Annex C. Major instruments of foreign portfolio equity investment

1. Venture capital funds

The rationale for venture capital is an imbalance created by an inadequate supply of capital on appropriate terms from existing financial institutions on the one hand, and a significant demand for funding for new or high risk ventures with prospects for high growth and profitability on the other. Venture capital financing provides early-stage financing, as well as financing for the expansion of established companies. Venture capitalists provide equity-type financing with a view towards participating in the high returns achieved by successful new ventures with high growth potential, particularly in the form of capital gains. The objective of investing only in ventures with high potential returns means that venture capital investors must screen closely investment proposals. An evaluation of venture capital investments typically focuses on whether entrepreneurs have credible business plans and whether they have the ability to implement them successfully.

Venture capital investing typically involves the participation of a venture capital institution in the investee company. This is motivated both by the need to protect the venture capital institution's investment against downside risks, particularly because investors cannot simply sell out their investments (in unlisted shares) if performance is poor, and by the aim of adding value to the investee company. The latter is accomplished by contributing the venture capital firm's experience and contacts to such areas as business strategy, management organization and processes, financial planning and control, and investor relations. In this respect, venture capital investment is very similar to FDI, with the difference, however, that venture capital investors have a predetermined objective, as well as (often) a time horizon, for divestment from the venture.

The venture capital industry has increasingly distinguished between the financing needs of companies at different stages of corporate development. These can be categorized as follows: early-stage financing; later-stage financing; and special situations.

(a) Early-stage financing

Venture capital, in its original concept, is intended to meet the needs of new ventures for seed capital and start-up financing. Seed capital is funding for the research and development of new products or production technologies before the setting up of commercial scale production. The amount of funds for this phase is generally very limited, but the investment lead-time is long, the risk (probability) of failure is very large, and later financing requirements, both for production and marketing, may be considerable. Start-up financing is funding for the setting-up of a new business, and involves investment in fixed assets and working capital, for which the entrepreneur does not have sufficient resources.

(b) Later-stage financing

Some characteristic types of development capital include expansion finance and replacement financing. Expansion finance provides working capital or fixed assets needed by unlisted companies to grow through entering new markets, developing new products or introducing improved technological processes. Replacement financing is funding for entrepreneurs to purchase shares of their associates in the venture who wish to realize all or part of their investment without a stock market listing.

(c) Special situations

Venture capital has also been directed to financing certain special needs of mature companies, often parts of large corporations, that can yield attractive returns. These include management buy-outs and management buy-ins, which involve the financing of acquisition of ownership and control from an existing business by a new management team, either from within or from outside the company. Turnaround financing is also included in this category. This type of financing is provided by some venture capital institutions to assist companies that have a poor record of performance but which are basically sound and have clear opportunities for improvement.

The final and critical phase of the venture capital investment cycle is to manage the divestment or exit from the investee firm. Since realising a substantial capital gain is essential to achieve high investment returns, determining and achieving the timing and conditions of the sale of investments are key elements of the venture capital process. There are three basic exit routes:

- Flotation of the investee company through an initial public offering of shares to the public, either through a stock exchange or in the over-the-counter market.
- Secondary or "trade sale" of the venture capital investor's shares to another investor or company. This is probably the most commonly used route, although in larger, developed countries the transaction is often initiated by the acquiring investor who has identified the investee company as having a good strategic fit with its own operations.
- Repurchase of the venture capital institution's shares by the entrepreneur or the investee firm. The original contractual agreements between the investors may provide for this possibility, and define the conditions for the buy back of shares.

The successes and failures of venture-capital funds to date point to some important lessons for the wider use of this type of financing mechanism in the future. The key lessons are the following:

- Venture capital funds need to be able to identify a substantial number of firms offering high returns on investment (at least 25 per cent). The market for equity financing depends on several conditions, including positive macroeconomic conditions to stimulate investment in the setting up or expansion of new ventures and the existence of entrepreneurs with adequate management skills, business experience and understanding of the "equity culture" necessary for a partnership between promoter and outside investors. The latter means a willingness to provide financial information, to respect the contractual rights of all shareholders, and to allow some degree of external control over the business.
- The regulatory framework in the recipient country should provide investors with an attractive tax regime, allowing a substantial proportion of the appreciation in value of the investee firms to be transferred to investors, and legal transparency and freedom from exchange-control restrictions.
- The limited choice of "exit" options for divesting investments makes it difficult in many developing countries to realize the substantial capital gains needed to achieve high returns. Experience indicates that, where local stock markets are inactive (annual turnover of less than $3 billion), stock prices are low (valued at less than 10 times their earnings per share), or are hindered by regulatory constraints, capital gains tend to be lower than in countries with an active and liquid capital market. While there has been a rapid development of stock markets in developing countries in recent years, it takes time before young stock exchanges have the depth and liquidity to absorb the flotation of new ventures. However, the flow of venture capital funding into Central and Eastern Europe shows that international investors have been prepared to invest in new ventures there in anticipation of the evolution of local stock markets into viable exit mechanisms.

