Cross Listing and Impact on Cost of Debt

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Executive Summary

Cross-border listing of shares via a Depositary Receipt (DR) program has several advantages for both issuers and investors. The increased activity in the DR space over the last decades clearly demonstrates acceptance of DRs as an effective vehicle for cross-border listing. The phenomenal success of DRs in the United States and in other European markets has prompted exchanges in Brazil, Hong Kong and Japan to initiate local DR programs. In the ensuing study, we analyze if establishment of a DR program has benefits for issuers in reducing their cost of issuing debt. Based on our sample, we conclude that during the period of one year following the start of a DR program, the cost of debt — on average — is reduced by approximately 79 basis points (bps). This result is consistent across industries, trading venues and regions.

Introduction

As a vehicle for cross-border listing, DRs have gained significant importance in recent years. Trading volumes have increased to 147 billion shares (CAGR[1] of 19% since 2006) and on a long-term basis,[2] the Citi World ex-U.S. DR Index has outperformed the S&P 500. From an issuer perspective, pent-up demand from investors for international equities is just one reason to start a DR program. Some of the other advantages and benefits of having a DR program include: access to more liquid capital markets outside the issuer's home country; diversification of shareholder base; international visibility in strategically important markets; facilitation of Employee Stock Option Programs (ESOPs); currency for strategic M&A transactions; and access to investors who are not otherwise allowed to invest in international securities. Increasingly, issuers are eager to start a DR program to improve liquidity in their home market[3] and reduce their cost of capital.[4] Although there are numerous academic papers discussing benefits of cross listing for shareholders (i.e., reduction in cost of equity), there is very limited literature that discusses benefits of cross listing in terms of reduction in cost of debt issuance. It is important to analyze the cost of debt, as debt comprises a significant source of funding for international companies, generally is an immediate source of financing and therefore has direct implications for the bottom line. The current study, which analyzes a random sample of 25 DR programs, provides insight into how initiation of a DR program impacted cost of debt for issuers.

Hypothesis

Investing in international debt instruments is perceived to be very risky by investors for a number of reasons. Some of the key risks include credit risk, interest rate risk, geopolitical risk, exchange rate risk and risk associated with inadequate disclosure requirements. While financial instruments exist that help to mitigate currency, credit and interest rate risks, there is no protection against inadequate disclosure in financial statements. What complicates the issue further is that the issuer's home country may follow local accounting standards rather than one of the major internationally recognized accounting standards (U.S. GAAP or IFRS), making interpretation and analysis of the financials difficult. However, if the issuer has a DR program, it will generally have to adhere to greater scrutiny by market forces entailing transparency, regulatory review and oversight by market participants. A DR program, therefore, should mitigate the risk of inadequate disclosure, and issuers that establish DR programs should see a benefit in their cost of debt issuance. This is the hypothesis that we will test in this study.

[1]CAGR: Compounded annual growth rate.

[2]Based on performance from 2001 – 2010.

[3]Citi published a study in 11/2009 demonstrating that DR program improves liquidity in home market.

[4]Citi published a study in 09/2010 demonstrating that DR program helps reduce cost of equity capital.

Data and Methodology

Cost of Debt

Cost of debt is defined as the effective rate that a company pays on its current debt. A company may issue various bonds and other forms of debt instruments and engage in direct borrowing through loans from lenders. This measure will provide an effective gauge of overall debt cost incurred by the company as it calculates the effective cost of debt by taking a weighted average of multiple sources of debt financing.

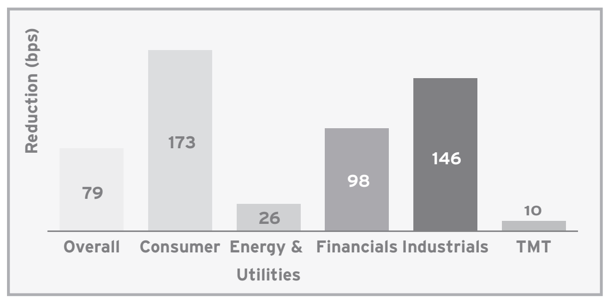
Sample and Approach

We drew a sample of 25 programs for which cost of debt could easily be ascertained from an external data provider. In this study we sourced cost of debt information from Factset. We determined the date on which the DR program started, populated cost of debt one year prior to the start of the DR program and then compared it with cost of debt one year later.

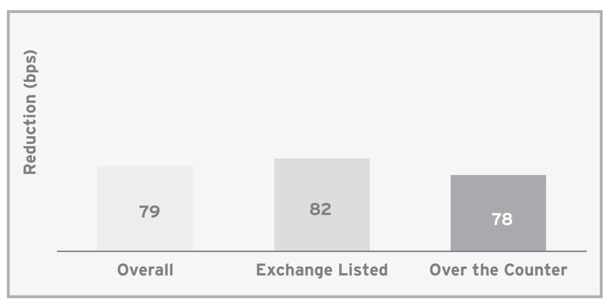
Results

- Our analysis shows that one year after the start of a DR program, cost of debt is reduced by an average of approximately 79 bps.
- Results were consistent across the geographic regions of the issuers that constituted the sample.
- All five industry groups represented by issuers in the sample showed a drop in cost of debt, with the Consumer industry showing the maximum decrease (173 bps) and Technology & Media showing the least decrease (10 bps).
- Decrease in cost of debt was consistent across trading venues of DR programs; exchange-listed names showed an average decrease of approximately 82 bps, whereas names traded in the over-the-counter (OTC) markets showed an average decrease of approximately 78 bps. This finding is consistent with the dynamics of exchange-listed DR programs, wherein they are generally more liquid, have a higher percentage of institutional ownership and are subject to more stringent regulatory oversight resulting in higher reduction in cost of debt versus an OTC traded DR program.

Results by Industry Groups



Results by Trading Venue of DR Program



Source: FactSet, Bloomberg

Conclusions

Results of our study clearly demonstrate that opening a DR program can reduce an issuer's cost of debt significantly (approximately 79 bps on average). This finding supports our hypothesis that establishment of a DR program and the increased scrutiny by market forces and regulators that follows has a positive impact on the cost of debt issuance. The results of our studies are also supported by an external independent study[5] published in 2010 by the European Corporate Governance Institute, which concludes that U.S. listing has a positive impact on cost of debt. The results of this study — coupled with an earlier study released by Citi on "DR Listing and Cost of Equity," which concluded that DR listing reduces cost of equity by 74 bps — provides a strong rationale for issuers to have a DR program.

[5]Equity Cross Listing in the U.S. and the Price of Debt published by European Corporate Governance Institute.

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