Debt or Equity? How Firms in Developing Countries Choose

Jack Glen
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Foreword

This discussion paper concentrates on corporate finance in developing countries and how managers make capital structure decisions. The paper documents what is happening to developing country finance at a time when economic liberalization and increasing international investor interest are allowing developing country managers access to financial markets and instruments that were previously unavailable. It provides insight into both the problems and opportunities in corporate finance facing the private sector in many developing countries at a time when the private sector is increasingly being called upon to provide the main source of economic growth. The findings bode well both for growth and for the private sector: firms in developing countries respond vigorously to well regulated domestic and international capital markets. The paper is pioneer work, presenting for the first time information on the nature of the capital structure decision in developing countries.

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& Economic Adviser of the Corporation
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Abstract

Long stifled by government controls, emerging market (EM) corporate finance is changing dramatically as recent liberalization is revitalizing stagnant domestic capital markets and permitting increased access to overseas markets. This paper examines how EM firms choose between debt and equity in their financing decisions. The paper starts with a discussion of the traditional features of EM corporate finance. It then presents a simple framework for the debt-equity choice based on the standard considerations of cost, risk, control and disclosure. The unique manner in which these considerations could be influenced by government control is illustrated with examples from several EM countries.

Our central conclusion is that, like Western firms, EM firms seek to minimize the cost of capital and retain control in the hands of existing shareholders. But they also face many non-market constraints, which are now disappearing. The concluding section remarks upon a number of interesting empirical regularities across countries as they embark on financial liberalization.
Executive Summary

The 1990s have become a watershed in emerging market corporate finance. Domestic capital markets are being revitalized and, in many countries, liberalization is permitting companies to go overseas with global depository receipts and convertible bonds. Today, emerging market companies face a much richer menu of financing instruments than ever before. Governments have initiated regulatory reform and financial liberalization, recognizing that private sector investment is going to play a dominant role in the economic activity of developing countries. The growing emphasis on private investment as the primary engine of growth has been accompanied by a new trend of directly financing individual companies rather than sovereign financing. The capital required for private investment, while often scarce, can be had from a variety of sources. How firms choose between these various sources and why has been the source of much debate in developed countries. This paper carries that discussion into the realm of emerging markets.

Firms have three main sources of capital: internally-generated funds, bank loans and financing raised in capital markets. The resulting mix of debt and equity determines a firm’s capital structure. Empirical evidence suggests that external financing (in contrast to internal financing from retained earnings) is more important in developing countries than in some developed countries. In addition, in the 1990s the use of capital markets as a source of external financing in developing countries has soared and further increases are expected. This interest in capital market financing has not been confined to the domestic markets. In the international markets, investor interest in emerging market instruments has reached headline-making proportions. For 1992 alone, international portfolio investment in emerging markets was more than $19 billion, which exceeds net loans from international commercial banks and is more than three times the level achieved in 1990. Further increases are anticipated.

Against this backdrop, this paper examines the development of capital markets in a set of developing countries and relates that development to the financing decisions of firms. The analysis is qualitative in nature, relating observed changes in financing behavior to particular events in an intuitive, rather than statistical, manner. The paper examines how market conditions together with government regulations and institutional features collectively influence capital structure decisions in these countries.

The importance of the debt-equity choice depends on how capital structure decisions actually influence the value of the firm and the riskiness of its earnings. On this point, existing theories for the developed world are not very convincing as they fail to satisfactorily explain actual financing decisions by firms. In fact, extreme versions of the theory claim that under very general conditions capital structure decisions should not matter. Yet firms behave as if capital structure decisions are important. This puzzle becomes even more complicated in developing countries owing to the myriad of controls and complicated institutional constraints that governments have created.

Despite the complexity of the problem, however, certain ideas stand out. First, cost is a key element in the choice between different financial instruments; as markets are liberalized, developing
country firms shift their capital structure to reflect the new costs as influenced not only by the pricing of the instruments but also by the tax code. Second, capital structure has important consequences for the riskiness of a firm's earnings; too much debt can sink even the most seaworthy firm. And finally, the control aspects of financing decisions are not to be dismissed lightly; equity issues that dilute control over the firm require important financial advantages before they are acceptable.

The findings here accord with intuition. Developing country firms face a number of constraints in the financing choices that are available to them. The most important of these relate to government controls, which not only limit the potential menu of instruments, but frequently circumscribe the issue and pricing of permitted instruments. But the market also imposes constraints, such as limiting available maturities in unstable macroeconomic environments. Within these constraints, however, developing country firms behave rationally and attempt both to minimize the cost of capital and to preserve corporate control in the hands of existing shareholders. Thus, they are not unlike their developed country counterparts.

With the financial liberalizations now underway in many countries, companies are beginning to re-examine their financial structures. They now have a richer and less constrained menu of instruments to choose from (in terms of pricing), including access to international markets that offer cheaper capital than was previously available.

IFC has played an active role in the capital structure decision of many developing country firms, both directly and indirectly. Directly, IFC provides long-term project finance, both debt and equity, that is not available in many countries. Indirectly, IFC also helps developing member countries both as an adviser and investor in developing local financial systems. As an adviser, IFC provides technical assistance to help member countries improve the environment and operations of their financial markets. As an investor, IFC supplies equity and loan funds and needed financial technology to help establish new, or to expand existing, financial institutions.

IFC helps private sector companies in developing countries mobilize foreign investment through securities offerings in the international capital markets. It advises, structures, underwrites, and places international corporate issues of equity, quasi-equity, and debt securities as well as pooled investment vehicles. IFC joint-lead manages these offerings in partnership with prominent international investment banks. Because IFC's goal is to attract international investment to under-capitalized markets, many of the investment vehicles underwritten by it are the first of their kind for the host country. During fiscal year 1993 IFC was involved as adviser or joint-lead manager in a total of 11 securities offerings with a total value of $978 million. Equity issues accounted for $730 million, debt issues for $200 million, and quasi-equity issues for $48 million.
I. Introduction

How do developing country firms decide between debt and equity? And what role do domestic and international capital markets play in this decision? These are topical questions given the tremendous interest in emerging markets in recent years and the observation that new patterns of foreign and domestic finance are emerging there. The new pattern of foreign finance emphasizes direct funding of developing country firms rather than sovereign borrowing, which was the dominant theme for many years. This switch is being facilitated by the trade and financial liberalization under way in many developing countries. Led by actual or potential balance of payments crises and the belief that globalization is inevitable, many developing country governments are jumping on to the free-market bandwagon to ensure that their firms can compete on the same terms as their less constrained foreign competitors. An exciting outcome partly attributed to such liberalization and accompanying privatization is that developing country firms have continued to grow in the 1990s in spite of recession in the West.

The reforms are also influencing domestic financing patterns by revitalizing capital markets at home. Developing country finance has traditionally been equated with state banks and development finance companies (DFCs) with an emphasis on project, rather than corporate, finance. Leverage ratios and financing requirements have been norm-driven, with guidelines for lending based on project technology, capital intensity, the applicant's track record, perceived importance of the project within national priorities, average payback periods and the like. This is an apt characterization of the 1980s; it applies less so to the 1990s, with domestic markets for corporate debt and equity undergoing substantial transformation. At the margin, there is a shift away from bank sources of finance to direct use of the capital markets. As a result, the role of banks and DFCs is also undergoing basic change.

Firms have three main sources of capital: internally-generated funds, bank loans and financing raised in capital markets, i.e. corporate debt and equity. The breakdown among these sources is not well documented for developing countries. One study of a set of developing countries covering the last decade found that internally-generated finance represented between 12 and 58 percent of total financing needs, leaving substantial portions to be financed by external sources; the available information does not permit a breakdown among bank loans on the one hand and corporate bonds and equity on the other. By comparison, internally-generated finance represented between 52 and 100 percent of the financing needs for the G7 nations. Evidently, external financing is more important in developing countries than in some of the developed countries.

In the 1990s, the use of capital markets as a source of external financing in developing countries has soared. In the domestic capital markets of a group of seven developing countries, new issues of equity and corporate debt were 19 and 41 percent higher in 1992 compared to 1990. Further increases are expected. In the international markets, investor interest in emerging market instruments has reached

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1 See The World Bank (1993a) and The Economist (1993).

2 We use the term "external" to refer to funding sources outside the firm, and the word "foreign" to denote non-domestic external sources.


4 Authors' calculations based on information provided by security market authorities in Argentina, Brazil, Chile, India, Indonesia, Turkey and Venezuela.
headline-making proportions. For 1992 alone, international portfolio investment in emerging markets was more than $19 billion, which exceeds net loans from international commercial banks, and is more than three times the level achieved in 1990.\textsuperscript{5} Again, increases are expected.

Against this backdrop, this paper examines the development of capital markets in a set of developing countries over recent years and relates this to the financing decisions of firms. The analysis is qualitative in nature, relating observed changes in financing behavior to particular events in an intuitive, rather than statistical, manner. The basic issue addressed is how firms arrive at a given debt/equity mix and how they view the cost and risk of different instruments.

Our findings accord with intuition. Developing country firms face a number of constraints in the financing choices that are available to them. The most important of these relate to government controls, which not only limit the potential menu of instruments, but frequently circumscribe the issue and pricing of permitted instruments. But the market also imposes constraints, such as limiting available maturities in unstable macroeconomic environments. Within these constraints, however, developing country firms behave rationally and attempt both to minimize the cost of capital and to preserve corporate control in the hands of existing shareholders. Thus, they are not unlike their developed country counterparts.

The first section of this paper presents a theoretical discussion of the importance of capital structure, and then examines empirically the capital structure of firms in one set of developing countries. The second section reviews the different financial instruments available to firms. In the third section, the markets for equity and corporate debt, both domestic and international, are analyzed. The fourth section discusses the sequence in which firms choose between internal and external funds, illustrated by a case study. The final section summarizes the paper's findings. An annex contains outlines of the experience of six individual countries.

\textsuperscript{5} The World Bank (1993b).
II. The Capital Structure Puzzle

Stewart Myers (1984) pointed out that financial economists have not hesitated to give advice on capital structure even though how firms actually chose their capital structures remained a puzzle. It was of particular concern to him that the theories developed did not seem to explain actual financing behavior.

This capital structure puzzle is even more complicated in developing countries, where markets do not always work efficiently and controls and institutional constraints abound. Developing country banking systems are often incapable of providing the needed resources for private sector expansion and diversification. This is especially true in countries where government intervention in the form of directed credit and subsidized lending to state-sector companies consumes a substantial share of available credit, as it is in countries where government demand for credit crowds out the private sector or where the macroeconomic environment is too uncertain for banks to lend long-term. In India, for example, of every rupee deposited in the banking system, 40 percent must be held as reserves (of one form or another); directed credit accounts for another 24 percent, leaving banks only 36 percent of deposits to lend freely. In transition economies such as Poland, the main complaint of private entrepreneurs is the unwillingness of banks to lend to them, partly because these entrepreneurs do not have prior track records and partly because state banks are more accustomed to dealing with state companies.

In the past, the capital markets in many developing countries have also not provided either the type of funding needed by the private sector or in the quantities required. But now as liberalization proceeds in the 1990s, more and more developing country firms are finding themselves faced with a choice of financial instruments, forcing them to make possibly important and sometimes difficult decisions about how to structure the capital side of their balance sheet. Theories abound on how firms should make these decisions. This section presents the basics, including a list of possible criteria for the selection of a debt/equity mix.

Theory

The idea that the cost of capital and hence the value of a company depend upon its debt-equity mix would seem pedestrian to businessmen. Finance managers know that restructuring the liabilities/equity side of the balance sheet can add value to the firm, just as changes on the assets side do. But in 1958, two Nobel Prize-winning economists, Franco Modigliani and Merton Miller, dropped a bombshell by deriving a result now known to generations of business students and economists as MM 1. This result asserts that in an idealized world without taxes, the value of a firm is independent of its debt-equity mix. The basic idea is that the value of a firm depends only upon the cash flows it generates, and not at all upon the manner in which these cash flows are distributed between various mixes of debt and equity finance. In short, capital structure is irrelevant. But, if corporate income is taxed and interest payments are tax deductible, then leverage has a tax advantage and companies would tend to go exclusively for debt financing.

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6 See the survey of Polish entrepreneurs in Wyznikiewicz, Pinto and Grabowski (1993).
7 Modigliani and Miller (1958).
Of course, these conclusions are at variance with what one sees in the real world, where capital structure matters and banks would be extremely reluctant to finance a project with 100 percent debt. MM spurred financial economists to come up with the conditions under which financial structure would indeed matter, a search that continues today and is the foundation of modern corporate finance. Factors which influence the debt-equity mix include bankruptcy costs, personal income taxes and differential taxation of income from different sources, for example, capital gains versus interest income or dividends, differences in information among corporate insiders and investors, and issues related to control and dilution and possible differences in objectives between managers and shareholders. The following paragraphs focus on three factors with great practical implication for capital structure.

The first factor is the tax advantage of debt. Interest paid on debt is deductible from income and reduces a firm's tax liabilities; therefore, debt has a tax advantage over equity and by increasing the amount of debt issued, a firm increases the earnings available to shareholders. In other words, the more leveraged the firm, the more valuable its equity.9

The second factor is related to segmented markets, with different sets of investors measuring risk differently or simply charging different rates on the capital that they invest. By choosing the instrument that taps the cheapest market, firms lower their cost of capital. This argument is especially attractive to internationalists who believe that domestic capital markets are (at least at times) segmented from their international counterparts, so that by issuing financial instruments abroad firms gain an advantage over their purely domestic competitors. But domestic markets too can be segmented, perhaps by tax policies which exempt some investors from certain taxes, thereby driving a wedge between the after-tax cost of various financial instruments.

The third factor is the impact of financing decisions on the riskiness of a firm. As firms pile on more and more debt, their ability to meet fixed interest payments out of current earnings diminishes. This affects the probability of bankruptcy and, as a result, the cost (or risk premium) of both debt and equity. Firms that adjust their capital structure in order to keep the riskiness of their debt and equity reasonable, should have a lower cost of capital. Adjusting for the nature of the industry in which a firm operates, highly leveraged firms may be more likely to issue equity and vice versa.

Collectively, these factors illustrate two important issues facing firms when they make capital structure decisions. First is cost; cheaper financing is usually the first to be used, whether the cost is less owing to the tax relief that it provides or because the markets price some instruments at a lower cost than others. This is the famous pecking-order theory of capital structure. Second is the issue of risk; every financing decision can affect the riskiness of the firm, and management should not overburden the firm with debt owing to the possibility of bankruptcy.

For some firms these two points might exhaust all possibilities, but for others a single and often overriding factor has been ignored: control. In most firms, whoever controls the equity controls the firm and is recipient of all its attendant perquisites. Especially in the emerging markets where the tradition of family ownership is strong, control can dominate the financial decisions of firms, forcing them to defer public issues of equity which would dilute control, but which would also permit the firm to invest in

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8 A useful survey of these issues is contained in Harris and Raviv (1991).
9 This is true when the after-tax interest rate does not exceed the firm's return on assets.
growth opportunities. In many cases, then, capital structure decisions can be important because they influence who has control over the firm.

Somewhat coincident with the control issue is the matter of disclosure. Public listing of equity usually entails the disclosure of information that closely-held companies might prefer to keep private. In some cases this preference is for personal reasons, but at times privacy can have economic benefits for the company as well.