- The quality of management is critical for the success of venture capital institutions. Venture capital managers play a key role in identifying and evaluating investment propositions, structuring and negotiating deals and managing and divesting the portfolio of equity holdings.

Venture capital funds are a form of private equity placements that do not necessarily require the existence of a stock exchange as an exit mechanism. As such, venture capital funds can channel risk capital to lower income countries provided that the ventures have a sufficiently high growth potential.

2. International equity investment funds

Investment funds can be managed or unmanaged. Managed funds actively trade their portfolio of securities, the composition of which will change over time. Unmanaged funds invest in a fixed portfolio of securities which does not change over the life of the fund. Among the various portfolio investment instruments, managed international investment funds have become the most popular vehicle for portfolio equity investment in emerging markets. Investment funds can also be divided into closed-end and open-end funds (commonly referred to as mutual funds in the United States or unit investment trusts in the United Kingdom). Closed-end funds are distinguished from open-end funds in that they issue a fixed number of shares at the time of their initial public offering. The number of shares offered by open-end funds is variable. New shares are issued when new investors wish to invest in the fund (or existing investors increase their investment) by subscribing for new shares, and shares are redeemed by the fund upon demand by the fund's investors.

In order to meet redemption requests, open-end funds can be forced to sell a portion of the portfolio of securities in which they have invested quickly. This can create downward pressure on securities prices in the market in which such sales take place and thereby contribute to equity price volatility in that market for purely external reasons. Open-end funds will therefore tend to invest more heavily in larger companies for which there would exist a relatively liquid market, and in more mature equity markets which can provide adequate liquidity.

Closed-end funds are not required to meet redemption requests (investors in these funds must find a buyer for the shares in the secondary market), and do not therefore need to be able to liquidate their investments upon short notice. Consequently, closed-end country funds can be expected to take a longer-term view, and they are able to invest in less liquid instruments and in less developed equity markets. They are also less likely to contribute to market volatility which can result from the large, sudden sales of securities which can occur with open-end funds. This explains the higher turnover ratios of open-end as opposed to closed-end funds, and why closed-end funds are, in general, more suited to investments in less developed (and therefore less liquid) equity markets. However, closed-end funds will, of course, actively adjust their portfolio of investments in such a way as to optimize the overall return on their portfolio in accordance with the fund's stated investment objectives (the fund may seek income growth, capital appreciation or balanced growth, and some will pursue higher returns more aggressively than others). There is, therefore, no guarantee that they will never contribute to security price volatility in the equity markets where they invest. Emerging market country funds are most often closed-end funds, while regional and global emerging market funds are often open-end funds.

Investment funds can be organized either as a corporation or a business trust. In most of Europe and Japan, the trust structure is more common, contrary to the United States where the corporate structure is more common. This is because the majority of investment companies in the United States were closed-end funds (which tend to adopt the corporate form) in 1940 when the

United States Investment Act was enacted. With the recent burgeoning in the number and total net assets of open-end funds in the United States, the trust form has become increasingly common.

Investment funds can be private or public. Public funds, which include most closed-end funds, are listed on one or more stock exchange (most often the exchanges in New York, London, Hong Kong or Ireland), while private funds are not listed and are not available to the general public. It can be advantageous for the fund to be publicly listed because some institutional investors are prohibited by home country prudential regulations from investing in unlisted companies. Closed-end funds can also be either diversified or non-diversified under the United States regulatory framework. Diversified funds face limits on the percentage of total assets which can be invested in a single security, whereas undiversified funds face no such restriction. This does not, however, preclude the undiversified fund from adopting such limits on a voluntary basis for prudential reasons. An undiversified fund will, nevertheless, tend to be relatively more risky because of the potentially higher degree of concentration in its investment portfolio.

