ADRs and Tracking Stocks

2015

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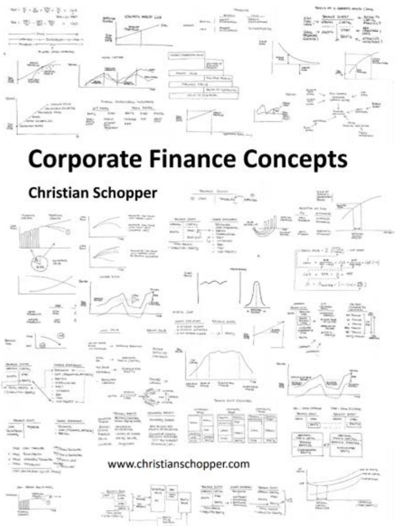

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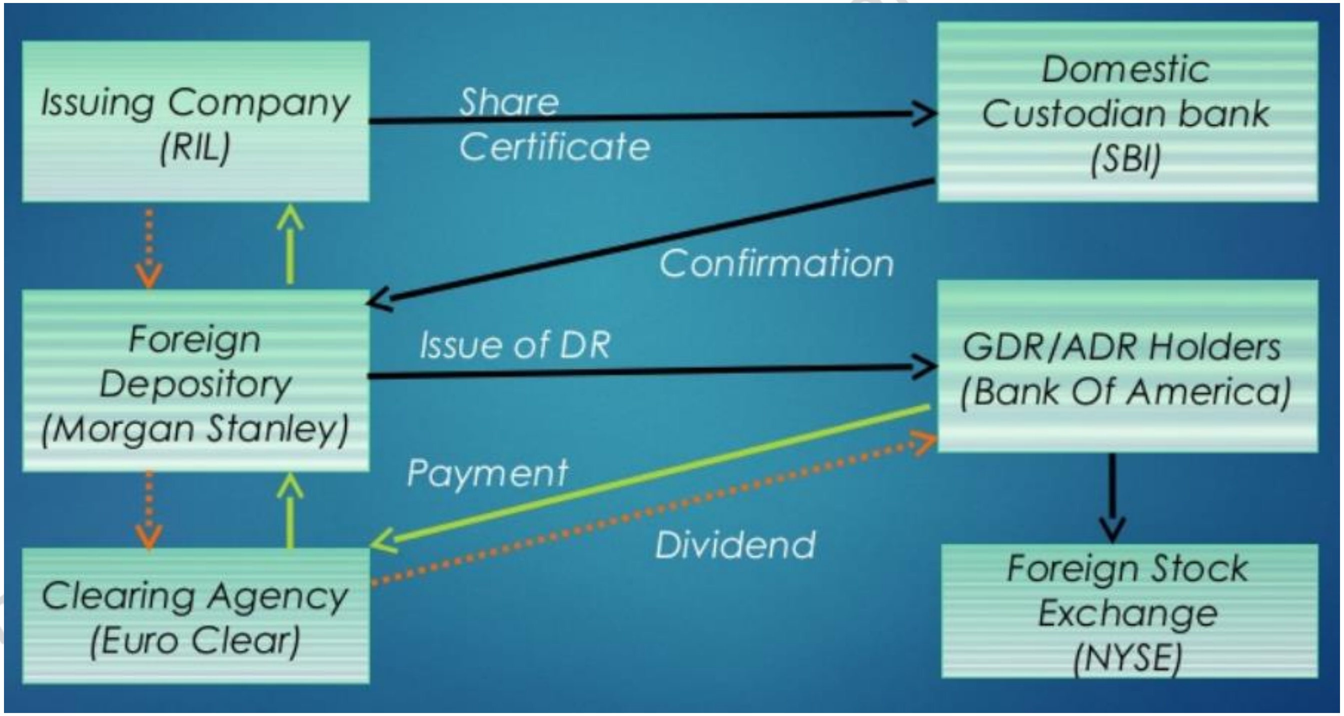
American Depositary Receipts

- A global depository receipt (GDR), also known as international depository receipt (IDR), is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account
- They are the global equivalent of the original American depository receipts (ADR) on which they are based

- Introduced to the financial markets in 1927, an American depositary receipt (ADR) is a stock that **trades in the United States** but **represents** a specified number of **shares in** a **foreign corporation**
  - ADRs are bought and sold on American markets just like regular stocks, and are issued/sponsored in the U.S. by a bank or brokerage.
- ADRs **allow U.S. investors to invest in non-U.S. companies** …
- … and give non-U.S. companies easier access to the U.S. capital markets
  - Many non-U.S. issuers use ADRs as a means of raising capital or establishing a trading presence in the U.S
- The first ADR was created in 1927 by a U.S. bank to allow U.S. investors to invest in shares of a British department store
- Today, there are more than 2,000 ADRs available representing shares of companies located in more than 70 countries
- In essence, an ADR is a negotiable **certificate that evidences an ownership** interest in American Depositary Shares ("ADSs") which, in turn, represent an interest in the shares of a non-U.S. company that have been deposited with a U.S. bank
  - It is similar to a stock certificate representing shares of stock