Reality

The empirical evidence presented in Figure 1 illustrates the difference in capital structures for a sample of firms in a set of emerging markets.¹⁰ Equity levels display significant variation, ranging from more than two thirds of all financing in the case of Brazil, to less than one third in the case of Korea. Brazil, Mexico and Malaysia all exhibit high levels of equity. Conversely, India, Korea and Pakistan carried relatively low levels of equity. What explains these variations? The Annex on the country studies provides some answers. Variation in the debt-equity mix depends upon the macroeconomic environment as well as government controls and intervention in the domestic capital markets. Thus, there may be a natural pre-disposition towards debt when interest rates are controlled and the real after-tax cost of debt is negative (India through most of the 1980s); high inflation and the associated uncertainty could create a paucity of long-term instruments, and hence force a reliance on equity (Brazil); and high growth and interest in emerging markets could create incentives for companies to list and issue equity (Malaysia).

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¹⁰ The countries included in Figure 1 are Brazil, India, Jordan, Korea, Malaysia, Mexico, Pakistan, Turkey and Zimbabwe. For each country, financial statement information for approximately the largest 100 publicly-traded companies was gathered. From these data, annual averages of the major account types were calculated across all firms in each country. These averages, which by construction place more weight on the largest firms, were used in preparing the graph.
To the extent that the environment changes over time, one might expect corporate financial structures to change as well. Figure 2 illustrates the dynamic nature of financing decisions by presenting annual ratios of both current liabilities and long-term liabilities over equity for the sample of Korean and Indian firms presented in Figure 1. The figure shows a marked decline over time in the importance of debt relative to equity for Korean firms, while that relationship is relatively steady for Indian firms, although much of the Indian corporate debt has been convertible into equity. The remainder of the paper investigates in more detail the reasons for behavior like that illustrated in Figures 1 and 2, especially as it relates to the use of capital markets as a source of financial capital.

To summarize, capital structure choices affect a firm's value by influencing the cost of capital and its riskiness. Firms choose their financing with cost and risk in mind, but can be influenced by control and disclosure considerations as well. Given market conditions and the preferences of owners, firms are likely to choose a capital structure that best serves their interests. As we shall see, the variations in capital structures across countries and over time, reflect the diversity of financial markets, tax codes and investor preferences.
III. Financial Instruments - Cost, Risk, and Control

A basic financial decision facing firms is the choice between debt and equity capital, although in some countries a third option—convertible debt, which combines features of those two instruments—is also available. As mentioned, the choice between the two will depend largely on three factors: cost, risk, and control. This section will look at the two primary instruments, debt and equity, and how they compare with respect to these three factors. In addition, as will be discussed in more detail in a subsequent section, the three factors can be influenced greatly by government decisions that impact either market cost or perception of the different instruments.

The Cost of Capital

As a reward for bearing risk, shareholders exercise considerable influence over the investment decisions of business corporations. Creditors can place restrictions on certain types of investments, but the ultimate investment decisions reside with shareholders and managers acting on their behalf. This leads to the cost of capital being defined simply as the minimum rate of return a project must generate to be acceptable to shareholders. After allowing for risk, a project will be deemed acceptable if it increases the wealth of existing shareholders. This requires that the project generate a return exceeding its financing costs in terms of the new equity and/or debt it needs. This cut-off rate is called the weighted average cost of capital, reflecting a composite of the interest paid on debt and the returns to equity.\(^1\)

Debt

The cost of debt capital is both easy to understand and to calculate. For every dollar of debt issued there will be issue costs, interest payments and, in some countries, taxes to pay. The net cost to the issuer can be expressed as the internal rate of return that equates the periodic net cash outflow for interest payments and principal repayment with the net proceeds from the issue. The higher the issue costs and taxes, the lower the net proceeds and the higher the all-in, effective cost of debt. Offsetting this cost calculation, however, is the fact that in most countries, interest paid on debt can be deducted from income before calculating income tax, which reduces the cost of debt by the amount of the tax savings.

Interest paid on debt is by far the most important element of its cost. In countries where interest rates are market determined, they move over time reflecting supply and demand variations. As rates move, the attractiveness of debt relative to equity and internal funds changes. When rates are high, firms issue less debt; declines in rates prompt firms to issue more debt. This cyclical firm behavior is illustrated in the following graph, which presents new issues of Chilean corporate bonds and real interest rates. New issues reached record highs in 1991, when real interest rates were at record lows. Subsequently, interest rates have increased and the level of new issues has declined.

\(^1\) An introductory treatment of these issues is contained in Copeland and Weston (1988), Chapter 13.
The cost of equity capital is a much more difficult concept to define than is the cost of debt capital and, as a result, is measured in a variety of ways by different firms. The source of the difference of opinion is that payments to equity holders both vary over time and involve no principal repayment; risk and an indefinite life are two important characteristics of equity. For that reason, many firms look at dividend yield, the ratio of dividend paid to price, as a measure of the cost of equity. But there are (at least) two ways in which this calculation can be performed. One is to use the price of the share at the time of issue, that is, the book price of equity, as the denominator in the calculation, the justification being that the firm received the book value and is paying a return on the original amount invested. Other firms choose instead to use the current market price as the denominator, arguing that any new equity would have to be issued at that price and so it should be used when calculating today's cost of equity. Both of these arguments have merit, although for firms considering the issuance of new equity, today's market price is clearly the more relevant price to use.
The use of dividend yield as the sole measure of the cost of equity has major drawbacks. When purchasing shares, investors do not expect all of their return to come in the form of dividends. If they did, then firms with low dividend yields would be shunned by investors, which is not the case. Instead, investors expect a significant part of their return to be paid in the form of future share price increases. These expectations for growth in share price must be related to expected future payouts in dividends as well, since equity is not repaid as debt is. Consequently, in order for firms and investors to have comparable (or symmetric) views, firms must consider not only current dividend yield, but also expected growth in future dividends. Using dividend yield alone as a measure of return on equity is likely to induce management to believe that equity is cheaper than debt, a belief that ignores the extra risk that shareholders bear and for which they demand compensation.

There is another reason to doubt that dividend yield alone determines the cost of equity. To a large extent management has control over dividend policy and, if dividends determined the cost of equity, management could adjust that cost to meet its needs by simply raising or lowering dividends. But that simple explanation ignores the market’s role in assessing and rewarding the risk that shareholders bear and places an enormous burden on management’s dividend policy. This importance is not widely accepted, although dividend policy has been the subject of nearly as much debate as has capital structure. In fact, Modigliani and Miller (1963), already mentioned with respect to capital structure theory, also developed a model of dividend policy that concludes there is no value added to a firm through changes in its dividend payout. Whether important or irrelevant, emerging market firms display a wide range of different dividend policies.

If dividends alone do not account for the entire cost of equity, then management must somehow incorporate expected future growth in earnings (and prices) when calculating the cost of equity. One simple way to do this is through the price/earnings ratio (PE), a common measure for comparing firms and markets. Mathematically, one can show that the PE ratio is related to the difference in the two constituent elements of equity valuation: required return on equity and growth in earnings (and dividends). The nature of the relationship between PE and required return is such that a high PE ratio implies a low expected return on equity and vice versa, given the firm’s expected growth rate in earnings. By estimating this growth rate (as, for example, the average growth rate in recent earnings), one can then derive the market’s required return on equity using the PE ratio.

These three methods for estimating cost of equity capital—dividend/book value, dividend/market value and PE—are all used by firms and investors in the emerging markets. The dividend/book value approach suffers from the shortcoming that it is entirely backward looking and ignores the cost of new equity. Regardless, it is commonly used as a measure of the cost of equity. The dividend/market value method is an improvement in that it accounts for the current market price, but both methods ignore future expected increases in dividends, which is the strength of the PE approach. Many firms in the emerging markets look at PE multiples as a guide to how new equity should be priced, in addition to using it as a measure of the cost of equity. Both dividend/market price and PE methods, however, give firms similar signals regarding changes in the cost of equity: when market price increases, the cost of equity decreases. As the following graph of new equity issues in Turkey illustrates, firms often do view market price increases as a reduction in the cost of equity; new Turkish equity issues increased substantially following market price increases in 1989-90 and fell back following market decreases in 1991-92.

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12 A fourth method, the use of an asset pricing model such as the CAPM, is also possible, but we found that it is little used by firms in developing countries.
Issuance Costs

Issuance costs vary greatly from country to country depending on the degree of competition among investment banks, which is determined to a large extent by the regulatory framework in which these banks operate. In addition, the issuance costs will depend on the nature of the investment banking services provided; the more risk assumed by the investment bank in the issuance process, the higher the cost will be. Issuance taxes also vary greatly from country to country and can take a variety of forms, one of which is the stamp tax, which may apply to all issues of financial instruments, either debt or equity, or alternatively may be targeted to only selected financial transactions, thereby creating an incentive to use specific instruments. Withholding taxes on interest and dividend payments are another form of taxation which, even when paid by the investor, increase the cost to the issuer by increasing the pretax rate that must be paid.

Domestic issuance costs can be exceptionally high in developing countries. In India, for example, these costs include the standard underwriting commissions (2.5 percent for equity and 1 percent for debentures). In addition, there is a fixed cost element related to compulsory advertising and the printing, distribution and collection of forms (about 30 million forms and 57 collection centers per issue). As a
result, issuance costs could amount to between 15 and 20 percent of small issues (issues less than about $1 million), which therefore become prohibitively costly. For large issues (exceeding about $66 million), costs account for about 6 percent of proceeds. In addition to control concerns, lower public issuance costs could explain why rights issues (for equity and debentures) have been so popular.

Taxes on Issuance - Debt

The importance of issuance taxes on financial decisions in the domestic market is illustrated by an example from Brazil where there is an issuance tax on bank loans but not on corporate debentures, which makes the issuance of corporate debentures relatively more attractive. Taking advantage of this, firms can register debentures and then hold them in treasury, selling them periodically to banks with a repurchase agreement as a source of short-term working capital. Some firms even lend their unused debentures to other firms, which then rediscount them to banks, as a source of short-term financing. Without the tax differential between bank debt and corporate debentures, it is unlikely that such behavior would be observed in the market.

Some emerging market governments now view the large capital inflows associated with the private issuance of offshore financial instruments with some trepidation, fearing inflationary effects and the outflow of scarce foreign exchange reserves when repayment occurs. To combat this, governments have turned to various forms of taxes in order to reduce the attractiveness of international funds relative to their domestic counterparts. In Brazil, the government has intervened in order to extend the maturities of international debt by imposing withholding taxes only on issues with maturities of less than a designated amount. Over time, as the supply of international debt from Brazilian firms has increased, the government has lengthened the minimum maturity immune from the withholding tax. Of course, the market determines what maturities will be available to Brazilian firms, not the Brazilian government, and once the government pushed the minimum maturity beyond the reach of firms, firms responded by issuing long-term debt, but with put options attached which allow the buyer to sell the debt back to the issuer prior to maturity. If the puts are exercised, the withholding tax will likely be payable, but from the firm's perspective, deferred taxes are better than taxes paid upfront.

Another tax angle on financial decisions comes from Chile where the government, concerned about the effect of capital inflows on the exchange rate, has given issuers of international debt two options: deposit a (substantial) fraction of the proceeds from the issue in a reserve account with the Central Bank for one year (with no interest paid) or pay the Central Bank an amount in advance equal to the interest the Central Bank would otherwise receive on the reserve account. Either way, the net proceeds from the issue are reduced by the amount of this "tax" on offshore debt and the cost of the debt increases. Not surprisingly, Chilean issues of international debt have been quite low relative to their Latin American neighbors.

The importance of taxes paid by investors on interest received is also significant. This is illustrated by Turkey, where the government has a large borrowing requirement which it makes easier to finance by exempting interest received on government debt from personal income taxes. That places private issuers of debt at a disadvantage by forcing their interest rates up to offset the taxes that must be paid. As a result, with real interest rates at high levels firms have been discouraged from issuing debt. Some relief is provided by the existence of a few tax-exempt institutional investors who are willing to hold private debt at rates nearer to those paid by the government. The appetite for debt by these tax-exempt investors is limited, however, and the private debt market in Turkey is therefore substantially smaller than is the equity market.
Governments sometimes place restrictions on firms that act like taxes. For example, concerned about foreign debt and past government guarantees on offshore borrowing, the Indonesian Government has placed restrictions on foreign borrowing since late 1992. Government companies and state-owned banks must obtain Government clearance to borrow abroad and private companies not using state banks as a conduit may borrow offshore but must report borrowings to the Government.

Governments can influence the cost of debt through subsidies that reflect overall economic development policy as well. In Indonesia, the Government channelled oil revenues through state banks to selected firms on special terms on the basis of plan priorities and other non-market considerations. But government intervention has been reduced since 1989, with the role of state banks declining in tandem with falling government oil revenues and limitations imposed on their exposure levels. Moreover, financial liberalization has permitted private banks to compete on equal terms with state banks.

*Taxes on Issuance - Equity*

Like its debt counterpart, new issues of equity are also subject to a host of fees and taxes. Investment banks charge fees that vary from country to country and reflect both the competition for clients in a market and the nature of the risk that they are exposed to as a part of their professional responsibilities. These fees reduce the net proceeds from an issue, as do any taxes imposed by the government. Taxes can also affect net dividend payments to investors, forcing firms to pay higher dividends than they otherwise might. Governments have, in some cases, favored international equity over international debt in the level of taxes imposed upon them. Because equity is permanent and therefore poses fewer potential foreign exchange problems for the central bank, issuance taxes and reserve requirements have not been imposed on international issues of equity to the same extent as they have been on debt.

Price controls on public issues of equity can function as implicit taxes and spur financial innovation. In India, before June 1992, listed companies sold shares under the dictates of the Controller of Capital Issues (CCI), which decided when, at what price and in what volume companies could make public equity issues. The price arrived at was often at a significant discount to quoted market prices, which conferred big capital gains on recipients (at the expense of the company). Partially convertible debentures (PCDs) were designed to minimize this transfer loss. A debenture would be issued, part of which (say 50 percent) would be compulsorily convertible into shares at a predetermined CCI price. The other 50 percent would carry a coupon significantly below market rates. Investors commonly keep the portion convertible into equity and sell the non-convertible part to an investment institution at a discount in order to give the instrument a market rate of interest. By permitting firms to issue bonds at below market rates, this structure enabled firms to recoup part of the loss on selling shares at a discount. With CCI abolished in May 1992 and listed companies free to price their issue, it remains to be seen whether PCDs retain their appeal. It is remarkable that of $11.4 billion of debentures issued by private Indian companies during the five years 1988-92, no less than 84 percent was convertible, or partially convertible.

Public equity issues can have indirect cost effects as well. In Turkey the government promotes public listing of shares by reducing the corporate tax rate as the proportion of shares held publicly increases. The result of this policy is an inordinately high number of listed companies on the Istanbul exchange, but control issues still play an important role and a significant number of the listed shares do not trade publicly.
Risk

Cost alone does not determine capital structure choices. This is because changes in the debt/equity mix change the nature of the firm, as measured by the riskiness of its earnings; and with that the cost of the two sources of financial capital are affected. Consider, for example, a firm that is one hundred percent equity financed. The firm’s earnings are subject to the natural fluctuations that arise from changes in the market place, commonly known as business risk. But as the firm adds more and more debt to its capital structure, it is required to make interest payments regardless of the level of current earnings. If sales dip too much, even temporarily, an over-leveraged firm can be forced into insolvency in spite of its long-term viability.

