A new age dawns for ADRs

American Depositary Receipts have been around since the 1920s, writes ***Tim Cobb****, and with the continuing internationalising of markets, they look set for a boom in the 1990s.*

One of the biggest recent initial public offerings in the US was the 1991 $US817 million listing of New Zealand Telecom's American Depositary Receipt (ADR) on the New York Stock Exchange. Ten million ADRs (20 shares equals one ADR) were traded on the first day. American investors do not seem shy about investing in non-US equities. The ADR continues to gain in popularity and usefulness as an investment vehicle. Even in a "private placement" environment, non-US companies are recognising their advantages, such as:

- easier trading;
- custody and settlement;
- dividend processing and payment;
- enhanced investor marketing opportunities.

The number of ADR programs grew by 43 per cent from fewer than 600 in 1983 to more 830 at the end of 1990. Australia has some 180 programs, making it one of the leaders in terms of number of issues. Of these, about two-thirds are "unsponsored" issues; of the remaining "sponsored" issues, 20 are listed on an exchange and 15 of these are regarded as "blue chip" or "pale blue chip".

Sponsorship

The main purpose of undertaking an ADR program is to gain access to the highly liquid US capital market. It is also a way of establishing a "presence" in the US before market entry.

Unsponsored ADRs, where the costs of the program are borne by the American shareholder or broker and the depositaries, are generally thinly traded and their issuers may see disadvantages in their lack of control over the program and the lack of aftermarket liquidity.

Wider corporate purposes usually dictate the use of sponsored ADRs, where costs are borne by the company and a single depositary institution is charged with administrative responsibility. A study by JP Morgan & Company in 1988 highlighted corporate purposes such as:

- raising additional capital in the US;
- seeking a US acquisition;
- listing on a major US exchange;
- providing incentives to US employees;
- centralising and controlling the US investor communication program.

Companies issuing sponsored ADR have few features in common. They represent a wide range of industries, are domiciled in a variety of countries (although UK and Australia are the most prominent) and include international giants and mid-sized companies.

Australian companies with ADRs

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listed on the New York Stock Exchange include News Corporation, Western Mining, NAB, BHP, Westpac and Coles Myer.

Significant listings on NASDAQ (National Association of Securities Dealers Automated Quotations) include Pacific Dunlop and Boral. Australian companies had combined ADR trading volume of nearly $US1 billion in 1990.

While sponsored ADRs constitute a relatively small percentage of the ADR universe, they are the largest source — more than 50 per cent — of ADR trading.

A Bank of New York study of the 1990 ADR market showed a high, and not unexpected, correlation between trading volume and institutional ownership. Each of the top 25 issues, in terms of trading volumes, was held by an average of 145 institutions. And the number of US institutions investing in foreign securities is growing steadily.

Among Australian companies, ranked by $US volume of trading, institutional ownership was sparser. There were reportedly 85 institutional ADR investors in the leader, News Corp, but the average number of institutional holders for other Australian companies was about nine.

The number of potential investors in ADRs of offshore companies with less-than-household names may be uncomfortably low and ultimately quite costly, measured by cost-per-transaction.

Any company coming into this market clearly needs a vigorous and continuous program of investor relations.

Coverage by US-based analysts

The correlations here are as expected: the higher the dollar value of trading volume, the greater the coverage by US-based research analysts. According to *Nelson's Directory of Investment Research 1991*, the top 25 had an average coverage of 13 analysts, with a high of 44 for Smith Kline Beecham. Australian companies had a low average because of lower dollar-value of trading and more concentrated institutional ownership.

First steps

The decision to initiate a sponsored ADR program, or to convert from an unsponsored program (and list) is not the culmination, but rather the beginning, of a strategic process.

ADR sponsorship should be seen as a signal by a company to the US financial community that it intends to launch a communications program to help the company become better understood and encourage a more fairly valued share price. Sponsorship alone, however, without a well thought-out investor relations strategy of proactive communications, does not enhance liquidity.

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One of the few shared characteristics of the top-traded issues is their maintenance of formal investor relations programs. Of the top 25, 17 identify a particular company official as being responsible for investor contact. The same number employ a US agency to provide investor relations support. Nine companies in this top trading group identify both a company official and a US agency. Eight do not specify a company official but do maintain contact through a US agency.

According to David Haslingden, of Allen Allen & Hemsley: "Whilst Australian companies have been quick to initiate sponsored programs and whilst the number of unsponsored programs demonstrates the broad spectrum of Australian companies which promoted US investor interest, not all companies have made full use of their potentiality."

In a study titled *The Usefulness of ADRs*, Haslingden noted: "Australian corporations have been world leaders in their willingness to use ADRs. There is no doubt that the recent developments in the US securities laws and market practices have increased the use and usefulness of ADRs and that they will play a critical role in the sale of non-US securities in the US.

"Although it is trite to say that if you can have an ADR program you should make it work as best it can, experience reveals that few if any programs are being put to their full usefulness. To some degree this is because existing ADR programs have not yet reacted and been amended to take advantage of recent regulatory developments. However, it is also because in many cases the usefulness of ADRs has been underestimated."