Process



Issuing Company (RIL)
Share Certificate
Domestic Custodian bank (SBI)
Confirmation
Foreign Depository (Morgan Stanley)
Issue of DR
GDR/ADR Holders (Bank Of America)
Payment
Dividend
Clearing Agency (Euro Clear)
Foreign Stock Exchange (NYSE)

Basic GDR Features

- **Issued** to investors **in more than one country** (usually U.S. plus one or several more) and may be **denominated in any acceptable freely convertible currency**

- **Issued by the depository bank** - and not the issuing company
  - The depository bank appears as the shareholder
  - **GDR holder therefore does not acquire any voting rights**
  - The voting rights accrue only to the depository bank.

- Although the **GDR is quoted and traded in a foreign currency** the underlying shares are denominated in the local currency

- GDR **holders** have the **option of cancelling GDR's** and arranging sale of the underlying shares in the domestic market …
  - … such as if the international price is less than the corresponding domestic price
  - This provision can however be used only after a "Cooling off" period of 45 days from the date of the issue

- GDR holders are entitled to all corporate benefits available to equity holders such as dividend, bonus and rights in the same proportion as their entitlement

Basic GDR Features (cont´d)

- The foreign currency funds acquired by the company through a GDR issue are permitted to be used for any normal business activity, but cannot be used for trading in international securities or real estate.

Therefore, the advantages of a GDR issue are :

- It **eliminates the equity funding risk**
  - This is because GDR holders do not acquire voting rights, and therefore the promoters are not in danger of losing management control
- Companies having international operations are able to **build a brand image** which helps in their marketing efforts
- Investors have the benefit of having access to good quality companies in other countries without political risk, operational risk and excessive regulatory control

Differences between ADRs and GDRs

- GDR is compulsory for foreign company to access in any other country's share market for dealing in stock
  - ADR is compulsory for non–US companies to trade in stock market of the US
- ADRs can be positioned from Level 1 to Level 3
  - GDRs are already equal to Level 2 and Level 3
- Globally operating companies prefer to get GDR due to its "global use"
- ADRs up to Level 1 need to only comply with general condition of the US SEC …
  - … whilst **in the US GDRs can only be issued under rule 144A**
- GDR is a negotiable instrument all over the world …
  - … whilst ADR only negotiable in the US
- US investors typically use regular equity trading accounts for buying ADRs but not GDRs

Types of Programs: Unsponsored and Sponsored ADR

Different types of ADRs have different degrees of backing and support from the underlying company

- **Unsponsored ADRs** are issued without a formal agreement between the issuing bank and the foreign company
  - indeed, the **company may have no desire to see its shares listed abroad** at all
  - They trade on the **over-the-counter market**

- **Sponsored ADRs** fall into three categories. All are supported by the company, but with different levels of regulation.
  - **Level I ADRs** trade in the **over the counter market**
    - **Reporting requirements are very low** – the company does not need to issue any reports in the US or under US accounting standards
    - It must be listed on a foreign stock exchange and issue a report in English in that country under local accounting rules
  - **Level II ADRs** can trade on a stockmarket such as NYSE or Nasdaq
    - The company **must register with the SEC** and issue annual reports in the US to US accounting standards
  - **Level III ADRs** are used by companies that don't simply want to float their shares abroad, but **also to raise capital in the US market**
    - Consequently, they are regulated to a similar standard to US companies
    - They must issue a offering prospectus, while all subsequent new releases made in their home market must also be issued in the US to US standards

Types of Programs: Unsponsored and Sponsored ADR (cont´d)

Disadvantages of Unsponsored Programs

- Issuer's loss of control over relationship with investors
- The depository
  - unilaterally sets the ratio of shares represented by each ADR and the program fees
  - has no obligation to provide company communications to investors or exercise the investors' voting rights
- The existence of multiple unsponsored programs with potentially variable fees and terms could cause confusion or discontent among investors

Advantages of Sponsored Programs

- Issuer can **negotiate the program terms**
  - Ratio of shares per ADR
  - Fees
  - Rights to shareholder information and voting
- Issuer and depositary can **modify the terms of the program**
- **Issuer maintains control over its investor relations**
- Often little or no cost to the issuer, as program fees pay for start up and program maintenence