The risk that debt imposes on a firm is recognized by creditors, shareholders and management. Creditors respond by adjusting the interest rate on firms as leverage increases, or by refusing to lend to firms that are too highly leveraged. In addition, creditors often impose restrictions on debtors that prevent them from issuing additional debt above some well-defined limit, from subordinating their credit to that of others, from making certain investment decisions and from paying dividends.

Leverage also increases the riskiness of equity. As a consequence, shareholders adjust the return that they require from a firm to reflect not only the operating risk of the firm, but the risk implied by the firm’s leverage as well. This adjustment in required return implies a higher cost of equity for firms as they increase leverage, at least above some threshold.

Management’s view on debt is to some extent similar to that of shareholders; after all, management compensation (and reputation) is often directly linked to the level of earnings. But management is in many ways better informed about operations than are shareholders, and this difference in information can alter management’s view of debt. If management is convinced that the firm’s earnings will not be jeopardized by taking on additional debt, they may be able to signal this insider information to shareholders through the issuance of debt. This idea of debt issuance as a signal of firm quality has generated a substantial amount of debate among economists, but the empirical evidence in favor of the theory is rather mixed. In the U.S., studies have found no statistically significant effect of domestic debt issues on equity prices; but in the Eurobond market it has been found that debt issues are associated with significant increases in stock price. No evidence for the emerging markets on debt as a signal of strength is available.

The importance of the risk associated with debt is most apparent in the covenants that creditors require of debtors. Such covenants are often a part of commercial bank lending, where creditors impose restrictions on dividend payout and issuance of new debt in order to protect the quality of the debt that they hold. Public issues of debt also frequently contain restrictions on management and shareholders that limit the riskiness of the debt by subordinating the rights of subsequent issues; interest rates paid on subordinated debt can be substantially greater than those paid on other debt.

While the effects of risk on emerging market capital issues is often tied in with cost, some directly observable evidence is available. For example, in countries where private pension funds play an important role, as in Chile, credit ratings which reflect issuer riskiness are periodically required of all corporate debenture issuers. Such ratings provide information to investors, identify the issues that

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13 Harris and Raviv (1991) review the literature on this and other aspects of capital structure.
qualify for inclusion in institutional portfolios, and play an important role in the market's pricing of the
debt. Of course, investment banks perform similar analyses prior to any issue of either debt or equity,
but the assessment of an independent credit rating firm may be more credible in the market.

After India freed pricing for corporate debentures in August 1991, ratings (by one of the rating
agencies) of all debt instruments exceeding 18 months maturity were made compulsory. Ratings are also
required for any public issue of commercial paper, which under a recent rule can be used to finance up
to 75 percent of a firm's working capital needs. The preoccupation with risk is asserting itself in yet
another way as trade and internal market liberalization proceed (details are available in the Annex). With
both goods and capital markets more competitive, some Indian firms also view their earnings as more
risky now than before and, consequently, the risk posed by highly-leveraged capital structures is unwelcome.14 To offset this, firms have started issuing more equity than previously, something apparent
in Figure 7 below. What is not shown in that figure, however, is that issues of debt also increased, but
that the relative level of equity has increased substantially.

Some developing country firms have been able to circumvent the risk issue through the use of
debt guarantees issued by more creditworthy entities. In Brazil, some issuers of Eurobonds have received
guarantees from major Brazilian banks in order to gain access to a market that otherwise might be closed
to them. In return, the guarantor receives a fee, commonly one percent or more per annum on the
guaranteed amount.

Control and Disclosure

From the outside, firms have a rather impersonal appearance. But on the inside, the personalities
of owners and managers have a strong impact on firm behavior. Struggles over control of the firm are
not infrequent for obvious reasons: with control comes access to the firm's earnings, not to mention
various nonpecuniary benefits. As a result, maintaining control can preoccupy management (or owners
if they are different) whenever capital structure decisions are being made, and the choice between debt
and equity can at times tilt in favor of debt on the basis of control, even when cost considerations would
favor equity.

The most obvious example where control plays an important role in financial decisions is the
typical family-owned business, of which there are many in the emerging markets. Accustomed to having
complete control over all decisions, including compensation, families are quite often reluctant to issue
public shares, even when the cost of equity would be substantially below the cost of debt and when the
issuance of debt might increase the riskiness of the firm. This is particularly remarkable when one
considers that in many countries equity can be issued in nonvoting form, which allows the original owner
to retain control.

Another manner in which the issue of control manifests itself is in the issuance of rights to new
equity. In many countries and companies, any new issues of equity must be made available to existing
shareholders before it can be made available to the public, a practice that permits existing shareholders
to avoid dilution of their voting rights. Of course, existing shareholders can refuse these rights, which

14 Basuwallamanian (1993) documents the rising leverage of Indian companies through the 1980s.
then permits the shares to be sold publicly. The problem is that unless existing shareholders have the capital available to purchase new shares, they may veto suggestions by management to issue new equity in order to preserve their voting power, even if the firm is economically hurt by that decision.

In Indonesia, the desire to protect the interests of small shareholders led BAPEPAM (Indonesia's securities regulatory authority) to issue a rule in 1992 on preemptive rights for existing shareholders. According to this rule, any equity or quasi-equity instrument must first be offered to existing shareholders. Only if they forego their rights can the shares be offered to others. This has affected the issue of Euroconvertible bonds—which were gaining in popularity in 1992—as clarifications are sought from BAPEPAM about whether the conversion option (of the bond into shares) is still feasible. Companies interpret the rule as requiring a convertible bond issue to be preceded with a rights offering to the existing shareholders. This would greatly protract the issuance process and increase the risk borne by underwriters that the market could move substantially by the time a rights issue is approved and the offering period ends. As a result, the issue of Euroconvertibles has temporarily stopped.

Rights issues have played an important role in India. Of the total equity of $6.4 billion issued during the five years 1988-92, no less than 49 percent consisted of rights issues. At the same time, there are many instances of families controlling businesses with small shareholdings, frequently less than 10 percent. This has become a source of concern recently, following substantial liberalization of the Indian stock market. In particular, with foreigners and non-resident Indians allowed to buy up to 24 percent of listed shares, prominent business families have been scrambling to increase their holdings to 26 percent.

Government-imposed restrictions on share ownership by foreigners have been one method for maintaining control in developing countries. Even today, restrictions on share ownership is widespread; in Mexico and Indonesia (and some other countries) foreigners can not control more than 49 percent of the votes of a company; in India the limitation is 24 percent; in Thailand, the level of foreign participation depends on the government's view of an industry's strategic importance, with banking being more important than most other sectors. These share ownership restrictions can have important effects on share price and the cost of equity capital. Restricted shares often sell at significant premia to the unrestricted shares or, alternatively, shares restricted to local investors are underpriced. In order to take advantage of the excess demand for their shares, companies in some countries issue special series of shares without voting rights, sometimes issued or traded in foreign markets in order to attract foreign capital and take advantage of the lower cost of equity capital that the higher prices imply.

Initially, families sought to maintain control by convening an extraordinary meeting of shareholders and obtaining their consent to award preferential allocations of shares to promoters (the original founding families) at throwaway prices. But the Indian financial institutions, which are significant shareholders, objected to this practice in November 1993. Thereupon, some promoters came up with the idea of issuing debentures with warrants attached. These debentures typically carry a below-market interest rate, the discount possible owing to the value of the warrants, which have a conversion price below the market value of the firm's shares. With promoters able to corner the market, they buy the debentures, strip the warrants, sell the stripped debentures at a discount to a financial institution, and convert the warrants into shares at the discounted price. The result is that promoters are able to secure the shares they need to maintain control, but without paying the market price. An alternative instrument that would permit the issuance of equity capital while avoiding any dilution of control is non-voting shares, something for which businessmen have now petitioned the Government.
Some emerging market countries, for example Brazil, limit access by foreigners to the domestic equity market to only qualified institutional investors who must satisfy registration and capitalization requirements before being allowed to purchase equities. In other countries, for example Thailand, entry is limited to shares in country funds that have been structured so as to avoid control issues and to prevent large inflows and outflows of foreign exchange reserves.

At the firm level, fear of loss of control often dominates decisions not to list publicly. With the exception of India, which has more companies listed publicly than any country but the U.S., the number of publicly-listed firms in the emerging markets is relatively small. In Turkey, where there are tax advantages to publicly-listed firms, enough shares are often issued to attain the tax advantage, but a majority of the publicly-listed companies are not publicly traded. Instead, the shares are closely held by a group of shareholders rather than by a single shareholder.

In some emerging markets, the control issue also reflects a fear of disclosing information. Public listing usually entails disclosure of financial information that otherwise would remain confidential. Without disclosure, firms might be better off economically because they are better able to shield earnings from tax collectors, especially when your direct competitors can choose not to issue stock and therefore be at an information advantage. Also important is the view that the public is to be feared and that disclosing information might make family members more susceptible to crimes, such as kidnapping.

In Brazil, control is maintained through the use of preferred shares, which provide no voting rights. Excluding one equity issue associated with the privatization of a utility company, preferred shares represented about two thirds of new shares issued in the first 10 months of 1993, with common shares comprising the remainder. The major attraction of preferred shares for Brazilian firms is their lack of voting rights. The appeal of issuing equity without sacrificing control carries over to other emerging markets as well. In Mexico, for example, central to the boom in the issuance of international equities that has occurred in the last three years is the fact that most of the issues carry no voting rights.

The possibility of diluting existing equity holders’ rights increases in importance as market prices decline. At a point where the ratio of market price to book value is less than one, any new equity issued will be obtained not only at the expense of existing shareholder control, but also at their economic expense since the new shareholders will be buying the firm for less than the accountants say that its assets are worth. This is uncommon, even in emerging markets, but two countries, Brazil and Zimbabwe, currently have price/book value (PBV) ratios less than one. In both of these countries recent declines in PBV ratios have also been associated with declines in new issues of equity. In Zimbabwe, there has been a high correlation between PBV and PE ratios; in Brazil, the correlation between these two measures has been less pronounced, with PBV ratios low even when PE ratios were relatively high.

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16 Book value is the accounting value of total assets minus total liabilities, i.e. net worth, divided by the number of shares outstanding.
IV. Capital Markets and Corporate Finance

In principle, firms have available to them a range of debt and equity instruments which can be used to meet the needs of even the most discriminating issuer. In practice, as already shown, firms in many emerging markets have only a limited menu of instruments, owing both to regulatory constraints that close some markets and economic instability that limit investor interest in others. But the liberal economic programs adopted by so many emerging market governments in recent years are fostering the development of vibrant domestic capital markets. In many cases, firms have, often for the first time, access to medium- and even long-term domestic-currency debt capital, not to mention equity and quasi-equity. Equally impressive is the rapid increase in international access that emerging market firms have to debt and equity capital. As a result, many emerging market firms are finding more and cheaper equity and debt capital than ever before.

This section reviews the type of instruments that are available to emerging market firms and describes the conditions under which they are used. It also illustrates the importance of local and international market conditions in the choice of instrument.

Equity

A menu of equity and quasi-equity instruments have been developed to meet a variety of financial needs. Common equity is, as its name implies, a very commonly used equity instrument, but in some countries firms find preferred equity more attractive because of the limited voting or economic rights that it carries. Preferred shares are, as their name implies, less risky than are common shares and, as a result, should bear a lower cost to the issuer. Moreover, preferred shares can also have limited (or no) voting rights, which drives at the heart of the control issue. As expected, the choice between the two share types involves the cost, risk and control issues already discussed.

Emerging Equity Markets

Emerging equity markets have grown in importance in recent years. Growth in stock market prices has been dramatic, especially in those countries where governments have embarked on liberalization measures, as well as in countries that have experienced rapid economic growth. This is apparent when one looks at either the market capitalization of the emerging markets, or at the number of firms listed in these markets. Both are presented in Figure 5.17

Except for the downturn in 1990, which can be attributed almost entirely to a significant decline in the Taiwanese market, the emerging equity markets have been extremely buoyant over the last decade, with total market capitalization increasing an average of 28 percent a year in U.S. dollar terms compared with only 13.5 percent in the developed equity markets. Such high emerging market growth arises from three sources: the number of firms listed; new issues by listed firms; and price increases. As shown in the graph, the number of firms listed has grown from less than 7,000 in 1983 to more than 13,000 in 1992, an average growth rate of nearly 8 percent. As this is significantly below the total increase in market capitalization, the difference must be due to price increases and/or new equity issues by already listed firms. Information on new issues by listed firms is not readily available, but the IFC emerging

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17 Figure 5 represents all markets included in the IFC Emerging Market Database.
market price index increased an average of 13 percent per annum in U.S. dollar terms over the period 1984-92, an indication of how significant price increases have been in recent years. Given the inverse relationship between stock price and cost of equity, it is not surprising that the number of firms choosing to go public in the emerging markets has been so high.

Despite rapid improvement in the emerging equity markets, however, they are still dwarfed in size by those of the developed countries. For example, the market capitalization of all of the emerging markets combined is only 92 percent of the U.K. equity market. And emerging market capitalization as a percentage of emerging market GDP was only 19 percent in 1992, compared with 60 percent in the developed economies.

Obtaining information on the primary markets for corporate debt and equity securities in emerging markets is not easy. Some information is available, however, and annual primary market activity for both equity and medium- and long-term corporate debt markets for a group of emerging market countries is presented in Figure 6. As the figure shows, both debt and equity markets have grown in importance over the years. Particularly striking is the relative growth in equity issues in the 1990s following two years in which debt dominated. One source for this divergence is the privatization programs that have taken place, especially in some of the Latin American countries in the sample. Argentina, for example, privatized a number of state-owned enterprises over the period 1989-93, which contributed significantly to the equity issues in those years. Those privatizations may have offsetting effects in future years.

The countries included in the graph are: Argentina, Brazil, Chile, India, Indonesia, Turkey and Venezuela.
however, as the privatized companies in Argentina were typically sold stripped of much of their debt, which the government assumed. To the extent that there are cost and control advantages to leverage, one should see debt being issued by these firms as they undergo their future investment programs. In fact, one is already seeing this happening. There have been substantial increases in international issues of debt by Argentine firms, some of which are coming from the recently privatized firms.

**Figure 6. Emerging Primary Markets**

Corporate Debt and Equity

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<thead>
<tr>
<th>Year</th>
<th>Debt</th>
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<td>1987</td>
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<td>1988</td>
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<tr>
<td>1992</td>
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</tbody>
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Country-specific information provides additional insight into the debt/equity choice. Figure 7 presents primary equity market activity over the last decade for India and Venezuela. The figure illustrates at least two points. First, the relative importance of equity can differ significantly across countries. India's GNP of more than $280 billion far exceeds Venezuela's $54 billion, but primary market activity in Venezuela was roughly comparable to India's during several of the years presented. Evidently, different countries have more or less preference for equity, but that preference is obviously affected by cost factors, which introduces the second point. New issues of equity jumped in both countries, but at different times: 1991 for Venezuela and 1992 for India. Both jumps represent relative cost shifts, but for different reasons. In India, the desire to issue new equity was tempered over the years by governmental insistence on pricing new equity according to a formula which apparently did not reward firms much for large movements in market prices; the Bombay market moved up significantly in 1985, as well as in 1988-91 without any large increase in new equity issues. In 1992, however, as part of the government's liberalization measures, new issues were priced according to the market, not by bureaucratic formulae. The result was a substantial decrease in the cost of new equity and a surge in new issues. The Venezuelan story is simpler. Market prices were high in 1986-88 and in 1990-92, and firms responded by issuing more equity, albeit with somewhat of a lag. What remains to be seen is if the Indian market in 1992 represents a new equilibrium level of equity issues, or if it was a one-time affair and if the relative importance of equity in the two countries will go back to its 1980s level.
International Equity Markets

Firms in need of equity are not limited to their domestic markets. By issuing equity (or debt) in foreign markets, especially the most developed markets of Europe and the U.S., emerging market firms gain access to a much larger group of investors than they have in their local markets. In many cases a move into these international markets provides firms with much more capital than they would have access to in their domestic markets, and, to the extent that international investors are better diversified and demand less return for risk, often at a lower cost. Moreover, the competitive pressure of an international issue can reduce the cost of capital at home as well.