From the investor's point of view, one disadvantage of closed-end funds is that their prices often do not reflect the value of the underlying portfolio of securities in which the fund invests. This is partly because their investment portfolio may concentrate relatively heavily in less liquid instruments in which trading activity is light. The price at which these securities are valued may not, therefore, reflect accurately the true value that would be realized should the securities be liquidated. A common finding is that country fund returns are somewhat correlated with returns on the market in which they are listed, and are less than perfectly correlated with the returns of their underlying assets.[1] This diminishes diversification benefits.

From the perspective of the emerging markets, the fact that prices of shares of closed-end funds can vary independently of the prices of their underlying assets is an advantage. This offers an insulating property when the local market in which the fund is invested is illiquid. Country funds can also provide indirect benefits to emerging markets by applying pressure for improvement of disclosure and accounting standards, as well as greater transparency. They can also lend pressure for the upgrading of services, such as clearance, settlement and depository systems. In addition, they can spur the growth of local credit-rating agencies. Many institutional investors are limited to investing in high-quality securities and press for growth of local credit-rating agencies as well. Apart from this, more direct benefits can be reaped through the provision of training services by investment funds that are often willing to participate in local training programmes.

It does not appear that a country's stage of development plays a role in determining where country funds are established. However, emerging markets at an early stage of their development generally allow foreign investment through closed-end funds, which are more suitable for less liquid markets. American depositary receipts (ADRs) and global depositary receipts (GDRs) (discussed below), as well convertible bonds and bonds with equity warrants, are more sophisticated forms of investment and appear to be accessible only to a small number of well known companies in the more advanced emerging markets.

3. American depositary receipts and global depositary receipts

An ADR is generally created by the deposit of the securities of a non-United States company with a custodian bank in the country of incorporation of the issuing company. The custodian bank informs the depositary in the United States that the ADRs can be issued. ADRs are United States dollar denominated and are traded in the same way as are the securities of United States companies. The ADR holder is entitled to the same rights and advantages as owners of the underlying securities in the home country. Several variations on ADRs have developed over time to meet more specialized

demands in different markets. One such variation is the GDR which are identical in structure to an ADR, the only difference being that they can be traded in more than one currency and within as well as outside the United States.

There are three types of ADRs:

- *Unsponsored* ADRs are issued without any formal agreement between the issuing company and the depositary, although the issuing company must consent to the creation of the ADR facility. With unsponsored ADRs, certain costs, including those associated with disbursement of dividends, are borne by the investor. For the issuing company, they provide a relatively inexpensive method of accessing the United States capital markets (especially because they are also exempt from most reporting requirements of the Securities and Exchange Commission).

- *Sponsored* ADRs are created by a single depositary which is appointed by the issuing company under rules provided in a deposit agreement. There are two broad types of sponsored ADRs -- those that are restricted with respect to the type of buyer which is allowed, and are therefore privately placed; and those that are unrestricted with respect to buyer and are publicly placed and traded. *Restricted* ADRs (RADRs) are allowed to be placed only among selected accredited investors and face restrictions on their resale. As these are not issued to the general public, they are exempt from reporting requirements of the Securities and Exchange Commission and are not even registered with it. Restricted ADR issues are sometimes issued by companies that seek to gain some visibility and perhaps experience in the United States capital markets before making an unrestricted issue.

- *Unrestricted* ADRs (URADRs) are issued to and traded by the general investing public in United States capital markets. There are three classes of URADR, each increasingly demanding in terms of reporting requirements to the Securities and Exchange Commission, but also increasingly attractive in terms of degree of visibility provided. Level I URADRs are exempt from the requirement that the issuing company conform their financial statistics to United States Generally Accepted Accounting Principles (GAAP), as well as from full reporting requirements of the Securities and Exchange Commission. They are also therefore relatively low cost. Level II URADRs are generally issued by companies that wish to be listed on one of the United States national exchanges. The issuing company must meet the Securities and Exchange Commission's full disclosure requirements, their financial statements must conform to United States GAAP and the company must meet the listing requirements of the relevant exchange. They are therefore more costly for the issuing company, but the public listing allows much higher visibility and makes the facility more attractive to potential investors. Level III URADRs are issued by companies which seek to raise capital in the United States securities markets by making a public offering of their securities. They must also make full Securities and Exchange Commission disclosure, conform to United States GAAP and meet relevant exchange requirements, and provide the highest degree of visibility of any ADR.