Types of ADR - Non-Listed and Listed ADR

	Non-listed program		Listed programs	
	RADR (Rule 144A)	ADR level 1	ADR level 2	ADR level 3
Description	Private investment with QIB allowing fundraising	US securities based on existing shares listed on a foreign market	Listed US securities based on existing shares listed on a foreign market	Listed US securities allowing fundraising
Place listed	PORTAL	OTC	NYSE, AMEX, NASDAQ	NYSE, AMEX, NASDAQ
Accounting rules	Local (option for US GAAP)	Local	Reconciliation with US GAAP	Reconciliation with US GAAP
Registration procedure (SEC)	Exempt	Form F-6	Form F-6	Form F-6 and Form F-1 for initial offerings
Periodic publications (SEC)	Exempt	Exempt (rule 12g3-2b)	Form 20-F	Form 20-F
Currency of exchange possible	No	No	Yes	Yes
Set-up time	7 weeks	5 to 9 weeks	14 weeks	14 weeks

Non-Listed GDRs

ADRs are usually offered to institutional investors **through a private offering**, in reliance on exemptions from registration under the Securities Act of 1933

- These exemptions are **Regulation S** (Reg. S) **for non-U.S. investors**, …
- … and Rule **144A for U.S. investors** that are Qualified Institutional Buyers (QIBs)

- The availability of these exemptions for GDR deals makes them an efficient and **cost-effective** means of implementing a cross-border capital-raising transaction

- Predominant listing venues for Reg. S GDRs are the **London** and Luxembourg Stock Exchanges, …
  - … with GDRs having also been listed on the Singapore Exchange, Frankfurt Stock Exchange and Nasdaq Dubai

- Rule 144A GDRs trade in the U.S. over-the-counter market

- When GDRs are offered simultaneously in Reg. S and Rule 144A form, but in separate and distinct tranches, they exist inside what is known as a bifurcated GDR program

Rule 144A

Foreign companies can raise capital through the "Rule 144A ADR" or "restricted ADR" (RADR), de-facto a sort of private placement

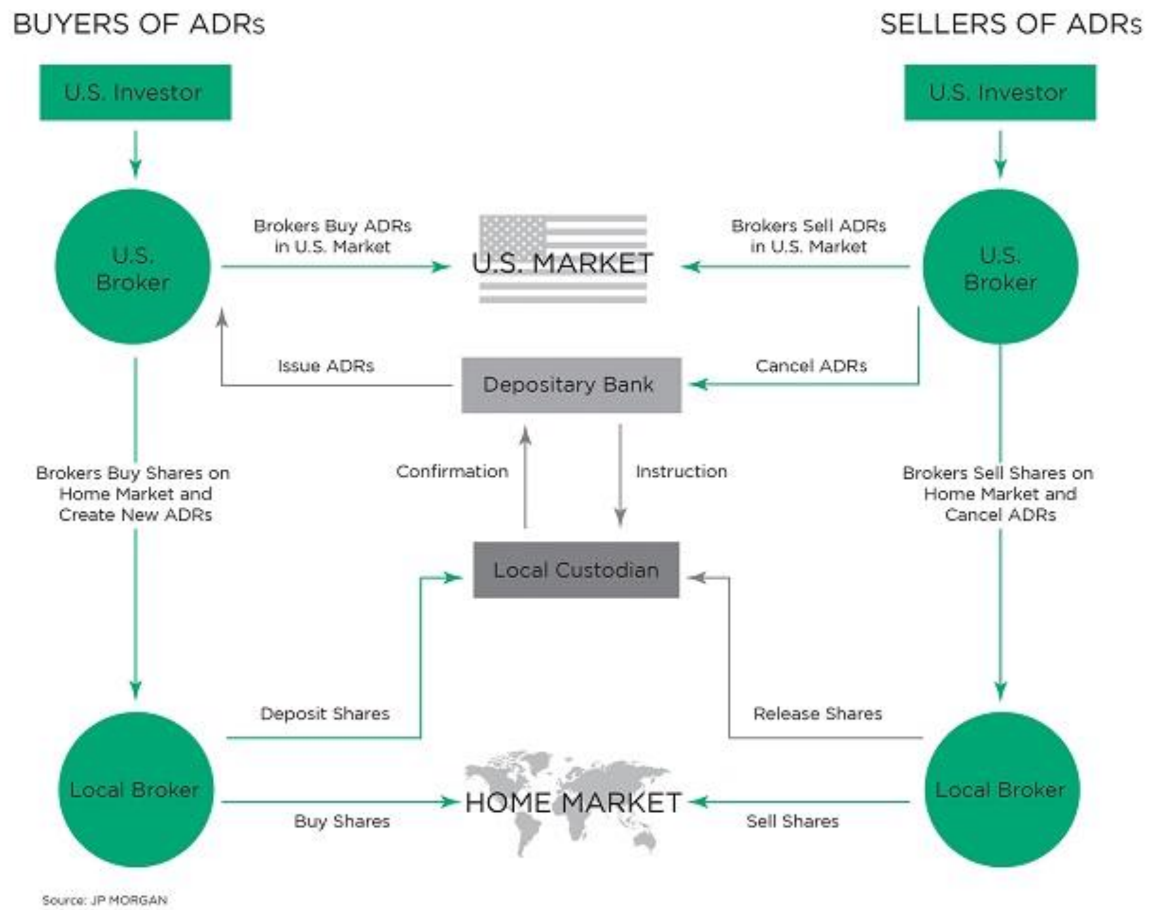
- These RADR **do not require registration with SEC or accounting reconciliation in US GAAP**, …
- … but they only constitute a **private investment** of securities with "qualified institutional buyers" (**QIB**) …
- … and have greatly **reduced liquidity**