For equity issues the most popular instrument among emerging market firms these days is the American Depository Receipt (ADR) or Global Depository Receipt (GDR). Named for the markets in which they trade, these instruments represent claims on shares held in trust by a depository. Issued by the depository, which is often an international bank, the receipts are registered financial instruments in the country in which they trade and can be issued either for existing shares, or as a part of a new equity issue in order to raise capital. Once created, depository receipts continue to exist only as long as they are held by international investors and can flow back into the country of origination when international demand for them subsides.

ADR and GDR are often used interchangeably. Indeed, many issues are done simultaneously in the U.S. and global markets. In other cases, however, only one of the two instruments may exist.
Firms choose to list their shares abroad through depository receipts in order to facilitate access to international investors. Listing of shares directly on foreign exchanges and attracting foreign investors to the firm's domestic market are other options, but depository receipts have advantages both for the issuer and for the investor that sometimes make them preferable. With a depository receipt, the depository is responsible for conversion of dividends into foreign exchange and for the distribution of dividends and financial statements to investors. In addition, unlike foreign investment in a firm's domestic equity market, because the depository receipts are registered securities in the market in which they trade, settlement is facilitated and restrictions that some institutional investors face on holdings of foreign securities can be avoided. Thus, depository receipts provide a convenient means for increasing a firm's shareholder base.

Furthermore, depository receipts can legally be created without the sponsorship of the firm whose shares are being traded. Un-sponsored ADRs exist for a number of emerging market firms, but they are a distinct minority. Sponsored ADRs require that the sponsor pay fees to the depository, but in return the depository provides services that contribute to the success of the ADR.

The importance of the cross-border market, which comprises both types of depository receipts, has increased dramatically in recent years. Figure 8 presents aggregate annual statistics for the market, and also identifies the major issuing countries for each year. The entry of different countries into the market corresponds to changing market conditions, especially the implications of government economic programs and, in the case of Argentina and Mexico, resolution of international debt problems which allowed those countries renewed access to the markets. The growth in the cross-border market has been especially significant for Mexico, which dominated the market in each of the last three years.

In the U.S. market, all publicly-traded shares must be registered with the U.S. Securities and Exchange Commission (SEC), which requires issuers to report periodically financial information compiled according to U.S. accounting standards, something that adds to the cost of any foreign equity issue. Shares listed on exchanges must also meet exchange listing requirements, but some firms elect to have their shares traded in the over-the-counter market (OTC), which reduces reporting requirements somewhat. The OTC market, however, has a major drawback as well: few of its shares receive the public notice that is offered by listing on a major exchange. For this reason, firms sometimes consider the OTC market as a first step into the U.S. market before undergoing the more formal process of listing on an exchange.

In a 1990 move that further increased the options available to foreign issuers, the U.S. relaxed requirements on issues traded exclusively among qualified institutional buyers. Under the assumption that institutions are better able to assess risk than private investors, firms whose shares are traded in the 144A market, named after the regulation that created it, are not required to disclose as much information to the SEC (and hence to shareholders) as do publicly-traded firms. These reduced disclosure requirements are appealing to many emerging market issuers who find the costs associated with disclosure onerous or who are reluctant to make some information public.

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20 The graph includes only equity issued by private companies; no issues by state-owned enterprises are included. Thus, Argentina's state oil company, YPF, which was privatized in 1993 through a combination of a local market offer and an ADR offering earning $3 billion in the process, is not included.
Both the over-the-counter and 144A markets have been attractive to emerging market issuers. In Mexico, for example, of 36 cross-border issues traded in 1992, 42 percent were traded in the OTC market and one third were traded in the 144A market, leaving just 25 percent of the issues listed on exchanges. By year-end 1993 the situation had changed in total number of issues, but not in the relative importance of the exchanges; similar patterns are evident in other emerging market countries. One hypothesis is that the number of listed shares will increase over time as the issuers become more sophisticated, but at this time it still appears that the marginal cost of listing on a major exchange outweighs the advantage that it generates for a majority of Mexican (and most emerging market) firms.

The decision to issue a depository receipt is not necessarily equivalent to raising new equity capital. Firms can choose to list existing shares in the foreign market. In this way, they gain access to a larger body of investors, which may increase the value of their equity. Ultimately, of course, most firms that choose this route expect to raise new equity in the foreign market at a future date, but decide to wait for some time in order to gain the attention of international investors before issuing new capital. In some cases, however, governments have intervened in order to prevent this seemingly logical progression. Chilean firms, for example, can go to the international markets only with new issues of equity; the trading of existing shares is prohibited.
Debt

While domestic equity markets have long been important in many developing countries, the development of medium- and long-term corporate debt markets is much more recent. One reason for this may be the lack of a network of institutional investors in such countries. Retail investors are willing to buy equities, which offer significant upside potential, but corporate debt often offers little advantage over government debt. Without well established institutional investors, such as pension funds, an active medium- or long-term corporate debt market might be difficult to establish.

Emerging Corporate Debt Markets

Information on the primary market for corporate debt in the emerging markets is limited. Figure 6 showed that the market has grown in recent years, but has fallen behind the equity market in importance. This trend most likely reflects the relative costs of debt and equity. As noted, increases in equity prices have reduced its cost, while real interest rates are up in many countries. The rise in equity price partly reflects the interest of international investors in emerging market equity.

Figure 9 shows primary debt issues for India and Venezuela, for which equity market activity was depicted earlier in Figure 7. Unlike equity, the debt market was substantially larger in India than in Venezuela over most of the period. There was a significant increase in Indian market activity beginning in 1986, ascribed to a more lenient attitude towards corporate fund raising by the Government. Further, much of the debt issued was in the form of partially convertible debentures, which (as explained earlier) were designed to enable firms to recoup part of the loss from equity price controls. Interestingly, the surge in debt coincided with the rise in the stock market noted earlier. In Venezuela the ups and downs in the market reflect a number of factors, including the current level of interest rates and the overall demand for investment capital by firms.
Parallel with development of the international market for emerging market equity, an international market for emerging market corporate debt developed both for debentures and convertibles. For the most part, this market is a part of the larger Euromarkets, but some issuers have participated in the debt side of the U.S. 144A market, and for firms from countries that are investment grade, access to the U.S. Yankee bond market, with its lower rates and longer maturities, is a possibility. As with the equity market, international issues of corporate bonds from the emerging markets have surged in recent years, as presented in Figure 10. The attraction of the international debt markets are the lower interest rates and longer maturities available there compared to the domestic markets of most emerging market countries. As with the equity market, growth in the debt market has followed international debt restructuring programs with the major debtor nations. Also like the equity markets, Mexico and Argentina have come to play significant roles in the debt market. Unlike cross-border equity issues, Brazil has tapped the cross-border debt market for large amounts, reflecting both the conservative nature of the capital structures of Brazilian firms, as well as the relatively low price level of the domestic equity market.

Case Study: India - Euroconvertible Bonds and Global Deposit Receipts (GDRs)

Indian companies were first permitted to tap the Euromarket in 1992. Between May 1992 and November 1993, 9 companies raised close to $1 billion in this market. Companies have been drawn overseas because the volumes that can be raised are higher while issuance costs at 2 to 3 percent of proceeds are substantially lower than comparable rupee issues. Achieving name recognition overseas is another important benefit. And the prevalent view is that Indian real interest rates are too high. Foreign
investors are drawn to these issues attracted by high yields compared to alternatives in the West and the expectation of significant capital gains.

Potential instruments include syndicated bank loans; Yankee or high-yield bonds; and GDRs and Euroconvertible bonds. Bank loans are ruled out over concern about exposure to India. India not yet being investment grade, Yankee bonds are infeasible, while high-yield bonds are considered too expensive. The strategy with GDRs and Euroconvertibles is to place these with groups that are chasing high yields and have low exposure to India, such as emerging market funds and various foreign institutional investors. Compared to Western issues, the size of these issues is small enough to allow them to be placed during the roadshow, which also lowers issuance costs. The job of signalling that the companies have a better grade than the sovereign rating is left to the lead manager, who not only complies with the due diligence requirements (disclosure, conformity with UK accounting principles, listing requirements in Luxembourg - the place of choice), but also promotes the issue. How do companies and lead managers signal that a given company is a better-than-sovereign risk? This is a tricky issue because of the trade liberalization that is in progress and lack of clarity about how corporate fortunes will look when the dust settles. The response is that lead managers market the issue by drawing comparisons from similar situations in other countries and by concentrating on the big firms, which they believe will be bailed out in case of difficulty.

The choice between GDRs, which amount to a new equity issue, and Euroconvertible bonds, a quasi equity instrument, is left to the company. The following are the main considerations: (a) GDRs are often issued at a substantial discount to existing quoted prices to compensate for risk and the settlement delay in case GDRs are redeemed. The first two GDRs, by Reliance and Grasim, were both issued at a discount of 18 percent; but the conversion price for Euroconvertibles is much closer to the quoted price; (b) Euroconvertibles avoid immediate dilution and carry low nominal coupons because of the conversion option. As a result, companies like them; (c) foreign investors like Euroconvertibles because there is limited downside risk through put options that guarantee a minimum rate of return.

Companies must obtain permission for international issues from the Ministry of Finance (MOF) and the Reserve Bank of India. Being the first, the Reliance GDR took some four months from conceptualization to the realization of proceeds. Subsequent issues have been much faster. The money raised is typically for the foreign exchange component of expansion projects, although Reliance went overseas to pay off foreign debt with its GDR issue proceeds. MOF recently indicated that it might put restrictions on overseas transactions designed purely for treasury purposes (for example, hedging or raising funds and keeping these offshore).

A number of different lead managers have been used by the various companies. For the first nine Euro issues, no fewer than five different lead managers were used.

- **Global Depository Receipts (GDRs):** Following the pioneering issue of GDRs by the Reliance group in May 1992 for $150 million, five subsequent issues have been done up to November 1993 for a total of close to $500 million. GDRs are basically an instrument for issuing equity overseas. The following parties are typically involved: issuing company; overseas depository bank; a local agent of the depository bank; investors; and a lead manager.

- **Euroconvertible Bonds:** Essar Gujarat, a steel company, was the first to issue a Euroconvertible bond, for $75 million. The liberalization affected Essar in two basic ways: first, with steel delicensed, the company decided to increase its investment outlay; second, with the free pricing
of equity introduced, it decided to go for a debt/equity ratio of 0.65 compared to an original target of 2.5! Further, the Euroconvertible bond itself was chosen (after the option became feasible) to lower borrowing from the Indian term-lending institutions, because their interest rates were regarded as high.

The bond has a 5-year maturity, a coupon of 5.5 percent and involved issuance costs of 3.5 percent. The conversion price was at a premium of about 1.5 percent over the market price of the share at the time the bond was issued in July 1993. The conversion option commences one month after issue. The bond can be called at any time after two years if the rupee price of the share exceeds the conversion price by 40 percent and the closing share price in dollars exceeds the dollar conversion price by 30 percent. The bondholders have a one-time put option (at par) at the end of the third year.

Companies are generally pleased with the pricing they have obtained on Euroconvertibles. A few months after Essar issued its bond, SCICI (a company financing ship purchases, but rapidly diversifying into other activities as well) issued its Euroconvertible with a conversion price premium of close to 7.5 percent. This is a $100 million issue with maturity of 10 years and five months, and a coupon of 3.5 percent. Conversion can take place anytime three months after issue. The bond can be called anytime after 5 years and five months if the share price exceeds the conversion price by 40 percent (in rupees and dollars). There is also a one-time put option after 5 years and five months whereby the investor can obtain a yield-to-put of 5.65 percent.

The SCICI issue was oversubscribed 10 times compared to 4 to 5 times for Essar, attesting to the growing popularity of this instrument among investors and the potential volume of funds that can be raised. It is difficult to directly compare the pricing of the bonds and conclude which one is "better", because the value of the conversion option is very different (depending upon the prospects of the company) and the call and put options may be structured differently.

Pricing of Euroconvertible bonds is based on market demand rather than mathematical models. The basic intuition is that in return for the lower interest rate, the investor would like a conversion option, which is a gamble on share price appreciation. Further, put options, which are typically part of the package, minimize downside risk for investors. Similarly, companies that issue Euroconvertible bonds are banking on eventual conversion.

Lastly, there are indications that even medium-sized companies can approach the Euromarket. Bharat Forge, not large by international standards, was able to do a Euro-issue for only SFR 20 million (about $14 million). Indications are that second-tier companies are already being approached for Euro-issues, a major attraction being low issuance costs compared to rupee issues.
V. A Pecking Order

All companies actively seek financing instruments that will minimize the cost of capital, thereby enhancing returns to shareholders. The notion of optimality in capital structure is related to the choice of a financing mix that makes the weighted average cost of capital as low as possible. In the theoretical world of corporate finance, this choice is made in an environment where capital markets work perfectly and interest rates and share prices are freely determined, a description that applies in large part to many Western economies. In such circumstances, how do companies choose between internal and external funds on the one hand and between debt and equity on the other? The so-called "pecking order" theory posits that firms choose the following sequence: first, rely on retained earnings, then issue debt and lastly, issue new equity. The reasons given for this sequencing stem from differences in information between company insiders and outsiders and transactions costs. For example, if existing shareholders believe that the market is going to undervalue new equity, then they would be reluctant to issue new shares. Likewise, if the transaction costs of securing debt are lower than those associated with issuing shares, then this would also be a deterrent to equity financing.

Interestingly enough, the pecking order theory may work quite well with developing country firms in that debt may be preferred to equity, even though markets may not function freely. There are four reasons for expecting this. First, with interest rates administratively set, the after-tax real cost of debt may be negative, creating a bias towards debt. Second, there may be restrictions on the issue price of new equity that function effectively as a tax on issuing shares. Third, with limited competition among investment banks, issuance costs may be very high, making bank loans a far cheaper alternative. Fourth, with the government directing credit through DFCs, there may be a predisposition towards debt.

With the financial liberalizations that have been underway in the late 1980s and 1990s, however, companies may begin re-examining their financial structure. They now have a richer and less constrained menu of instruments to choose from (in terms of pricing), as the example below illustrates.

Case Study: An Indonesian Pecking Order

Indonesian companies first rely on internal funds and state bank loans, then private and foreign banks, then list on the Jakarta Stock Exchange (JSE) and lastly, go overseas. The pressure to list and go public is growing as the role of state banks goes down in tandem with declining oil revenues (see Country Annex). At the margin, non-state bank sources, including private and foreign banks, equity and direct access to foreign capital markets are becoming more important; but the role of state banks is still large in absolute terms. In particular, for small companies, the major sources of funding continue to be existing shareholder funds, retained earnings and bank loans.

