When companies make a public offering in a market other than their home market, they must launch a depository receipt program. Depository receipts represent shares of a company held in a depository in the issuing company’s country. They are quoted in the host country’s currency and treated in the same way as host country shares for clearance, settlement, transfer, and ownership purposes. These features make it easier for international investors to evaluate the shares than if they were traded in the issuer’s home market. They also enable international investors to invest in foreign companies with low transactions costs and without the tax and paperwork complications of acquiring foreign stock.

**Types of depository receipts**

Issuing companies have a choice of several types of publicly traded depository receipts. Global depository receipts (GDRs) are usually traded on major international exchanges outside the United States—mainly the London Stock Exchange (LSE)—and in the U.S. over-the-counter market. A company issuing GDRs does not have to comply with U.S. Generally Accepted Accounting Principles (GAAP) or full disclosure requirements of the U.S. Securities and Exchange Commission (SEC). Thus, GDR programs allow companies to enjoy the benefits of an internationally traded security without changing their reporting practices. Companies that wish to offer their securities to U.S. institutional investors and list their shares on a U.S. stock exchange use American depository receipts (ADRs), which usually require adherence to U.S. GAAP and more stringent SEC disclosure requirements. Both GDRs and ADRs must also meet the listing requirements of the exchange on which they are traded.

International equity offerings are now a well-established privatization route for telecommunications companies—in addition to local offerings and sale to a strategic partner. However, while many governments have raised billions of dollars using this method, some governments of emerging economies still fail to give it serious consideration. The main advantages of international offerings stem from the greater market depth and liquidity provided by international capital markets: telecommunications companies are sometimes too big for local markets to absorb, and more active trading attracts a wider shareholder base, implies continuous evaluation of a company’s value, and increases management’s accountability for financial performance. International offerings also enhance the legitimacy of shares being offered because companies must comply with transparent accounting rules and strict disclosure standards in the host market. This Note outlines the offer process and implementation risks.
A company can also access the U.S. market through a private placement of depository receipts, under SEC Rule 144a. So-called Rule 144a depository receipts, which trade only among large U.S. institutional investors, can be used to raise capital in the U.S. market without extensive disclosure, because the issuing company does not need to register with the SEC. Offerings of GDRs outside the United States are usually combined with Rule 144a depository receipts.

The choice of type of depository receipts and of the international markets to access depends on the related disclosure and reporting standards and, if the securities are to be listed, on the requirements of the stock exchange. Although ADRs usually offer higher visibility and attractiveness compared to GDRs, they require higher standards of disclosure. Other factors influencing the choice include the potential demand from investors and the objectives of the offering.

**Process**

An offering of depository receipts usually starts with the appointment of a financial adviser—a financial institution such as an international investment bank—to manage the process. The adviser sets the number of shares to be represented by one depository receipt—that is, the depository receipt ratio (when the Chilean telephone company Compañía Telecomunicaciones de Chile, or CTC, issued depository receipts, for example, each one represented seventeen common shares). The ratio is set so that the price of a depository receipt is comparable to that of similar securities in international markets. The adviser also appoints a depository bank in the host market and a custodian bank in the country of the issuer. The depository bank has responsibilities relating to shareholder rights (such as payment of dividends and voting at shareholder meetings), which are stated in the depository receipt certificate, and must also maintain a share register of depository receipt owners.

The issuing company determines the number of shares to be sold in the international market and delivers the shares to the custodian bank. The custodian registers these shares in the name of the depository bank, which issues the appropriate number of depository receipts and delivers them to the members of the underwriting syndicate. Trading then begins. Although depository receipts are traded exclusively in the host market, continuous arbitrage between the host market and the issuer’s home market tends to minimize the price differential between the two markets.

Depository receipt issues are usually marketed through a book-building route, an offering method that leads to efficient price discovery. Typically the lead manager, or book runner, builds the order book by forming a syndicate that fans out on a marketing run among institutional investors. The price and size of the issue are determined on the basis of both an in-house valuation of the issuing company’s intrinsic worth and the bids received. Because depository receipts trade mainly among large institutional investors, shares can be sold in bulk and thus quickly and cheaply.

A useful advantage of depository receipt offerings is that the question of foreign ownership is addressed when the shares are first registered in the name of the depository institution. This is of special importance in emerging markets, where foreign equity investment is often restricted.

**Implementation risks—lessons from Indian issues**

Ongoing privatization and financial liberalization in emerging economies have led to continuous growth in the number of depository receipt offerings from these countries (table 1). The amount raised and the equity share sold vary depending on the size of the company, the privatization strategy, and financial market conditions. Asian and Latin American companies have been the biggest source of offerings.

India, which has heavily relied on depository receipts as a method of introducing private ownership, has been one of the largest issuers of these securities among emerging markets, raising more than US$4 billion in capital since
BPL Cellular Holdings, which includes US West as a joint venture partner, operates greenfield cellular services in three telecommunications circles in India: Kerala, Maharashtra, and Tamil Nadu. Its successful ADR issue followed a failed attempt in December 1996, an issue pulled out only hours before it went on offer. At a share price of US$16, this initial public offering was expected to raise US$200 million by selling 12.5 million shares, 22.3 percent of the company’s equity.