- QIB are institutions:
  - Having an investment portfolio of at least 100 million dollars,
  - Are considered sufficiently expert as to not need a preliminary opinion on the negotiated securities from the SEC

- Rule 144A was introduced by the SEC in 1990 in order to stimulate the raising of funds by foreign companies in the United States

- RADR are exchanged by QIB on the "PORTAL" (Private Offerings, Re-sales and Trading through Automated Linkages) and are only eligible for a traditional ADR program 2 years after issuing shares via Rule 144A

Trading ADRs



Tracking Stocks

- **Tracking stock is often set up by companies that have several diverse divisions, both so that investors can take a share in a division of their interest, and so that the performance of these divisions can be tracked in terms of shareholder interest**
- **A company will sometimes issue a tracking stock when it has a very successful division that it feels is underappreciated by the market and not fully reflected in the company's stock price.**

- Tracking stock or targeted stock are specialized equity offerings issued by a company that is based on the operations of a wholly owned subsidiary of a diversified firm
- Therefore, the **tracking stock will be traded at a price related to the operations of the specific division** of the company being "tracked“
- Tracking stock typically has **limited or no voting rights**
- Often, the reason for doing so is to separate a high-growth division from a larger parent company
- The **parent company** and its shareholders **remain in control** of the subsidiary's or unit's operations

Tracking Stocks (cont´d)

- **First tracking stock issued by GM in mid 1980s**
- **1991: USX Corp. is first company to use tracking stock to separate businesses**

- Tracking stocks are shares issued by a company which *pay a* ***dividend determined by the performance of a specific portion*** *of the whole company*
- Generally a class or series of common stock of the issuing corporation
- Tracking stock does not represent or require any change in business structure
  - Holders of tracking stock are considered to hold equity in the parent company and not the specific entity represented by the tracking stock
- Payment is subject to the risk of the operations of the issuer as a whole

- **Voting Rights**
  - Holders of tracking stock typically have voting rights, which may be fixed at the time of issuance or floating (*e.g.*, fixed but subject to periodic adjustments based on relative market values)
- **Dividend Rights**
  - The dividend rights of tracking stock are based on the earnings of the tracked business
- **Liquidation Rights**
  - Holders of tracking stock do not have a special right to the tracked assets and share in all of the issuer's assets
  - Liquidation rights are often based on the relative values of the tracked and total assets at the time of issuance
- **Conversion Rights**
  - The issuer can generally elect to convert the tracking stock, often at a premium, into another class of stock subject to certain restrictions

Listing Requirements

- The SEC's registration and reporting requirements for tracking stocks are basically no different from the requirements for any company issuing a new class of common stock
- Unless an exemption applies, a tracking stock must be registered under the Securities Act of 1933 if it is publicly offered
- The reporting requirements under the Securities Exchange Act of 1934 extend to the company that offered the tracking stock to the public
- In most cases, since the company is already filing reports with the SEC, the only effect of issuing a tracking stock is that the company must include financial statements about the tracking stock in its reports

Why Do Firms Issue Tracking Stocks?

