Companies can become increasingly profitable through ECB.

External Commercial Borrowing-Disadvantages

- The company could develop a lax attitude as the funds are available at lower rates. Companies could borrow excessively due to this and it could eventually lead to higher debt on the company’s balance sheet, thereby adversely affecting financial ratios.
- Rating agencies see companies with higher debt on their balance sheets in a negative light, which could lead to a potential downgrade of such companies. Eventually, this could enhance the company’s cost of debt, thereby destroying the image of the company in the market.
- Furthermore, the shares of the company could also be subject to a decline in market value over a period of time.
- Considering the fact that raising funds through External Commercial Borrowing is done in foreign currencies, the principal as well as the interest will have to be paid in foreign currencies. As such, the company is exposed to risks associated with exchange rates.
- Hedging costs may have to be incurred by the company, thereby leading the company to incur heavy losses.

External Commercial Borrowing-Risks

- There are two issues regarding India's foreign borrowing. One, the quantum of borrowing and debt.
- While multilateral and bilateral debt is welcomed, India has been conservative in the matter of external commercial borrowing (ECB) ever since the balance of payment (BoP) crisis of 1991-92. After that, annual caps were imposed on additional borrowing, particularly on short-term debt, and the end use of external commercial borrowings was restricted. What that experience taught was that short-term debt could not be rolled over, since panic gripped the markets, aggravating the crisis of liquidity.
- ECB policy has been liberalised over the years, although RBI is, by instinct, conservative. India's external debt remains within prudent levels, at 21% of GDP and 150% of foreign currency reserves in 2018-19. Nirmala Sitharaman's budget speech does not propose relaxing quantitative limits on ECB.
- Two, ECB raised directly by GoI as sovereign debt. GoI has in the past pushed public sector utilities (PSUs) to borrow from external markets for fiscal and BoP support, and foreign portfolio investors (FPIs) are allowed to buy domestic government bonds denominated in rupees. But it has so far avoided borrowing directly on its own books from international financial markets. The budget announcement marks a structural shift in policy.

External Commercial Borrowing-Indian Scenario

Depository receipt (DR) mechanism of Equity offers

- DR is a source of raising foreign capital. It enables already listed company to further raise capital from international markets.
- DR helps issuers to raise funds outside their home jurisdiction and helps in tapping foreign investors who otherwise may not be able to participate directly in the domestic market.
- The local bank of a company issues a DR and the exchange of the issuing country lists the DRs
- The most prevalent DRs traded today include
  - ADRs
  - GDRs

Types of Depository Receipts

- General
  - Sponsored
    - Capital raising
    - Non-capital raising
  - Unsponsored
- Trading Status
  - Listed
  - Unlisted
- International Experience
  - ADRs
  - GDRs

Depository receipt issuance: Process

- Parties Involved
  - Depository Bank
  - Custodian Bank
  - Broker
  - Foreign Stock Exchange
- Process
  - Step-1
  - Step-2
  - Step-3
  - Step-4

Depository receipt issuance: Process (Japan and USA)

- Step-1
  - The US broker purchases the shares of Japanese company through is international branch situated in Japan.
  - He then delivers these shared to Custodian Bank (Japan)
- Step-2
  - The depository Bank (USA) confirms the delivery of the underlying shares with the custodian bank.
  - It’s a signal from custodian bank to depository bank that the shares are deposited and ADRs can be issued
- Step-3
  - ADRs are issued upon confirmation. A predetermined number of underlying shares are consolidated to constitute ADR. ADR ratio is decided upon consideration of several economic factors
- Step-4
  - The broker receives the formulated ADRs and then proceeds to the listing of ADRs in the US stock exchanges, say NYSE.

Characteristics of Depository Receipt

- Global Accessibility
- Diversification
- Foreign Exchange Exposures
- Ease of operations
- Derived Value
- Statutory compliance
- Cost of issue

Indian Regulatory regime for global market floats

- In India, the issue of DRs were regulated by the "the Issue of FCCBs and Ordinary share (through DR mechanism) scheme, 1993", issued by Ministry of Finance
- The 1993 scheme was formulated at a time when India's capital markets were substantially closed to foreign capital and the domestic financial system was not well developed.
- With the development in Indian capital markets for the past two decades and increased participation by both domestic and foreign investors and capital controls have been eased substantially.
- In this period many aspects of Indian legal and regulatory system have evolved with substantial changes
- These developments led to the Depository receipts scheme, 2014, implemented from December, 2014.

Process flow of international offering

- SEBI through its October, 2019 Circular has laid down a framework for issue of depository receipts by listed/to be listed companies.
- Initially DRs are regulated by the Issue of FCCBs and Ordinary share (through DR mechanism) scheme, 1993, which has been repealed for only DRs by the 2014, Ministry of Finance (MoF) Scheme.
- Issue of DRs are governed by
  – Companies Act, 2013 – read with
  – The Companies rules (Isuue of GDRs), 2014-The GDR Rules
  – The Foreign Exchange Management Rules (non-debt instruments), 2019- The FEMA Rules
  – MoF Scheme, 2014.

Key Principles of DRs as per SEBI 2019 circular

- International Exchanges and Jurisdictions
- Permissible securities
- Eligibility
- Compliance with Minimum public shareholding norms
- DR issuances
- Identification of Beneficial owner
- Simultaneous listing outside and within India
- Filing of offer documents for DRs
- Disclosures on Indian stock exchange
- Voting rights
- Pricing

Thank You