The impression picked up from interviews is that the focus is much more on the volume than the cost of funds. Companies are expanding rapidly and rates of return are very high. The concern is much more with profit potential and market share. Beyond a point, however, companies may be forced to list to both expand the sources and lower the cost of funding. There is a tendency to regard existing equity as "free" and to measure its cost by the dividend yield alone. As companies get established, it becomes easier to borrow in foreign currency, which is stimulated by the belief that rupiah interest rates have

always been too high (in comparison to dollar interest rates plus expected depreciation). If companies wish to gain direct access to the international capital markets, then they have to go through a rigorous process of disclosure to satisfy listing requirements abroad. At this point, it will usually be the case that companies have already been through the listing process on the JSE. Once companies go public, they will be increasingly subject to the scrutiny of banks, foreign investors and brokers. At this stage, business intrinsics and the debt-equity ratio become extremely important.

**An Example:** This company, belonging to a well-known business group, has had its own "pecking order" in sourcing funds. It started in classical fashion with internal funds and state bank loans. It went public during the 1990 stock market boom, doing a 100 percent listing. The initial public offering (IPO) proceeds were partly used to pay off state bank loans. The rest was kept for use in connection with the company's long-term business plan, which involves a new rayon plant and an expansion in its existing market-pulp business. After the expansion is complete, the pulp/rayon mix is expected to be 60/40. The total expansion cost is $250 million, of which $100m will come from the balance of the IPO proceeds and retained earnings. The remainder has come from issuing new long-term debt.

The company has made a calculated decision to go for long maturity US dollar and Swiss franc convertible bonds to raise the $150 million. The desire for long-term debt was motivated by the observation that the pulp business is cyclical. And convertible bonds gave the company the best pricing. The company is betting that inflation will remain low and that there will be no maxi-devaluation, the last one having occurred in 1986. Fixed rate rupiah funding for the same maturities is simply not available.

The typical structure of the convertible bonds is illustrated by the US dollar bond, which was issued in late 1992 with a maturity of 10 years. It carries a coupon of 5 1/2 percent. The investor can convert to shares at any time at a pre-determined price. The price used for determining the number of shares for conversion was set at the time of issue at a premium of 9 percent over the prevailing quoted price. At the end of 5 years, the investors have a one-month window to put the bond back to the company with a yield-to-put of 9 percent. The company expects market pulp prices to peak in five years' time and is betting that stock prices will have risen sufficiently that conversion will take place.

The company also recently did a high-yield US dollar bond issue of 7 year maturity of amount $110 million, with an option to call the bond at a small premium between years 5 and 6 and at par thereafter. Including underwriting fees of 2.5 percent, the all-in-cost is about 10 percent. In order to issue this bond, the company went through a rating process and secured a BB, which places it below investment grade. This ruled out a private placement or a "Yankee" bond, both of which require investment grade. The company therefore chose a high-yield, non-investment grade bond, which is US SEC registered and requires maximum disclosure (as compared to a private placement or 144A). Anyone can buy this bond. The company plans to use this issue as a stepping stone to a NYSE-listed ADR. It already has an ADR traded in the OTC market.

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22 For example, if the face value of a bond is $1000, the rupiah/dollar rate is 2000 and the price of the company's share at the time of issue is 5000 rupiah, each bond will be convertible into \((1000 \times 2000)/5000 \times 1.09 = 367\) shares if a 9 percent premium applies.
VI. Conclusions

Developing country firms have the same objective as their advanced country counterparts; to minimize the cost of capital given the financial instruments available. But the environment in which these firms operate often differs dramatically from what is found in most developed countries.

The capital markets of most developing countries are only now emerging to fully serve the needs of issuers. State banks and development finance companies have traditionally been the prominent lenders, often not operating on commercial principles. Government controls have in the past limited, and in many cases continue to limit, the potential list and pricing of capital market instruments. And access to international markets has been constrained both by controls and by sovereign credit ratings that may be below investment grade, overshadowing the true potential of the private sector. As a result, developing country firms have faced much more constrained choices than their developed country counterparts. Thus, the observed "pecking order" in the funding decisions of firms in developing countries is likely to reflect the extent and sequence of financial liberalization chosen by the government.

But financing decisions go beyond cost considerations. Risk, control and disclosure also have an impact. While family-owned businesses have played a dominant role in the past, as markets develop and stock prices increase, more and more firms are going public, despite the potential control problems and disclosure that this entails. The alternative, issuing corporate debt, is also popular, but only for firms with healthy balance sheets that can absorb the risk involved.

The 1990s are fast becoming a watershed in corporate finance, with significant financial liberalization under way in several emerging markets. This is reflected in a number of interesting empirical regularities that show up in the country reports presented in the Annex, summarized here.

First, in many instances, financial liberalization has been spurred by actual or anticipated foreign debt and balance of payments crises, and/or a realization that traditional funding sources may not be sustainable in the long run.

Second, governments have consciously begun limiting the role of state banks and DFCs either by phasing out special guarantees that enable cheap acquisition of funds, or curtailing their operations in various ways. Freeing corporate finance has meant that the larger, more creditworthy companies, the traditional clients of the banking system, will increasingly be self-reliant. This is likely to lead DFCs to direct their financial expertise towards small and medium-sized enterprises and more risky companies.

Third, in many cases, large spreads in the banking system as a result of inefficiency or bad loans are spurring companies to issue commercial paper for working capital and bonds for long-term finance.

Fourth, financial liberalization is being accompanied by trade liberalization, which is bound to affect the competitiveness, and hence the risk class, of many established companies. Such liberalization is also affecting corporate business strategy, for example, a focus on scale economies and the core business in India in contrast to haphazard, license-driven diversification.

Fifth, foreign institutional investors and private mutual funds have arrived, inevitably implying greater pressure for more disclosure, improved accounting standards and rational financial regulation.
And lastly, the interest in emerging markets poses an interesting question. To what extent is this a temporary "flavor-of-the-month" phenomenon in response to low yields and recession in the West? What will happen when the economic slump in OECD countries is replaced by growth? Our hunch is that interest in emerging markets will continue for three reasons: first, growth rates in the emerging markets surpass those of most of the developed countries, giving emerging markets higher potential returns; second, low correlations between emerging markets and the rest of the world suggest that there are substantial diversification benefits from investing in these markets; and third, the percentage of assets invested by Western institutional investors in emerging markets is still relatively small. Total equity assets managed by U.S. institutional investors alone was $2,018 billion in 1991 and has grown at the rate of 14.5 percent per annum over the last decade. Gross portfolio capital flows to the emerging markets on the other hand was equal to $34 billion in 1992, less than 2 percent of the U.S. portfolio. Evidently, there is still some way to go before international investors have their fill of emerging market assets.

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23 World Bank (1993a) and Gooptu (1993).
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Country Reports

Argentina 33
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Note: These country reports were prepared on the basis of visits that occurred in late 1993 and reflect conditions as represented to us at that time.
Argentina

Prior to 1991, capital market activity in Argentina was limited owing to macroeconomic instability and the regulatory environment. Investment levels were also low and so firms were able to finance much of their operations from retained earnings and what short-term bank financing that was available. Access to international capital was practically nonexistent, and the domestic capital markets were not well developed. In addition, the government discouraged the issuance of securities through a stamp tax on financial instruments.

The Convertibility Law of 1991 changed the macroeconomic environment by ushering in an era of stability. At the same time, the government embarked on a series of other reform measures which would have important effects on corporate financial decisions. One such reform was the elimination in 1991 of the stamp tax on financial transactions, thereby reducing the cost of issuing securities. Other reforms gave international investors the same legal status as domestic investors, which increased the pool of savings available to potential issuers. Finally, privatization of a large part of the publicly-owned companies provided impetus to the development of the local capital markets and generated a great deal of international interest in the country's private sector.

The result has been a rather dramatic change in the way Argentine firms behave and finance themselves. Investment levels have increased (somewhat), and with that the need for additional external finance has grown. In the domestic market this has been followed by the issuance of increasing amounts of both corporate debentures and equity. In addition, the reform program (and subsequent Brady Plan deal with the country's international creditors) has also allowed the Argentine private sector increasing access to international capital markets. Figure A-1 shows recent activity by private Argentine issuers in both the domestic and international markets for both corporate debentures and equity.

Figure A-1. Argentina: Primary Market
Corporate Debentures and Eurobond Markets

Legislation allowing the issuance of corporate debt was passed in 1989. However, up until 1991, market development was limited owing to macroeconomic conditions. Following Convertibility the market started to open, exhibiting steady growth from a total of $41 million in 1989 to more than $4 billion in the first eleven months of 1993. These figures consist of issues from two quite different markets: the domestic and international markets for Argentine corporate debt. Despite the strong interest by issuers in the Euromarket, most issues are registered in the Argentine market (with the Comision Nacional de Valores, CNV) prior to issuance abroad. In some cases issuance occurs in both domestic and international markets, in other cases only abroad. The reason for CNV registration is that it eliminates the 12 percent withholding tax that would otherwise increase the cost on international issues. Despite this tax, some international issues occur without registration because of the time required to register. Given the importance of CNV registration, one should interpret the statistics for the domestic debt market with caution; most of the domestic issues were actually placed internationally and are contained in the statistics for the international primary debt market.

Maturities are at best medium term and depend on the creditworthiness of the issuer; dollar-denominated paper can carry longer maturities than peso-denominated paper. Dollar-denominated credit is also much cheaper in Argentina than is peso-denominated credit; one year loans carry a dollar rate of about 18 percent per annum, whereas a peso-denominated loan would carry a rate of roughly 35 percent. Consequently, issuers prefer the dollar market, despite the implied exchange risk. Rates can be either floating or fixed, with floating rates linked to LIBOR. Interest payments are tax deductible.

Since early 1992, in an attempt to improve the information available to investors, issuers are required to have two credit ratings. These are performed by independent rating agencies at a cost of about $20-25K/year for a total of $40-50K/year; issuers are required to be rated every six months. Rating involves standard accounting and economic analysis and results in a rating from AAA (the best) to BBB (investment grade) to sub-investment ratings. At this time, the importance of the ratings is limited to information, but their importance will increase substantially in 1994 following privatization of the pension fund system. At that time, the rating will play an important role in determining the eligibility of corporate debt paper for the pension funds.

In order to reduce registration costs and streamline issuance procedures, the CNV now allows medium-term-note facilities, that is, shelf registration. This permits a series of (medium-term) notes to be issued under a single registration, provided they conform to the terms of the registration, which includes total amount and a final issue date. An example is Acindar, which did the first of these facilities in February 1993. That facility was for a total of $200 million over a five year period, with issues of from 31 days to 5 years. Issues can be done in pesos or foreign currencies at floating rates. The facilities reduce issuance costs by eliminating paperwork and also permit companies to take advantage of favorable market conditions.

Most issuers place their paper in the Eurobond market rather than the domestic market because no institutional investor market has yet developed in Argentina. This lack of liquidity should change with the development of private pension funds, but at this time the ability of the domestic market to absorb corporate paper is limited. Within the Euromarket, in some cases Euroissues have been privately placed, which in addition to reducing issuance costs, has allowed lower interest rates to be obtained. Some issuers have also used the U.S. 144A market, which targets institutional investors.
Much of the activity in the Euromarket has been on the part of banks. For example, of the $1.9 billion raised through corporate debentures in 1992, $620 million (33 percent) was raised by banks. Apparently, some of this money has been used by the issuers to lend (in dollars) in the domestic market in the form of private home mortgages, which were not previously available.

Commercial Paper

Short-term working capital can be financed using commercial paper, which is available for terms of up to one year. This paper is sold to local banks, without registration with the CNV. As with debentures, issues can be in either dollars or pesos, with the terms depending on the currency and the issuer. For the dollar paper, the Argentine banks then resell the paper abroad to their affiliates in the Bahamas or Cayman Islands, who finance their activities in the international markets.

Some Euro-Commercial paper has been issued, but access to the U.S. commercial paper market is limited to investment grade issuers, of which Argentina has none.

Equity

The primary market for new equity in Argentina has been somewhat more volatile than has the market for corporate debt. Following Convertibility and the introduction of the government's privatization program, $2.7 billion in equity was issued in 1991, followed by $350 million in 1992 and more than $3.9 billion in 1993.3

This volatility in issue amounts reflects both the precipitous fall in the domestic stock market in 1992, which cooled the demand for new equity by firms, as well as the timing of the government's privatization program. Issues of new equity have followed the market. Prior to the surge in 1991, stocks were trading at below book value, which eliminated the incentive to issue new equity, at least publicly. When prices were up in 1991 and early 1992, rights issues were a preferred form of financing among publicly-listed companies. Now, debt has gained in importance following the market's collapse. When the market was high, one also saw some interest on the part of issuers in debt with conversion features as a perceived way of reducing the cost of debt. That interest in conversion features is now returning following the revival of the equity market and the prospect of further price increases.

Issuance of equity in the domestic market is still limited, apparently for three related factors. First, many Argentine companies remain family-owned businesses with no interest in going public. Their refusal to issue publicly-held equity is based on a fear that they will lose control and be forced to disclose what is believed to be personal information. Second, investment needs in Argentina (except possibly in the recently-privatized companies) are still low, allowing most investment plans to be met with internally-generated funds. And, third, many issuers (and investors) do not believe that the CNV is doing a good job of regulating the market, which makes issuance of equity less attractive since it is viewed as increasing its cost.

There are some industries in which issuance of equity is determined by external factors. For example, one Argentine bank wanted to issue equity in order to both grow and meet regulatory

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3Privatizations are not included in the international statistics presented in Figure 1. This is especially significant in 1993, when the privatization of YPF alone earned more than $3 billion.
restrictions on balance sheet ratios. The bank felt that the international market was the most attractive source of equity. After analyzing the market, the bank's management was ready to issue an ADR, but then was told by the Central Bank that foreign holdings in excess of thirty percent of their shares would force the bank to be reclassified as foreign. Theoretically, foreign banks are not discriminated against in Argentina, but in practical terms this designation probably would have excluded the bank from some of the privatization work that it subsequently did. As a result, management decided against the ADR and made a domestic rights issue, which has been successful. In the placement of these rights, management permitted foreigners to purchase only fifteen percent of the total. Of course, management has no control over the secondary market for shares and if Argentine shareholders choose to sell to foreign investors, the bank could end up with a large foreign shareholder base and be classified as foreign in spite of management's efforts.

Registration with the CNV is required for all equity issues. The registration process was somewhat cumbersome in the past, but has improved recently; registration can now be accomplished in about forty-five days.

International Equity Market (ADR)

Most Argentine issuers of ADRs have been at level 1: trading of existing shares on the over-the-counter market. ADRs are viewed as a marketing tool that gains companies access to international institutional investors, although a large part of their internationally-held shares are held as Argentine shares directly, not as ADRs. Some issuers also start at level 1 in order to begin the process of meeting SEC requirements for future issues of new equity or debt abroad.

Argentine activity in the ADR market has been limited in the number of companies involved, but the nature of those companies has meant that the issue amounts have been large by emerging market standards. The market was initiated in 1991 with the privatization of telecommunications and the issuance of $360 million in ADRs. That was followed by further privatizations in 1992 and the first New York Stock Exchange listing by an Argentine company—BAESA—with total issues in that year equal to $392 million. The market surged ahead in 1993 with the privatization of YPF, the state-owned oil company, which contributed the lion’s share of the $2.7 billion raised.

Moving from a level 1 ADR to a listing on a U.S. exchange (level 2) or simultaneously listing and issuing new equity (level 3) requires that the company maintain its accounts according to U.S. GAAP. In the past, this would have been a problem for Argentine companies, but now, with Convertibility, most companies do not see this as an obstacle.