Companies that apply for either listing or public issue of securities on the national exchanges of the United States must meet exchange requirements. These include specific minimum requirements with respect to the size of total assets, earnings and/or shareholders equity. These requirements, along with the reporting requirements, serve to make it difficult for small capitalization companies of emerging markets to issue either Level II or Level III URADRs. A large number of ADRs are therefore offered through private placement, especially under Rule 144A, where activity is reported to be strong. Rule 144A, passed by the Securities and Exchange Commission in 1990, eased restrictions on the resale by qualified institutional buyers of private ADR issues amongst themselves once these

issues were made under this rule. Typical ADR issues appear to be relatively large. Emerging market ADR issuers tend to be large domestic companies with considerable financial resources and high international visibility. Relatively small ADR issues appear to measure in the range of between $15 million and $80 million, while many mid-sized issues fall within the range of $100 million to $300 million. Several exceptionally large issues have exceeded $1 billion in size.

From the investor's point of view, ADRs lower the cost of trading non-United States companies' securities. Trades are settled in the United States within five working days (or less, given the increasingly heavy volume of trading in ADRs), whereas trades overseas can take a much longer time and raise significantly settlement risk. The depositary provides both settlement and clearance services. As the facilities are traded in the United States, there is a much lower information search cost, and the problems of unfamiliarity with foreign markets and foreign laws, regulations and trading practices are overcome. The difficulties associated with locating a broker and/or custodian in the foreign market and the fees charged for these services are also avoided, and so are the obstacles that foreign languages may present. A major advantage of ADRs for the investor is that dividends are paid promptly and in United States dollars. Furthermore, the facilities are registered in the United States so that some assurance is provided to the investor with respect to the protection of ownership rights. These instruments also obviate the need to transport physically securities between markets. Communication services are also provided by the depositary, including provision of periodic reports on the issuing company (in English) in a format familiar to United States investors. Important information pertinent to the issuing company is transmitted to the investor by the depositary. Together, these advantages provide an incentive for investors in the United States capital markets to invest in the equity of emerging markets via ADRs.

For the issuing company, the main costs of ADRs are the cost of meeting the partial or full reporting requirements of the Securities and Exchange Commission and the exchange fees (for relevant classes of ADRs). However, ADRs can be useful means for issuing companies of gaining access to United States capital markets. Thus, institutional investors that are precluded by their charter from holding foreign securities are able to invest in such securities via ADRs. They can also allow foreign investors to avoid constraints that may be placed on such investments in cases where emerging markets still maintain limits on direct investment by foreigners. In general, ADRs increase access to United States capital markets by lowering the costs of investing in the securities of non-United States companies and by providing the benefits of a convenient, familiar and well regulated trading environment. Issues of ADRs can increase the liquidity of an emerging market issuer's shares, and can potentially lower the future cost of raising equity capital by raising the company's visibility and international familiarity with the company's name, and by increasing the size of the potential investor base.

Emerging-market ADRs are in many instances issued by newly privatized companies. A small number of economies in transition (the Russian Federation in particular) have started to use depositary receipts as a way of attracting foreign investment, despite lingering difficulties associated with aspects of their market infrastructure, such as transparency of financial statements, long settlement periods and potentially unreliable registration practices. The limited development, or lack of, domestic debt and equity markets in these countries makes access to foreign capital markets critical. In other cases, issues have been created by large and well known companies from emerging markets that are active in the ADR market (such as Mexico, Brazil and India), or countries with relatively good international credit ratings and a relatively long history of accessing foreign investment (such as the Republic of Korea and Chile). There have been noticeably few issues from companies in low-income countries (apart from India, and to a lesser extent, China), and only a handful in least developed countries. The few issues made by the latter group of countries have been mainly by

companies involved in the minerals, oil, banking and utilities industries that can be expected to be able to attract foreign financing. The growth in the number of issues from transition economies between 1992 and 1996, however, is quite noticeable (especially from Russia and Hungary).[2]

One disadvantage of depositary-receipt issues for the foreign markets in which the issuing company is incorporated is the disincentive to the development of a local capital market. Companies in emerging markets may issue ADRs because the underlying share issues may represent a relatively large volume of weekly or monthly trading activity and the domestic stock market may be considered too small to absorb the issues. While individual companies may be able to attract additional financing, at the macroeconomic level, an increasing trend towards emerging market issue of ADRs can retard the development of domestic capital markets by denying domestic markets additional instruments in which to invest.