- Increase in analyst following after the issuance of tracking stock suggests that there is a reduction in the extent of asymmetric information in the equity market following tracking stock issues
  - This also partially explains the increase in the P/E ratios of firms immediately following such issuances

- Further, tracking stock parents and subsidiaries are more related than in the case of equity carve-outs and spin-offs suggests that the preservation of existing synergies is one of the motivating factors in the issuance of tracking stock

Tracking Stocks: Benefits to Parent Company

- Take advantage of high-growth business
  - “Pure play” investor preference
  - More attention from investors and analysts
- Enhanced executive compensation
  - Tracking stock is expected to grow faster then the stock of parent company
- Acquisitions
  - Increased Market Capitalization results in enhanced buying power
- Defensive Mechanism
  - Tracking a high risk unit (e.g. biotech R&D unit)
- Retain control of business unit
- Retain operating synergies & economies of scale in overhead
  - Impossible when selling entire stake
  - Business remains under the same corporate umbrella
- Subsidiary can use credit quality of parent
  - Smaller money-loosing spin offs need a lot of cash to grow
- Well suited for conglomerates with business units that have different growth
  - One is cash caw and the other is sexy growing business

Tracking Stocks: Risks and Downsides

- ***"There is a tremendous conflict of interest. It's like parents with two kids. They have to figure out where to allocate time and resources, and somebody is going to be on the short side of the stick"***

  Jeffrey Hass, Professor of securities law at New York Law School

- Inferior rights for tracking stock owners
  - Some withhold voting rights
  - Potential for asset transfer between parent and subsidiary
- Conflict of interests
  - One board of directors trying to balance the competing interests of two groups of shareholders
- Designed to increase transparency …
  - … but investors and analysts may be put off by complicated structure
- No takeover premium for owners of subsidiary's stock
  - 10 to 50% in typical takeover bid
- Governance concerns
  - Lack of independent board of directors
  - Subject to benefits of subsidiary, but to all business risks of parent and subsidiary simultaneously
- Complicated to unwind
  - Complex

Alternatives to Tracking Stock

Spinoff

- The “tracked” assets of the parent are dropped into a new subsidiary, which is then spun off to shareholders of the issuer

IPO Carve Out

- The “tracked” assets are dropped into a subsidiary and the subsidiary engages in an initial public offering - for up to 20% of its stock
- The parent and the new subsidiary remain consolidated for tax purposes

Convertible Debt

- Issuer issues debt, which is convertible into stock of the subsidiary

Alternatives to Tracking Stock (cont´d)

SPIN-OFFS*	
Advantages	Disadvantages
• Flexibility - new company created • Encourages cultural change in spun off unit • Stock can be used for incentives/acquisitions • Allows for separation of higher growth or higher risk business unit • Complete freedom for spun-off unit to follow strategic objectives	• Duplication of administrative costs – no economies of scale • Cannot be unwound • Risk of being bought up • Can be tax penalties

SUITABLE WHEN:
•Business unit is ready for full independence
•There is little to lose in terms of economies of scale
•New & substantial capital required
•Potential for conflicts of interest between parent & spin-off candidate is high

EQUITY CARVE-OUTS*	
Advantages	Disadvantages
• Some flexibility • Culture change in carved out unit more likely than for tracking stock structure • Stock can be used for incentives/acquisitions • Might still require consolidation of financial statements	• Can be hard to unwind • Must set up new, separate board • Can have less desirable tax consequences than tracking stock structure • Doesn't give complete independence • Might risk competition with parent company

SUITABLE WHEN:
•Business unit is not ready for full independence, but some independence is strategically desirable
•Net losses from carved out division can be used to offset gains from parent company

TRACKING STOCKS*	
Advantages	Disadvantages
• Usually tax-free • No need to set up a new board • Maintain full control • Stock can be used for incentives/acquisitions • Obtain a higher company valuation • Enhanced executive compensation • Can borrow on parent's credit	• Corporate governance concerns • Potential for misunderstanding by investors/analysts • No chance for takeover premium for tracking stock shareholders • Risk of strategic conflict with parent company • Might be hard to unwind

The balance of this section will provide recommendations on how this structure can and should be used.

Contact

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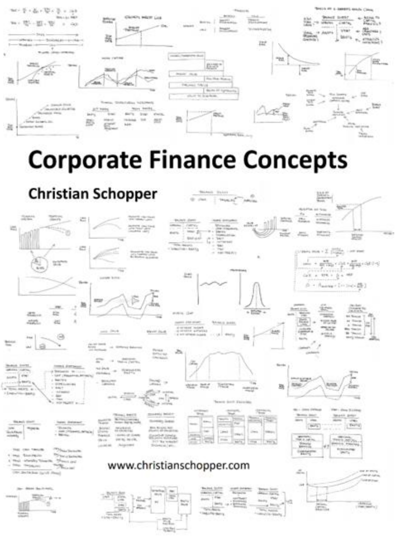

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