Cost of Funds

The Argentine view on the cost of debt financing is simple; it is the after-tax interest cost. Equity financing is slightly more complicated. When calculating the cost of equity, some firms consider only the dividend payments that they make, i.e. the dividend yield, as the total cost of equity. Other firms, in some cases those with U.S. business school-educated finance managers, also try to incorporate the capital gains that shareholders expect into their calculation. This is done by estimating an expected growth rate. The alternative of using P/E ratios is viewed as unreasonable because the market is too volatile.
Not all companies consider the cost of funds to be the most important element in the financing decision. In some cases, a decision to issue an ADR or a certain type of debt instrument is made in order to market the company to international investors so that future financing will be less expensive. In general, however, the Argentines believe that the cost of capital is lower abroad.

Financing Strategies

Following the stabilization that has come with the Convertibility Law, Argentine companies find themselves in one of two situations:

- **Privatized Firms:** Those firms that were recently privatized were usually sold with very low levels of debt. Consequently, any investment plans that they have will most likely be financed using some form of debt. These firms apparently believe that increasing leverage will lower their cost of financing.

- The remaining firms are also in need of new credit, but more in order to replace existing short-term credit. For these companies, there are two main considerations in this restructuring exercise. First, in most cases there is an existing majority shareholder and any equity issues must preserve that majority position. Second, many companies came out of the 1980s with unattractive balance sheets. Consequently, they are in the process of restructuring, which should make them more presentable, especially to international investors.
Brazil

After the decade of the 1980s, during which Brazil went through a sovereign debt crisis, high inflation and low levels of growth, the Brazilian private sector entered the 1990s with balance sheets that contained, in many cases, real assets used to hedge inflation but which were not used in the production process, for example real estate, and working capital financed by expensive short-term local-currency financing. With the high government borrowing requirements and a Central Bank decision to run a tight monetary policy, financing costs have risen and companies are scrambling to find ways in which to decrease their financing costs and to reduce their working capital needs.

Restructuring has been the keyword so far in the 1990s. That entails two complementary strategies: reducing debt by liquidating unproductive assets; and replacing short-term expensive bank debt with medium-term capital raised in either the local or, increasingly, the international capital markets. That restructuring is being accomplished through the use of both debt and equity, and through both the domestic and international capital markets.

Restructuring is particularly important for those sectors of the economy that have not had access to the long-term financing available through the government-owned development bank. Based on its own views of a sector's importance in economic development terms, the government's development bank provides relatively low-cost long-term financing. Aside from this source, comparable financing in Brazil has been practically nonexistent. As a result, for companies not included in the government-targeted sectors, the opening of the international markets and increasing activity in the domestic market can substantially change the resources available to them.

The lack of long-term financing generally can be attributed to two factors which are closely related: economic instability and a lack of long-term savings. As a result, only offshore funds are long-term in nature. The major change that is taking place in Brazil now is that access to those offshore funds to the private sector is increasing. Previously, only the government and state-owned entities had access.

Figure A-2 presents statistics on primary market activity by the Brazilian private sector in recent years. Included in the figure is activity in both the domestic and foreign markets for equity corporate debentures and convertibles. Discussion of trends and developments is provided in the following sections.

Corporate Debentures

The economic recession has taken its toll on the corporate debenture market, with issues declining substantially in three of the last four years. Following decreases in 1990-1992, Not shown in the figure, is the increase that has occurred in 1993, following substantial improvement in economic growth. The earlier boom in 1988 is almost entirely due to a single issue by one of the large state-owned companies. Prior to that, activity in the market was limited for much of the early 1980s.

The domestic corporate debentures market has been active for a number of years. The market provides issuers with medium-term credit instruments in either cruzeiros, or on a dollar-indexed basis. Terms depend on the type of instrument issued, with cruzeiro paper maturities commonly set at three years, but with the interest rates indexed to inflation and renegotiated approximately every six months; failure to reach agreement on the terms at time of renegotiation will force issuers to repay the creditors. Dollar-indexed paper can carry somewhat longer maturities, more like five years, and renegotiation of
the terms occurs less frequently, perhaps every two years. In both cases, however, rates are high in real terms, with cruzeiro rates of 25 percent or more being common, whereas dollar-indexed rates are about half that. Competition among local investment banks is intense, so issuance costs are not high. Government approval of new issues is routine, except when the issue introduces an innovation to the market.

One interesting aspect of the domestic debentures market in Brazil is that, as financial instruments approved and registered by the Comissao de Valores Mobiliarios (which regulates the local capital markets), they are not subject to the tax charged against bank loans. Consequently, debenture issuers can take advantage of this tax break to lower their cost of what might otherwise be short-term bank financing by registering the debentures and then holding them in treasury until short-term working capital is needed. At that time, the debentures can be issued to banks, with an agreement for repurchase in, say, ten days. These repurchase agreements will carry a market-determined interest rate which may differ from the face rate on the paper, but which is favorable to the issuer owing to the tax avoidance that they permit. In addition, issuers who have registered-but-unused debentures in their treasury can lend them to other companies, at a cost, so that they too can profit from the tax advantage that the debentures provide. For these reasons, as well as the medium-term credit that they provide, corporate debentures are popular in Brazil.
In comparison to the market for straight debentures, the market for convertible debentures has been less active. With the potential for capital gains if stock prices increase, interest rates are somewhat lower on these convertibles, making them attractive for issuers. Unfortunately, the stock market has not been priced very attractively from the issuer's perspective, with price/book value ratios averaging well below one. When this is the case, new equity would dilute the value of existing shareholders. For that reason, convertible debentures represented only 9 percent of all corporate debentures issued in the first ten months of 1993. With higher stock prices or the belief that profitability will increase, one should expect to see more activity in the convertibles market in the future.

One factor which has discouraged the use of corporate debentures is the lack of any formal independent rating process. Unlike some other countries where an independent credit rating is required before government approval is given on new issues of debt, Brazil has no such requirement. Consequently, investors are left to their own devices and must depend on company-provided information when assessing the riskiness of an issue. This lack of a formal rating system limits the attractiveness of these instruments for unsophisticated investors.

**Eurobonds**

Growth in the Eurobond market has been phenomenal. Beginning with the first Brazilian issues in mid-1991, which were state-owned enterprises, Brazilian issues by private sector firms increased from $3555 million in (late) 1991 to more than $2.6 billion in 1992. The increased demand continues in 1993, with issues totalling more than $4.8 billion.

Access to the Eurobond market by Brazilian issuers is still very sensitive to international perceptions of the country risk involved. For example, following the opening of the market in 1991, 1992 started with a significant inflow of funds. When the corruption allegations against then-president Collor became serious, the market fell significantly in the second half of the year.

Aside from the state-owned enterprises, the Brazilian Eurobond market has been dominated by banks, who have issued more than $5 billion in Eurobonds since the market opened in 1991, out of a total of $7.8 billion. Much of this capital is being used by the banks to provide credit to their Brazilian clients who themselves do not have direct access to the market. This onlending of dollar-denominated credit exposes the final borrower to currency risk in those companies where they have no dollar-denominated export operations. Despite this, the terms are sufficiently attractive that, so far, demand is strong for the credit.

The motivations for going to the international market for debt financing are three. First, there is the lower cost available in the international market, even compared to the dollar-indexed financing available domestically. Second, as discussed, many companies are in the process of restructuring their balance sheets and the maturities available in the international market exceed those available locally, especially when one considers the renegotiations that are required on even dollar-indexed debentures in the domestic market. And third, the larger and better-known companies believe that gaining exposure to international investors will provide them with future access to international credit, either debt or equity, and they are taking advantage of the current market opening in order to assist them in raising future capital.
Access to the Eurobond market has been made easier in some cases through the use of bank guarantees by issuers. By paying one or more local banks to guarantee the issue, at a cost of perhaps 1.5 percent per annum, companies can improve the terms they receive in the market and, in some cases, gain access which would not otherwise be available.

The government is aware of this massive inflow of foreign capital and has become concerned with its possible future effects on money supply and reserve levels. In order to reduce the attractiveness of these funds, the Central Bank has made it increasingly difficult for the Brazilian private sector to access the market. This has been done in three ways. First, the minimum maturity that the Central Bank will accept on international debt issues has been increased to three years, which is beyond the maturity that the market would extend to some Brazilian companies. Second, the minimum maturity which is exempt from withholding taxes has been extended from three to five and now to eight years. As most Brazilian private sector firms are insufficiently creditworthy (perhaps for country risk reasons) to obtain eight year terms, more firms are forced to pay the withholding tax, thereby increasing the cost of the money. And third, very recently the Central Bank imposed a tax of three percent on the principal amount of any funds raised abroad.

Brazilian issuers have found one way to partially circumvent the eight year minimum maturity on withholding tax-free financing. By issuing eight year bonds, but with put options attached which permit the buyer to sell the bonds back to the issuer at the end of five years, the bonds are effectively transformed into five year bonds, but without the withholding tax. Of course, theoretically, if the bonds are sold to the issuer after five years the withholding tax will have to be paid ex post. Depending on the extent to which it is indexed and collected, however, the real (present) value of those payments could be quite small.

Despite the concerns of government on the impact of these issues, approval by the Central Bank is neither difficult nor time consuming, except in those cases where the issue involves an innovative feature that the authorities are unaccustomed to. In fact, by law, the Central Bank is required to respond to requests for approval within one week, or the approval is automatic.

Equity

Interest by Brazilian companies in the issuance of shares has been limited in recent years following significant market price declines in both 1992 and 1993. As evidence, primary market activity in the domestic stock market in the first 10 months of 1993 totalled only $507 million, whereas nearly $2.6 billion was issued over the same period in the corporate debentures market. There are two basic reasons for this difference.

First, Brazilian companies entered the current decade with quite strong balance sheets. After years of operating in an inflationary and unstable economic environment, they knew from experience that the risk associated with high leverage was more than they were willing to bear. Consequently, as the international markets have opened to Brazilian firms for the first time in years, one has observed more interest by issuers in the Eurobond markets than in the ADR/GDR market. Similarly, interest in the issuance of shares in the local market has been low.

Second, the market conditions in Brazil have not been good for the issuance of equity. Price/book value ratios are currently about 0.4. Provided that the accounting system has appropriated adjusted the book value in order to offset inflation, the implication of this is that the issuance of new
shares dilutes the equity of existing shareholders, unless the new issue is purchased by those existing shareholders. The current market conditions were, to some extent, a result of the political problems surrounding the previous president. When the corruption scandal became serious in 1992, the market reacted strongly, losing more than 25 percent of its value in a single month.

One other factor has contributed to the lack of interest in equity. By law, Brazilian corporations can issue both voting and nonvoting (preferred) shares, but they are limited to a maximum of two thirds of the shares in nonvoting form. Issuing nonvoting shares is viewed as a means of maintaining control, but the constraint on the number of nonvoting shares prevents controlling shareholders from taking this too far. To the extent this constraint is currently binding, new equity can not be raised without increasing the number of voting shares, which may not be possible without diluting the control of existing shareholders. Empirically, one sees that firms do prefer to issue nonvoting shares. In the first ten months of 1993, excluding the issue of a privatized utility, Brazilian equity issues favored preferred shares to ordinary shares by a margin of nearly 2 to 1.

ADR Market

Despite market conditions that do not promote the issuance of new equity, one Brazilian firm has issued new shares as ADRs (raising $133 million), and others have listed existing shares in the ADR market. Some companies are interested in entering the ADR market, but are inclined to wait for an improvement in market prices. Other companies are willing to absorb the dilution implied by low price/book value ratios, but are still in the capital restructuring phase. Their view is that the ADR market is not interested in financing restructuring and that they will have to wait until they have new investment plans before they attempt to tap the ADR market.

Institutional Investors

Corporate pension funds dominate the institutional investor market. Of the pension funds, about 84 percent of the assets are held by the funds representing state-owned enterprise workers. With approximately $5 billion to invest in equities (out of a total portfolio of $19b), the funds play an important role in the local equity market, which has a total market capitalization of about $80 billion. That importance is augmented by the fact that most activity is in preferred shares, which represent about 60 percent of the market total and are the main target of the pension funds. Regulatory controls on the investment behavior by these pension funds have an important aggregate effect on the market. The funds are constrained to invest at least 25 percent of their funds in equity. Moreover, the funds tend to purchase preferred shares. Consequently, issues (especially of ordinary shares) in excess of the growth in pension fund assets will have a depressing effect on the market.

Other institutional investors include domestic mutual funds, banks and insurance companies. Total investment funds available to these institutions was nearly $13b in 1992. Each institutional investor faces restrictions on the amount of corporate equity that can be held, ranging from 25 to 50 percent of total assets. Foreign investment in Brazil is also institutional in nature. Following the opening of the market in 1991, foreign investment has been limited to registered investment funds and the registration requirements limit access to investors who are institutional in nature. Total foreign investment through these funds is about $7 billion now, of which perhaps 80 percent is invested in the equity market.

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Chile

Unlike most of its Latin American colleagues, Chile began its economic liberalization program in the 1970s and its private sector now has a rather more lengthy experience of operating in a market-based economy. Moreover, the Chilean liberalization program has been quite successful in the sense that the economy has prospered and exports have become an important part of the economic base. Given this, and the government's international creditworthiness, the Chilean private sector has been able to access the international capital markets with remarkable success in recent years. Despite this, the importance of the international capital markets in financing the Chilean private sector is limited owing to the overwhelming importance of the domestic market.

The situation in the Chilean domestic capital markets also differs substantially from its other emerging market counterparts. In 1981 the government privatized the pension funds. Private fund managers emerged as the guardians of individual's pension savings, subject to constraints imposed by the government on their investment strategies and competition for those savings by other fund managers. The result has been an increase in the supply of private savings available to issuers of financial instruments, with the consequence that financing decisions in Chile are greatly influenced by the role of the private pension funds in the domestic capital market. Owing to the restrictions that those funds face on the amount and type of securities that they can purchase, issuers may be excluded from the market or face abnormally high costs.

Amounts raised by private Chilean issuers in both the domestic and international markets in recent years are presented in Figure A-3. Discussion of trends and developments follow.

**Figure A-3. Chile Primary Market**

*Domestic and International Issues*

![Graph showing Domestic and International Issues over years (1980 to 1993)]

- **Dom. Equity**
- **Dom. Debt**
- **Intl. Equity**
- **Intl. Debt**

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Foreign Investment/Issues

Restrictions on foreign investment in Chile and the issuance by Chileans of debt instruments in the international markets reflect government concerns related to capital flows. Foreign investors must maintain any portfolio investment in Chile for 1 year, or they are subjected to a 35 percent tax on both capital gains and dividends/interest.

Chilean issues abroad are also restricted by the government. Issue size may not be less than $50 million. ADRs must raise new equity and are limited to voting shares; the listing of existing shares is precluded. A portion—30 percent—of all debt financing raised abroad must be placed as a reserve with the Central Bank for 1 year, with no interest earned; alternatively, issuers can pay the equivalent amount of interest to the Central Bank in return for access to all the funds.

The international market has also been restricted to only those issuers with the highest domestic credit rating. Private credit rating agencies have emerged following the privatization of the pension system and all issuers are obliged to have ratings, which determines their eligibility for purchase by the pension funds. The government has also used this rating in order to restrict access to international credit. The rating system is biased against some issuers because it does not incorporate industry differences into its credit rating. Consequently, some issuers who could otherwise obtain international credit may be forced to remain in the domestic market and to pay a higher cost of capital.