Where did the ADR offer go wrong? Market analysts have cited several reasons for the failure. First, the issue price, initially US$16 a share, seemed unjustifiably high to most investors. The lead underwriters found few takers, even after deferring the issue twice and reducing the price to US$12 and then to US$10. The discounts, unusual in the ADR market, made investors even more wary of the offering.

Second, investors prefer mature companies to new ventures that are about to take off. Several potential investors made their preferences known by not attending the road show. A better

<table>
<thead>
<tr>
<th>Company</th>
<th>Year</th>
<th>Type of depository receipt</th>
<th>Amount raised (millions of U.S. dollars)</th>
<th>Depostitory receipts as a percentage of company equity</th>
<th>Stock exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>VSNL (India)</td>
<td>1997</td>
<td>GDR</td>
<td>448</td>
<td>17*</td>
<td>LSE</td>
</tr>
<tr>
<td>MTNL (India)</td>
<td>1997</td>
<td>GDR</td>
<td>360</td>
<td>10*</td>
<td>LSE</td>
</tr>
<tr>
<td>BPL Cellular Holdings (India)</td>
<td>1997</td>
<td>ADR</td>
<td>100</td>
<td>11*</td>
<td>NASDAQ</td>
</tr>
<tr>
<td>SK Telecom (Republic of Korea)</td>
<td>1997</td>
<td>ADR</td>
<td>100</td>
<td>...</td>
<td>NYSE, LSE</td>
</tr>
<tr>
<td>CANTV (Venezuela)</td>
<td>1996</td>
<td>ADR</td>
<td>1,200</td>
<td>41*</td>
<td>NYSE</td>
</tr>
<tr>
<td>PT Telekomunikasi (Indonesia)</td>
<td>1995</td>
<td>ADR</td>
<td>540</td>
<td>7</td>
<td>NYSE, LSE</td>
</tr>
<tr>
<td>Pakistan Telecommunications Corporation</td>
<td>1994</td>
<td>GDR</td>
<td>898</td>
<td>10*</td>
<td>LSE</td>
</tr>
<tr>
<td>PT Indosat (Indonesia)</td>
<td>1994</td>
<td>ADR</td>
<td>873</td>
<td>25</td>
<td>NYSE</td>
</tr>
<tr>
<td>Telmex (Mexico)</td>
<td>1991</td>
<td>ADR</td>
<td>2,200</td>
<td>15</td>
<td>NYSE</td>
</tr>
<tr>
<td>CTC (Chile)</td>
<td>1990</td>
<td>ADR</td>
<td>100</td>
<td>12</td>
<td>NYSE</td>
</tr>
</tbody>
</table>

... Not available.

a. Estimated.

Source: Company reports and newspaper articles.
route for start-up companies is to first establish a network, invest the company's own funds, and then approach international markets.

Third, the offering was poorly timed. Several telecommunications issues were offered in the same period, including a US$1.2 billion issue from Venezuela's CANTV, a US$450 million issue from Russia's Vimpel Communications, and a US$12 billion issue from Germany's Deutsche Telekom. The offering by BPL Cellular Holdings fared poorly relative to those of the other telecommunications companies. Investors' general caution toward Indian equity issues at the time of the offering may also have influenced U.S. investors' judgment.

Fourth, potential investors were concerned about the financial health of BPL Cellular Holdings. The ADR offering document indicated negative net worth, large liabilities, and operating losses of US$117 million in the year of the offering. The document also contained qualifications by the company's independent international auditors.

Finally, the absence of an independent regulatory agency at the time of the offering was another reason cited for the failed ADR. When BPL Cellular Holdings concluded its successful US$100 million ADR issue in May 1997, the Telecommunications Regulatory Authority of India had just been established.

VSNL

Another success that followed a failure is the GDR issue by VSNL, the exclusive provider of international telecommunications services in India. After two failed attempts in 1994, VSNL successfully issued India's largest-ever GDR offering in March 1997, raising about US$448 million. The issue was listed on the LSE and was several times oversubscribed. It reduced the government's ownership in VSNL to 65 percent (15 percent of VSNL's equity is owned by Indian institutional investors).

Why did VSNL's 1997 GDR issue succeed? First, there was better balance in demand forecasting and marketing between the U.S. market and the European and Asian markets. Two road show teams circled the world twice in marketing the issue, attracting about 650 institutional investors from twenty-eight countries to the offering.

Second, with unrealistic pricing cited as the main reason for the previous failed attempts, the government had by then realized that it could not dictate the share price. It instead adopted the market-driven book-building approach to price the issue.

Finally, changes in investor sentiment toward Indian equity issues and India's improved economic fundamentals favored VSNL's offer. A prudent government budget further boosted investor confidence before the offering.

Conclusion

Depository receipts offer a well-established route for telecommunications companies in emerging economies to access foreign capital markets. And they help improve corporate governance in these companies by increasing accountability and upgrading financial accounting standards. But experience has shown that to guard against failure of a depository receipt issue, much effort needs to be put into choosing the right type of depository receipts, marketing the issue, forecasting investor demand, and determining the share price. Issuers cannot control all the conditions, however. The health of financial markets, the sector's regulatory environment, and the overall economic and political risk of the issuer's home country influence the perceptions of international investors and thus the success of an international public offering through depository receipts.

1 The New York Stock Exchange is launching an initiative to allow companies to list directly.

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