The expected entry of foreign issuers and new institutional buyers into the private placement sector, following SEC moves to substantially ease the rules for participants and eliminate the two-year holding period, occurred but not exactly as forecast. Although some observers had argued that large US institutions would prefer direct ownership of shares, ADRs are quickly becoming the investment instrument of choice. The economics are simply better from the standpoint of transaction and service costs. In 1990, the private placement marketplace emerged as an important alternative to the US public market, raising $US700 million through privately placed unregistered securities.

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ratio of the former is 33.9 per cent and the latter's is 23.5 per cent. The effect of brand capitalisation is generally to eliminate the gap between the treatment and control samples, although the median ratio for the capitalisers remains slightly smaller than that for the non-capitalising controls — 21.0 per cent compared with 23.5 per cent.

These results provide strong support for the debt covenant hypothesis. Brand capitalisation is an accounting technique which appears to be effective in eliminating the difference between the gearing levels of capitalising and non-capitalising firms.

The book-to-market valuation results can be summarised as follows:

- The effects of brand capitalisation on the valuation ratios are very marked: the median ratio increased threefold. Moreover, the median valuation ratio without brands is 21 per cent for the treatment companies and 35 per cent for the controls, indicating very clearly that the capital market is very well aware that companies have substantial intangible assets. Intangibles and growth prospects (together with unrecorded valuation gains on tangible assets) typically amounted to more than twice the book value of net tangible assets. Brand capitalisation removed about half of this discrepancy.
- The results provide some support for the shareholder approval hypothesis. Nine of the treatment companies had lower ratios than their controls and (as noted above) both the mean and median is smaller for the treatment group than for the control one.

One possibility which needs to be considered is that early adopters of the brand capitalisation technique are systematically different from late adopters. To explore this possibility, we split the treatment sample into two sub-samples, according to whether capitalisation occurred before or after the controversy over brand capitalisation became public in August 1988.

The median gearing ratios of the early adopters, computed without brands, are not much higher than those of their controls (30 per cent compared with 26 per cent) but late adopters are more heavily geared (34 per cent compared with 22 per cent).

The picture is the same with the valuation ratios, late adopters having substantially lower ratios than their controls (32 per cent compared with 61 per cent) where early adopters are not (both 26 per cent).

These results suggest that whereas the early adopters capitalised brands for a variety of reasons not necessarily connected with the contracting hypotheses, the publicity surrounding the capitalisation debate alerted corporate managements to the usefulness of the technique as a means of avoiding covenant restrictions or stock-exchange requirements.

Finally, if the contracting costs avoided by brand capitalisation are real, we would expect such avoiding actions to be reflected in share prices. Evidence of this was discovered: abnormal share returns were positively (albeit weakly) correlated with the capitalisation-induced changes in gearing and book-to-market ratios.

The results of this study do not support the common assertion that the stockmarket systematically undervalues companies with large investments in intangible assets. There is some indication that share-price gains were marginally related to the size of the change in book values brought about by capitalising brands, but there is reason to believe that this relationship is largely spurious and disappears when allowance is made for the simultaneous release of other information.

Brand capitalisation markedly lowered reported gearing ratios and, certainly in the case of late adopters, capitalising firms had noticeably higher gearing levels (before capitalising brands) than did their controls. Brand capitalising firms have lower book-to-market-equity valuation ratios than their controls, again particularly so in the case of late adopters. The results are therefore consistent with the debt covenant and shareholder approval hypotheses.

Despite the lack of support for the suggestion that the market systematically undervalues firms with unrecorded intangibles, it is clear from the pressure placed on the accounting profession, not to mention the costs incurred by the firms concerned, that managers of brand-heavy companies consider the absence of brands from their balance sheets to be a serious matter. The reason for their enthusiasm to capitalise brand values might lie in the contracting role played by corporate financial reports. ■

New age for ADRs

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Another indication of the dramatic increase in ADR activity came with the SEC's decision to seek comments from the industry on regulatory matters affecting ADRs. Issues under examination include qualifications of depositaries; the adequacy of information about issuers of securities underlying ADRs; and, perhaps most significantly, the question of approving both sponsored and unsponsored ADRs in a single stock.

The latter issue was triggered by a filing by Security Pacific seeking to create an unsponsored program for the West Australian mining company Sons of Gwalia, which already had a sponsored program with a US bank. Although not specifically prohibited by any current regulation, the dual-track question had not been raised previously because most depositary banks believed the agency would not sanction the arrangement.

Another development encouraging to participants in the ADR market is the increasing interest being shown in dividend reinvestment programs by ADR holders. Like similar programs used in direct share ownership, they have given the market an important boost. Haslingden argues that dividend reinvestment programs are only one example of the potential flexibility and usefulness of sponsored ADR programs.

ADR trading does not constitute the full trading of non-US securities. A Gavin Anderson survey of institutional investors' preferences in trading vehicles showed 51.2 per cent preferred ADRs, 26.4 per cent preferred ordinary shares and 22.4 per cent were happy with either. But all indications are that growth in the ADR market will expand as the rising tide of interest in overseas investment continues. ■