Corporate Debentures

The domestic debentures market is active and well developed. Issuers have a choice of currency, pesos or dollars, and maturities up to 10 to 12 years are not unusual. Owing to the country's previous experience with inflation, peso interest rates are indexed to inflation, with current 10-year government bonds earning approximately 6 percent in real terms. Dollar rates are somewhat less, but interest in domestic dollar-denominated debt is limited because both issuers and investors alike are wary of bearing exchange risk. Moreover, there is a widespread impression among investors that the dollar will depreciate against the peso, thereby reducing their effective yield and diminishing their appetite for dollar debt. International investors could offset this, but current restrictions on foreign investment have limited their participation.

Participation by issuers in the debentures market has varied tremendously over time, generally following interest rates and other market phenomena. In 1981, the collapse of a number of financial institutions made bank credit scarce; many firms then went to the market for corporate debentures. New issue amounts were high between 1988 and 1991, when real interest rates reached record lows, but following an increase in interest rates, issues declined substantially in both 1992 and 1993.

All issuers must obtain a credit rating by one of the country's rating agencies, which takes about two months. Ratings determine if an issuer's paper will be eligible for pension funds, and for international markets. Only firms with "A" ratings are allowed access to the international markets.

Registration of new issues is easy and fast, provided the issuer already has a credit rating. Issuers must pay a 1.2 percent stamp tax. Pricing is done by the market and competition between investment banks is keen.
The institutional structure of the market has implications for issuers of debentures. Small issues can be priced competitively owing to competition between the private fund managers. But as the size of an issue increases, the small overall market size works against issuers, increasing the cost of capital. Consequently, the cost of domestic debt capital for some of Chile's largest companies has been high by international standards, despite the relatively high credit rating that those same issuers have achieved internationally. Some companies have been forced offshore for hard-currency financing, even though doing so may entail exchange risk that the issuer is uncomfortable with bearing. Following success overseas, issuers have been able to use that option as a threat in order to reduce their cost of debt in the domestic market.

The dominance of the pension funds can limit access to the market of some otherwise creditworthy borrowers. Because the pension funds must limit their exposure to any one borrower, some companies who have issued large amounts of debt (or equity) in the past may be excluded from the (pension fund) market. For those companies with an investment grade rating, the domestic market can be replaced by the international market, but others may be forced to borrow from banks instead, and at rates or maturities that are not advantageous.

Convertible debentures have played an insignificant role in the domestic market so far. Familiarity with the instrument is not high and, moreover, the ability of the pension funds to hold additional equity in some of the major companies is constrained by regulation. Given that the attraction of convertibles to both issuers and investors is the equity option that it provides, the market has not been enthusiastic about convertibles.

Eurobonds

Chilean interest in the Eurobond market has been limited. In fact the first issue, since 1981, was not done until mid-1993. Unlike their Latin American counterparts, Chilean companies did not enter the Eurobond market quickly and in mass for two reasons. First, as mentioned, the government has restrained the private sector in order to control the inflow of foreign capital. Second, with the development of the private pension fund system, domestic long-term credit has been readily available to all qualified borrowers, often at competitive rates. Given their aversion to exchange risk, many borrowers prefer this domestic funding. And for those companies who have significant export earnings and prefer dollar financing, export credit is available.

The domestic rating system has implications for even potential Eurobond issuers. In order to restrict the inflow of foreign capital, the government has restricted access to the Eurobond market to investment grade companies. But Chile's investment grading system does not adjust for differences in the industry in which a firm operates. A firm in a very stable industry, for example a utility, where firms normally carry higher levels of debt, would be judged by the same standards as firms in more volatile industries. As a result, some private companies that operate at normal international industry levels of debt are not considered investment grade and are prohibited from issuing securities abroad. This penalty can increase the cost of borrowing for these firms, depending on their demand relative to market size.

Chilean activity in the international convertible market has been limited to a single issue.
Chile has one of the most buoyant of the emerging markets, with market capitalization increasing from $2.6 billion in 1983, to more than $35.5 billion in mid-1993. Market capitalization, as a percent of GNP, is now nearly 100 percent, which, by that measure, puts Chile in the same league as Japan, the U.K., and the U.S.

New issues in the equity market have followed market conditions. Privatizations in 1987-88 led to large increases in primary market activity in those years. Rapid increases in the level of the market in 1991-93 have been followed by substantial amounts of new equity being issued, as well as the listing of a number of new companies.

The cost of equity capital is thought by most Chilean companies to vary inversely with market price. Dividend yield is viewed as an important part of the cost of equity because publicly-traded firms must pay 30 percent of earnings as dividends. Given that yields are now below interest rates, equity is the preferred form of raising new capital.

As with corporate debentures, the structure of the institutional market has implications for issuers of equity. The market is dominated by the pension funds, who face several restrictions on the amount and type of equity that they can hold. They face a ceiling of 30 percent of their entire portfolio which can be held in all equity instruments. But not all equity is counted equally. Least constrained is the equity of companies that is widely held, with no single shareholder controlling more than 20 percent of the company. For companies with a less diversified shareholder base, the pension funds face a ceiling of no more than 10 percent of their portfolio. Similar constraints exist on the holdings of individual shares.

Pension funds are also limited in the type of equity that they can hold. Initial public offerings, that is, newly listed companies, are ineligible because they have no track record. In addition, listed companies which have insufficient trading volume in the past are ineligible. For initial placement offers, that is, new listings, issuers try to circumvent the restrictions on pension funds by issuing a first tranche of equity and then, after that tranche has been seasoned long enough that it is considered eligible for the pension funds, a subsequent tranche will be made available. By delaying the second tranche until the pension funds can invest, the firm maximizes the price that it receives for the shares, thereby lowering its cost of equity capital.

One additional influence of the pension funds in the Chilean equity market is their role as relatively passive, long-term investors. By making equity capital available without attempting to control management (too much), the pension funds may have prompted otherwise hesitant companies to publicly list their shares. The number of publicly listed companies has grown significantly in recent years.
As mentioned, access to the international equity markets has been limited to the most highly-rated Chilean companies (as measured domestically) and to issues of new capital only. As a result, activity by Chilean companies in the international markets has been more limited than one might expect given the investment-grade rating that the country has. Chile entered the ADR market ahead of the rest of the Latin American countries, with a major issue in 1990. The next year was quiet, however, with no issues. Two issues were placed in 1992. The situation changed quite dramatically in 1993, with a total of $512 million raised, more than the total of all previous years.

The appeal of the ADR market is strong, especially for large issuers. Price/earnings ratios on ADRs have been substantially higher than in the domestic market, with the result that issuers find the ADR cost of equity capital significantly lower than equity issued at home.
India

India has had a long tradition of active bond and equity markets. After New York, the Bombay Stock Exchange boasts the largest number of listed companies. As early as 1988, the Credit Rating and Information Services India Limited (CRISIL) started rating corporate debt, a pioneer in the developing world. But the pricing and issue of corporate financial instruments has been controlled in various ways. State banks (for working capital) and DFCs (for term finance) have been preponderant. And Indian companies have been protected from foreign competition and hampered internally by barriers to entry into new businesses and expansion. This picture has been undergoing a major transformation since 1991.

The turning point has been the internal and external liberalization that started with the maxi-
devaluation of July 1991. This had its genesis in a foreign debt and balance-of-payments crisis. Foreign debt more than doubled during the 1980s as the emphasis shifted to external commercial borrowings to supplement official funding, reaching a level of $82 billion by the end of 1990. With the rise in oil prices following from the 1990 Gulf Crisis, foreign reserves dropped below $1 billion by July 1991. International rating agencies downgraded India’s credit.

Shedding its image of a reluctant reformer, the Government launched a decisive economic liberalization in 1991-92 that has included delicensing industry; revising the monopolies and foreign exchange regulations to give big companies more latitude in expanding and engaging foreign ownership; making the rupee convertible for trade and lowering average tariffs; removing the wealth tax on shares and reducing corporate income tax rates substantially.

In the capital markets, the pricing of corporate debentures, which were subject to interest rate ceilings up to August 1991, has been freed. The office of the Controller of Capital Issues (CCI), which determined when, how much and at what price equity could be raised, was abolished in May 1992. Equity is now issued under the guidelines of the Securities and Exchange Board of India (SEBI) published in June 1992. Such issues can now be freely priced with exceptions applying to greenfield projects and new companies. And since May 1992, Indian companies can tap offshore markets directly. Between May 1992 and November 1993, nine companies raised close to $1 billion through GDRs and convertible bonds, with more than $700 m. in the pipeline.

The role of the domestic financial institutions, which have a commanding presence in Indian corporate finance, is changing fundamentally. The term-lending institutions, IDBI, IFCI and ICICI are being increasingly compelled to tap the domestic capital markets directly. Traditionally, these institutions have benefitted from government guarantees, enabling their bonds to be eligible for inclusion by commercial banks under their statutory liquidity ratio (SLR). By issuing SLR bonds, these DFCs have borrowed from commercial banks and on-lent to companies for long maturities, effectively at subsidized rates. These implicit subsidies are being phased out.

25 Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI) and the Industrial Credit and Investment Corporation of India (ICICI).
During 1993, no less than 108 FIIs registered with SEBI. These can buy listed shares and receive firm allotments of up to 24 percent of new issues. Private mutual funds commenced operation in late 1993 and will compete at the margin with the state-owned giants, the Unit Trust of India, the Life Insurance Corporation and the General Insurance Corporation.

Figure A-4 shows primary debt and equity issues (in dollars) by private, listed Indian companies in the domestic capital market for the period 1980-81 to 1992-93. The year 1992 is distinct in two respects: first, the magnitude of funds raised dwarfs that raised on average; second, there is a sharp upward spike in the amount of equity raised. In Indian rupee terms, the amount of equity raised in 1992 exceeded the total amount raised in the preceding twelve years! Although there is no marked preference for debt or equity in Figure A-4 (except after 1989-90) Figure A-5 shows that most corporate debt is really quasi-equity, being convertible into shares. This is explicable by the earlier controls on the issue price of shares. Partially convertible debentures were configured in such a way that the pure debt portion would carry a very low interest rate, say 12 percent when the market rate was 19 percent. The investor, who cared only for the equity portion (because of the huge initial capital gain owing to equity price controls) would sell the non-convertible portion to a financial institution at a discount. Everyone gained: the investor got equity; the firm indirectly recouped part of the loss from the equity price control by paying a low interest rate on the pure debt component of the convertible debenture; and the financial institution received the pure debt portion at a discount. Figure A-6 shows the pre-dominance of equity rights issues, symptomatic of the concern for ownership dilution.

Free pricing of primary issues, tapping offshore markets for the first time, DFCs going directly to the market to fund themselves and the entry of FIIs constitute the core of the new corporate finance in India.
Figure A-4. Primary Bond and Equity Issues by Private Companies.

Equity — Debt

Source: Reserve Bank of India, Annual Report, various issues.

Figure A-5. Corporate Bond Issues by Private Companies.

Nonconvertible — Convertible

Source: Reserve Bank of India, Annual Report, various issues.
Cost of Capital

In the old regime, the Controller of Capital Issues would decide the price of new issues, which were often well below prevailing quoted market prices of listed shares. With the advent of the free pricing of equity issues, new issues can be priced closer to the prevailing market prices of shares. As a result, companies can raise more money through public issues of the same number of shares. Further, companies tend to define the cost of equity by the dividend yield alone, which peculiarly is measured with reference to the nominal, and not the market, price of shares. A company declaring a dividend of 40 percent is really declaring a dividend of Rs 4 per share, the nominal value of a share typically being Rs 10. Dividend policy has not changed, so that companies pay the same dividend per share but receive a higher issue price, lowering the cost of equity.

This poses the puzzle of why companies can raise more equity now than before, as this means returns to equity holders (market dividend yield plus capital gains) have come down. An appealing explanation is that with equity issues so underpriced in the past, firms were reluctant to sell shares, especially in an environment where the real after-tax cost of debt was low. Underpricing caused huge excess demand for shares, with the chances of actually getting shares in a company very small. Further, there was typically a big jump in the price on the first day of trading, conferring a capital gain on those lucky enough to get shares in the initial allocation. Subsequent share purchasers did not benefit

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26 In India, shares have a nominal price, usually Rs. 10, and a market price. If a share is issued above Rs 10, it is "issued at a premium".
from this initial jump in share price, and count more on long-term capital gains. This may have improved with the liberalization and better opportunities for dynamic companies. Also, under the new pricing, the extent of over subscription has gone down, improving the chances of securing shares in the initial allocation and raising expected returns. In short, as the equity market moves into a supply-demand equilibrium, the amount of equity can be expected to go up.

The tendency to regard equity cheap is reinforced by the accounting treatment of shareholders’ funds. These funds are defined as issued capital (number of shares issued multiplied by Rs 10), share premium (the excess of issue price over Rs 10 times the number of shares) and retained earnings (reserves and surplus). Companies look upon share premium and retained earnings as "free" funds. The emphasis is on nominal values rather than market capitalization and capital gains.27

The cost of debt has gone up. Real interest rates have risen. Thus, minimum lending rates for loans exceeding Rs 200,000 (about $6700 at today’s exchange rate) have been coming down very slowly, from 20 percent in October 1991 to 16 percent by June 1993, although point-to-point annual inflation has dropped from 13 percent to 6.5 percent.28 Corporate income tax rates came down substantially in 1992 and are expected to fall further. This increases the real, after-tax cost of debt. Lastly, DFCs are increasingly being forced to tap the market directly for their own funding.

Direct access to offshore capital markets was permitted for the first time in 1992. Equity issues do not involve currency risk, although bonds do. But companies seem willing to bear this risk based on their assessment of exchange rate movements in relation to interest differentials. Offshore issues have another advantage: issuance costs are much lower than for comparable rupee issues.

Overall, the feeling among companies polled is that the cost of capital has come down with the liberalization. But the underlying sample is limited and this claim will need further study.

Freeing of Controls: New Instruments

Before the recent liberalization, working capital loans (like term loans) were norm-driven. Companies were allowed a certain level of loans based on historical indicators rather than based on expected sales and profit growth. Loans exceeding Rs. 5 crores ($1.67 million) required companies to put together a consortium of banks. Any increase in working capital limits involved a time-consuming and laborious process. And commercial banks charge a minimum lending rate based on their deposit rates plus a hefty spread for administrative costs and (a more recent phenomenon) to compensate for non-performing loans. The dependence on banks has been changed by a rule that now permits companies to finance up to 75 percent of working capital needs through commercial paper. With companies finding that they can raise money at about 10 percent compared to the 15 percent charged by banks, commercial paper has grown rapidly over the last several months.

But of course, for the investor, whose opportunity cost is the interest rate, capital gains do matter and the sum of dividend yield (measured relative to market price) and capital gains must exceed the interest rate sufficiently to compensate for the higher risk.

Indications are that actual lending rates for term loans are much higher than the minimum lending rate of 16 percent, closer to 20 percent. Real interest rates have risen substantially.
GDRs and Euroconvertible bonds are no longer inconceivable. Between May 1992 and November 1993, 9 companies raised no less than $ 944 million through GDRs ($ 629 million) and convertible bonds ($ 315 million). These instruments have helped companies lower issuance costs. Issuance costs for local public issues run at 7 to 10 percent of proceeds for large issues and could be as high as 15 to 20 percent for smaller issues. A major reason for high rupee issuance costs is that the market is retail in character and the advertising, printing and collection costs (30 million copies of applications, 57 collection centers, now reduced to 30) lead to high fixed costs that make small issues prohibitive. In contrast, Euroissues, including all commissions, underwriting charges and the "roadshow" cost between 2 and 3 percent. Further, companies are betting that the rupee will be on a stable path and that any depreciation will be less than the local-foreign interest differential. The prevailing belief is that rupee real interest rates are very high and that these will come down.