4. Convertible bonds and bonds with equity warrants

A convertible bond is a bond which gives its holder the right to exchange the bond for a specified number of the issuing company's shares at any time up to and including the maturity date of the bond. Many convertible bonds include a call option which gives the issuing company the right to call the bond for redemption before the bond's maturity date. Once the company exercises the call, the bond holder is usually allowed approximately thirty days in which to either convert the bond into shares or surrender the bond and receive in return the call price in cash. The issuer will usually be obliged to pay a premium above the bond's par value in the event that they exercise the call.

An equity warrant is a security which gives the holder the right to buy (in return for cash) a specified number of shares directly from the issuing company at a specified fixed price for a given period of time, which is known as the exercise period. The warrant can usually, but not always, be detached from the bond and sold as a separate security. This is not the case with convertible bonds, and represents one important difference between the two. Warrants are also sometimes issued by themselves as separate securities.

With bonds attaching equity warrants, the bond holder can utilize the exercise period to determine whether to exercise the warrant or not. The bond holder will exercise the warrant if the price of the shares exceeds the exercise price of the warrant, in which case they make a net gain. This will happen when the company's share price rises (that is, if the company prospers). Likewise, with convertible bonds, the holder will exercise the right to convert the bond into stock if the value of the shares for which the bond could be exchanged exceeds the value of the bond.

Finance theory has not yet developed any generally accepted explanations for why convertible debt instruments are issued, although several suggestions have been offered. Convertible bonds do not represent a relatively inexpensive form of debt. Any difference between rates of interest demanded by investors in straight bonds and convertible bonds actually represents the value of the conversion option. Also, viewing convertible debt as a form of future equity financing is not valid, because conversion into equity is not guaranteed. There have been issues of convertible bonds with mandatory conversion provisions, but this is not the norm.

The issuance of convertible debt securities has tended to be concentrated among relatively small, high growth and heavily leveraged companies (Mikkelson, 1981) which are therefore relatively risky. Investors might be positively disposed towards investing in convertible bonds because, if the market value of the company rises quickly, it will be possible to share in this growth by exercising

the conversion right. However, if growth is not very high, the investor can retain the bond, which will provide a stable, relatively safe income flow and provide a floor on the potential future value of the security. Additionally, as the interest payments on convertible bonds and bonds with equity warrants are lower than on straight bonds (because of the value of the right to convert and the value of the warrant, respectively), the company will be able to apply a larger amount of financing towards expansion of the company or towards general operating expenses. The special rights included in these securities are therefore sometimes regarded as "sweeteners" for growth companies to attract financing. There have also been explanations offered to explain the issue of convertible bonds invoking the argument that, by incorporating an equity-type component, they help overcome the divergent wishes of bond holders and equity holders with regard to the desirable risk profile of projects undertaken by the company (so-called agency costs).

It is interesting to note that issues of equity-related bonds have emanated overwhelmingly from a small number of emerging markets that are well known in international capital markets, and almost exclusively from the relatively large middle-income emerging markets that receive the bulk of FDI and foreign portfolio equity investment. The notable exceptions are China and India, which are perhaps special cases among the category of low-income countries in light of their unusually large size and potential for market growth. Pakistan is the only other low-income country for which issues of such securities have been recorded (there were $92 million worth of convertible bond issues in 1993 and $45 million in 1994).

The Organisation for Economic Co-operation and Development records only fifteen emerging markets as having floated equity-related bonds in the international markets (OECD, 1996e). This may indicate that access to these markets by emerging-market countries has so far been limited to those that are creditworthy or large with a relatively high visibility among foreign investors. Due to scarcity of information, however, it is not possible at this time to provide details on the characteristics of individual industries or companies in emerging markets that have participated in the market for these instruments.

Notes

1 While the number and net asset value of closed-end funds investing in emerging markets has grown rapidly in the past five years, many of these funds trade at large price discounts from their net asset value. Portfolios of funds with large discounts subsequently generate excess risk-adjusted returns and abnormal profits can be earned by "raiders" who can buy out the funds and liquidate at the "right" value.

2 A listing of 1,000 ADR issues as of end-1992 is provided by Duggan, 1995. An updated list was obtained from the Bank of New York.