

Dear Students,

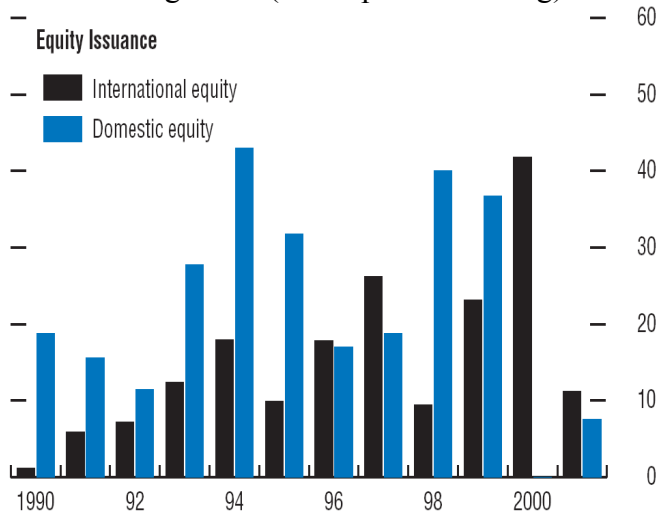
The answer to my question (what does ADR fungability mean?) is that fungability is the feature of ADRs to be redeemable (i.e. exchangeable) for the original shares in the home country. If that feature is present, then prices of ADR move very closely to the prices of the underlying asset. Here are the answers to your questions.

WACC: MNEs have absolute lower WACC for high capital budget projects than DCs have for small capital budgets. How can the WACC be lower for raising \$20-40 million more? Wouldn't the MNE WAC be lower only compared to a DC that has a capital budget of the same amount?

Great question, thanks for asking it Rob. Actually, MNE do have lower marginal cost of capital (or marginal WACC) for high capital budget projects relative to the same size project's cost of capital for a domestic company (DC).

Why would there be no domestic equity in 2000 when the bubble burst?

The graph I showed in class is about equity issuance: that is new equity, coming to the market through *IPO* (initial public offering) or *SEO* (secondary public offering).



Sources: IMF, *International Financial Statistics*; and IMF staff estimates.

In my view (and it is up for grabs, not fully sure I am getting it right here), the main reason for the large decrease in the domestic equity issuance is the break of the stock market bubble in the US. The outflow of investor demand in the US had large and significant repercussions for the other markets, since the US stock market is the anchor market for many other equity markets around the world (that is, other markets would depend on it for transaction volume). In addition, there is a general trend to internationalize equity issuance, so the decrease in the past two years in equity issuance

might be an artifact of this trend, too. Signs for this trend towards internationalization of equity issuance are the de-listings in local markets, ADR issuance, issuance of dual class stocks, etc.

What do you mean by PORTAL for 144A US Depository Receipts programs?

PORTAL is the name of an automated screen-based trading system that was established by the National Association of Securities Dealers (NASD) to support the distribution of primary issues & create liquidity for SEC Rule 144A private placements.

I just want some clarification – on the website and on the original syllabus the final exam is on December 12th but on the revised schedule the final is on Dec. 18th. Which is it?

Yes, that's right. See, the registrar has its own schedule, which has scheduled our final for December 18th, 10-12am, in UC-59.

Do options on ADR exist?

I don't know. Any leads on that? As a established product, that enjoys higher liquidity as compared to local markets, I would imagine that there are OTC options written on ADR.

Why have ADR grown recently when ADR are actually more expensive?

The bullish market in the US created opportunities to time the US investor sentiment pre-bubble period. So many high-quality international investors decided to take advantage of that opportunity.

Can you please go over the difference between fungability vs. non-fungability? I am still unsure of the difference?

Fungability of ADR implies that you can use the receipt to redeem the shares they represent. How does this happen? The ADR is issued by a US Bank, which at the same time would maintain an equity account with a custodian bank in the local (for the stock) market. So, you as a customer of the bank can purchase the ADR, and then advise your bank that you wish to convert them to local stock. What the bank will do is contact its correspondent in the overseas market (the custodian bank) to create an account in your name with the number of share you have (as implies by the ADR).

Vice-versa, non-fungability of the ADR means that you can not convert the depository receipts into the underlying shares. Usually this is due to regulatory restrictions such as investment ceilings for foreign investors (remember the hand out I gave in class from the Emerging Markets Factbook, it described in detail what are the investment ceilings for foreign investors in stock markets around the world; for example, in India, the investment ceiling for some companies is 40%).

Can you please go over arbitrage activities in ADR (40% market cap short-sell ADR)

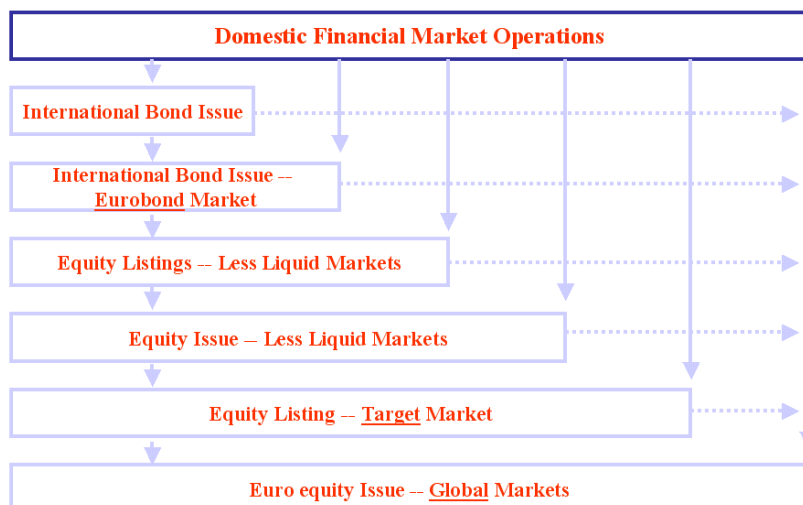
ADR oftentimes are non-fungible, in other words, you cannot redeem them for the underlying local market's stock. So, that generates a gap between the prices of ADRs and the prices in the local market. Why? Because, even though both assets give claims to the same payoff, you can not make arbitrage by taking positions in both markets. For example, imagine high demand for, say Indian ADRs. India imposes ceilings on foreign investor ownership of local stock, e.g. 40% of the overall amount of shares. So, imagine that the depository bank in NY that issues the receipt, has already sold about 40% of the total stock amount. And, a new client comes to ask for more Indian ADR. Technically, the bank has no more capacity to sell the stock, but still it will, in order to try to keep the client. This higher demand in the US market will drive the ADR price up above the local market share price. The result? B/c no fungability exists, the gap between the ADR price and the local market price will be unarbitraged, and will stay there for some time.

However, if the ADR were fungible, such an upward price pressure would have resulted into the conversion of local stock in ADR, to take advantage of the ADR premium. So, what you do, is to ask your banker to convert the deposited shares into an ADR that you can sell on the NYSE (if second or third lever ADR).

Are there other reasons than “not being known” that domestic operations can't skip steps in the international pecking sequence shown in class?

I apologize for not explaining the steps in the slide. So, let's do it here ☺.

Pecking Order of Issuance Alternatives



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The reason why the domestic operation cannot skip the steps in the diagram above is the one we discussed in the case of the theory of pecking order – that is, companies tend to

issue first securities that are not information-sensitive. So, a pure domestic play firm can not issue directly Euro equity, since it will be very costly (in terms of revealing too much information) for that company to raise the Euro equity (we can say the same thing a bit differently: since the local company is not known in the international capital market, investors require a larger premium for taking the risk to subscribe for the company's stock, and so lowering the net proceeds for the company's Euro equity issuance).

“SPY” on the Amex is an example of ADR?

The “spiders”, SPDR (or ticker symbol SPY), are **Standard and Poor's Depository Receipts** that give ownership to a unit trust established to accumulate the portfolio of S&P 500 index. They are a type of exchange-traded fund (ETF), just like the I-SHARES by Barclays Institutional Investor we discussed in class. So, they are different from ADR ☺. However, notice that just like the ADR, SPDR (or SPY) are only depository receipts (not actual shares). More on spiders (SPDR) at

http://www.amex.com/?href=/etf/prodInf/EtPiOverview.jsp?Product_Symbol=SPY

Sorry but can you explain the difference between ADR and GRS and can you explain how GRS work?

Sure, in my answer I would use a very recent article by Professor G. Andrew Karolyi on the GRS¹. So, here is the list of differences between ADR and GRS.

1. GRS *is not a receipt* but an ordinary share that entitles the GRS holder to voting rights, rights offerings, etc. To the contrary, ADRs are only receipts that certify the existence of the underlying actual shares held by a depository bank affiliate overseas. So, share ownership w/ GRS is more direct than w/ ADR, where depository bank stands b/n the issuer & investor.
2. GRS can be traded, denominated, & quoted in local currency in multiple markets, whereas ADR is limited to US\$ only.
3. GRS are fully fungible.
4. GRS have no conversion fee, while ADR has conversion fee
5. The trading fee for ADR (issuance & cancellation of ADR) is about \$0.03 - \$0.05/ share, the per-share fee for conversion of GRS is \$5 flat per trade, independent of the number of shares traded.

¹ G. Andrew Karolyi, “DaimlerChrysler AG, the first truly global share”, Journal of Corporate Finance, 9, 2003, p. 409-430. According to G. Andrew Karolyi, ADR “...represent negotiable claims against home-market ordinary shares (in bearer or registered form) issued by a U.S. depository bank (...) and coordinated in the home-market through a local custodial bank affiliate...ADRs quote, trade, and settle in US\$ and dividends are paid in US\$ through the bank...”