Most Indian big business is family-controlled. Earlier, families could control their empires with less than 10 percent of the equity, often times with as little as 2 to 3 percent. Now, there is fear of dilution with FIIs, NRIs and private mutual funds permitted to buy shares of listed companies. The original promoters first tried to increase their shareholding through preferential allotments of shares at well-below quoted prices. This stopped in November 1993 when the Indian financial institutions, the biggest shareholders in Indian companies, objected. Families have responded with newer innovation, nonconvertible debentures (NCDs) with warrants attached being an example. NCDs, never a popular instrument with the investing public (which has always preferred equity) are issued at below market coupons with warrants attached that enable shares to be purchased at throwaway prices. The promoters corner the NCDs, strip the warrants and sell the NCD portion to a bank at a discount, to make up for the low nominal coupon.

DFCs have also responded with financial innovation. IDBI has taken advantage of its knowledge of the Indian investor base to raise Rs. 490 crores ($ 163 million) in February 1992 through AAA-rated zero coupon bonds that have a maturity of 25 years and yield 15.54 percent a year. At the end of every five-year interval, IDBI can call the bonds and the bondholders can put the bonds to IDBI (both at par). These options compensate for the absence of floating rate funding. IDBI can "call" the bonds if interest rates drop, while the investors can "put" the bonds back to IDBI if interest rates rise.

Another example is the issue of non-guaranteed bonds by IDBI and ICICI to take advantage of the recent relaxation, whereby, after 1993, provident funds and pension funds are permitted to invest up to 15 percent of their portfolio in such bonds (both institutions are rated AAA by CRISIL).

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29 The bonds were priced at Rs. 2,700 and can be redeemed at Rs. 100,000 after 25 years. The appeal is that people can buy them now for their children, who will then have Rs. 1 lakh (= Rs 100,000) a substantial sum of money when they grow up. This will make them "lakhpatis", important in the Indian investor psyche.
Possible Future Trends

Corporate finance is in a state of flux as companies adjust to the liberalization. With Indian companies highly leveraged, a shift towards equity is likely, in view of rising real interest rates and the lower cost of equity. This shift is likely to be strengthened by the rising uncertainty in earnings and long-run solvency as competition grows, which will be resolved only after trade liberalization is fully implemented. Companies expect a low uniform tariff by the year 1997, and a fully convertible rupee in the next two years, with its corollary of free domestic interest rates. In the medium term, domestic debt could become more attractive if capital account convertibility brings rupee interest rates in line with foreign rates plus expected currency depreciation.

Domestic issuance costs are likely to decline as the stock market shifts its focus from retail to wholesale. From December 1 1993, a big fraction of any public equity issue can be pre-allotted to institutional investors, including FIIIs, NRIs, domestic mutual funds and multilaterals (such as IFC).

With DFCs now compelled to raise funds at market rates, their focus is likely to shift to smaller and more risky companies.

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Balasubramanian (1993) comprehensively documents Indian corporate finance in the 1980s, and discusses (Chapter 2) the rise in the importance of debt in financing companies.
In Indonesia, for twenty years or more, Indonesia has had a convertible currency and free international capital mobility. Interest rates have been market determined at least since October 1988. In view of this foundation, which is absent in most developing countries, it might be assumed that it would be easy to introduce state-of-the-art financial technology.

However, corporate finance has been only slowly developing over the last five years. Before 1989, the story was one of family businesses heavily reliant on state banks, which in turn served as the conduit for channeling state oil revenues to industry. The Jakarta Stock Exchange (JSE) was dormant for years, with only 24 listed companies, 20 brokers and a reported 15 minutes of daily trading activity. The domestic bond market was dominated by government companies and banks. Such bonds were issued at below-market rates and bought by government agencies, such as the state pension fund and social security fund. As a result, the debt-equity decision was of limited relevance.

Now, in spite of fundamental changes, corporate finance is still in its infancy. The trigger for change has been declining oil revenues. Falling oil prices and Indonesia's limited oil reserves led to a strong push by the government to lessen dependence on oil. The process started with the maxi-devaluation of 1986, resulting eventually in the financial liberalization of 1988, which allowed private domestic and foreign banks to compete freely with state banks; and for the first time permitted foreign investors to buy up to 49 percent of the listed shares. Other key features were: reducing bank reserve requirements from 15 percent to 2 percent; eliminating the option of DANAREKSA, the state-owned mutual fund, to buy up to 50 percent of listed shares in any public offering; removing controls on the initial offer price of equity and on the daily movements of share prices.

Today, there are some 175 companies on the JSE with a (listed) market capitalization of about $20 billion. Almost all the money has come from foreign sources as a result of the initial public offerings (IPOs - companies going public for the first time). Companies listed sufficient existing shares coupled with new share offerings to meet the 49 percent foreign ownership limit. This fact has been attributed to the timing of the liberalization, which came on the heels of the stock market crash in the west (October 1987) and general recession in the OECD countries. The early wave of IPOs coincided with the growing interest in emerging markets and were easily absorbed.

Bank lending grew rapidly as private banks mushroomed and state bank reserve requirements were reduced. Companies typically used the proceeds from IPOs to pay off existing bank loans and finance ambitious expansion plans. At the same time, they leveraged on the increase in equity to borrow

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31 An overview is contained in Hanna (1992). Conceptually, with free capital mobility and a managed exchange rate, there should be limited or no control over domestic interest rates.

32 Indonesia initially permitted partial listing of shares in the sense that a company could list a fraction of paid-up shares. This has stopped in the last several months. All companies now going public must list all shares.

33 Thus, if a company wished to issue 15 million new shares, it would simultaneously list, say, 16 million existing shares. In this event, foreigners would be able to buy all 15 million newly issued shares and be within the 49 percent limit on listed shares.
from the new banks, which were anxious to lend. Between August 1989 and August 1990, credit to the private sector grew by a huge 70 percent. The stock market continued to boom; in many cases, IPO equity issues were heavily overpriced as companies window-dressed balance sheets and inflated financial projections.

The JSE index peaked in April 1990. At the same time, inflation showed signs of picking up. In mid-1990, credit policy began to be tightened and interest rates were raised. In February-March 1991 came the famous Sjarlin Shock. In an attempt to cool the economy, Finance Minister Sjarlin instructed state companies to withdraw their deposits from the banking system and place these in certificates of Bank Indonesia, effectively an open market operation. This caused a liquidity crunch and interest rates rose. Figure A-7 plots the real interest rate, which rose from March 1990 to a peak in June 1992, before falling. The declining interest rate has been accompanied by widening bank spreads, as shown in Figure A-8.

Menu of Instruments

Corporate finance has been gradually evolving through all this. The menu of instruments includes bank loans, commercial paper, rupiah bonds, equity and Euroissues (mainly US dollar and Swiss franc Euroconvertible bonds). But long-term rupiah funding is severely limited. The longest bank deposit is of one-year maturity. As a result, bank loans tend to be of short maturity. Further, state banks, the pillar of financing, are finding it difficult to meet capital adequacy requirements. They are now unwilling to lend money to companies. Also, the legal lending limit for exposure to a single business group was lowered from 50 percent of the capital base to 35 percent in February 1992 and again to 20 percent in May 1993, with banks being given until the end of 1997 for compliance.

Figure A-9 shows primary corporate bond issues in the domestic market. The volume of issues grew from $214 million in 1990 to $1.14 billion in the first 11 months of 1993, coinciding with falling interest rates, but rising bank spreads. The total stock of rupiah bonds outstanding in November 1993 was $2.1 billion, of which $1.5 billion is accounted for by government banks and companies. Long-term fixed rate rupiah funding is limited. More recently, the trend is for bonds to have a fixed rate for a year or two and then be repriced every six months at the average deposit rate in the banking system.

![Figure A-7. Ex Post Real Rates - All Banks](image-url)
Figure A-8. Interest Rate Spreads - All Banks

Source: Table 4, Hanna (1993).

Figure A-9. Bond Issues

Source: Own estimates, based on information from investment banks.
Figure A-10 depicts the remarkable increase in initial public offerings (IPOs) of equity. Following the liberalization at the end of 1988, some 100 companies went public in 1989 and 1990 as the stock market took off. After a slump in 1991 and 1992, some $3 billion was raised in the first 11 months of 1993. IPO issues track the trend in the JSE index, showing the importance of market timing in the decision to go public. Also, the larger volumes of equity raised compared with bonds is a logical response to perceived high real interest rates.

Commercial paper has become an attractive alternative to bank overdrafts for working capital since about mid-1992. This is because of widening bank spreads (Figure A-8) as a result of deteriorating bank portfolios. Companies can issue commercial paper at around 14 percent instead of bank overdrafts at 19 percent. Depositors also gain by shifting to commercial paper because deposit rates are low. For banks, this works out well because commercial paper is a source of fee-based income - banks broker the transaction - with no impact on capital adequacy.

Euro'ues started becoming popular in 1992. U.S. dollar and Swiss franc convertible bonds have been the instrument of choice. This instrument is regarded as having several benefits for issuer and investor alike: it carries a lower coupon than a straight bond, improving cashflow and avoiding the immediate dilution and reduction in EPS associated with a share issue. For the investor, it offers limited downside and a chance to participate in future capital gains.
Factors Influencing Corporate Finance

Macroeconomic goals and constraints: The Government has frequently signalled that it will take drastic steps if inflation exceeds 10 percent per annum. Companies believe that the Government's inflation fears will keep the currency stable. They thus prefer to borrow in dollars and take the exchange risk, as dollar rates obtainable are low in comparison to rupiah rates of 15 to 19 percent. The desire to grow away from the oil-based economy and a recognition that Indonesia must compete with China and Vietnam for foreign direct investment mean continuing liberalization, increasing the menu of financing instruments.

Corporate ownership and control: Business in Indonesia is family-controlled. With high protection and the dominant role of state bank lending in the past, companies have tended to be financed with internal funds and state bank loans. Going public would mean audited financial statements so that tax dues would become transparent. The feeling expressed by company managers is that in spite of substantial improvements, taxes are still negotiable with the authorities. Going public also means the risk of dilution. However, companies are increasingly beginning to feel the pinch of not listing and going public. With oil revenues and the role of state banks declining in tandem, businesses have to look for new funding sources to maintain a competitive edge and expand.

Economic growth: Indonesia's rapid growth - the country has consistently exceeded the growth target of 5 percent - has had an interesting impact on how companies look at funding choices. They are more concerned about the volume than the cost of funding. Returns are exceptionally high, barriers to entry are going and competition is increasing. Companies want to expand rapidly and establish market share; the cost of funding and debt-equity mix is a secondary consideration. This is being counterbalanced by banks, which are becoming more cautious and commercially-oriented in their financing decisions; and by greater accountability to shareholders as awareness grows and FII's and private mutual funds come into the stock market.

- **Tax code:** This has apparently not influenced debt-equity choice because the tax code is not uniformly enforced and taxes are considered negotiable. Ironically, if the tax code is formalized and enforced, companies would have little incentive not to go public and list. In the past, the tax code had one peculiarity. Interest received by companies was tax free, later taxable at 15 percent final. Interest paid by companies was (and is) tax deductible for corporate income tax assessments. The corporate income tax rate is 35 percent. When the spread between deposit and lending rates was small, it paid a company to borrow at an effective after-tax cost of 65 percent of the lending rate, deposit the money in a bank account, pay the tax of 15 percent on interest earnings and still come out ahead. This loophole has been removed since 1991, with all interest earnings to be netted out against interest expenses before computing taxable income.

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34 On the macroeconomic background to the recent reforms, see Hanna (1992).

35 For example, if the deposit rate were 15 percent and the lending rate were 17 percent, the effective borrowing cost would be 17×0.65 = 11.05 percent and the after tax return (at a 15 percent tax rate) would be 15×0.85 = 12.75 percent.
Legal and regulatory framework: This is considered weak and is evolving. An example frequently given was a new rule by BAPEPAM (Indonesia's SEC) on preemptive rights for existing shareholders. According to this rule, any equity or quasi-equity instrument must first be offered to existing shareholders. Only if they forego their rights can the shares be offered to others. This has apparently stopped the use of Swiss franc and US dollar convertible bonds as the conversion option is no longer feasible. Companies will have to precede a convertible bond issue with a rights offering to the existing shareholders. This will protract the issuance process and increase risk as the market operates on timing. The market could move substantially by the time the documentation for a rights issue is cleared and the offering period ends. Convertible bonds, which were gaining in popularity in 1992, have stopped as companies and investment banks seek clarification on this preemptive rule.

Other deficiencies cited were: existence only of bearer bonds in the domestic market, which increases custodial and insurance costs; absence of a trustee law, which makes it difficult for one party to act on behalf of another financially; in leasing, the tendency of courts to associate ownership with an asset with its possession, making it extremely difficult for leasing companies to recover their assets in the event of a default; and precedents not applying to new cases.

On the positive side, the JSE was separated from BAPEPAM and privatized in 1992. During the initial wave of IPOs in 1989-90, the JSE was part of BAPEPAM and BAPEPAM would actively promote issues and comment on the merits of various stocks. Thus, BAPEPAM was both the securities commission and stock exchange. Now it restricts itself to making sure that the listing procedure is followed (notification, advertising, and documents) and that disclosure requirements are complied with, the standard oversight performed by SECs.

Accounting: Accountancy standards are regarded as low and unreliable. The JSE has witnessed many cases of IPOs being overpriced based on doctored financial statements and highly optimistic projections. This has dampened confidence in the domestic stock market to some extent. In fact, there is not a strong retail interest in the stock market. Most of the new money has come from FIs or domestic pension funds.

Rating agency: There is no rating of domestic bonds, although this is expected by the end of 1994.

Size: Small companies are much more constrained in their funding choices and must rely on own funds, retained earnings and bank loans.

Restrictions on foreign borrowing: Concerned about past Government guarantees on offshore borrowing during the heavy expansion in the late 1980s, the government has placed restrictions on foreign borrowing since late 1992. Government companies have been severely limited in offshore access. Such companies and state-owned banks must obtain clearance from the Foreign Loan Evaluation Team (PKLN) coordinated by the Ministry of Finance. Private companies not using state banks as a conduit may borrow offshore but must report this to PKLN.

Widening bank spreads: Widening spreads as a result of deteriorating portfolios has stimulated both the rupiah bond market and commercial paper market over the last two years or so.
Future Trends

Trends in Indonesian corporate finance are going to be influenced by the factors above. The most important at the margin are the diminishing role of state banks, continuing prospects for growth and liberalization, and the regulatory framework, including the tax code.

As the role of state banks shrinks and reorients towards SMEs, big companies will be increasingly forced to tap the markets directly and approach private domestic and foreign banks. In fact, private banks have been rapidly bridging the gap with state banks in terms of total assets. The interest in foreign currency funding and the open capital account are likely to put downward pressure on rupiah interest rates, which would increase the attractiveness of rupiah instruments.

If the anecdotes circulating in Indonesia are true, the volume and not the composition or source of funding is going to be the binding constraint. Economic growth prospects and expected returns to capital are considered exceptionally high. But there is little doubt that as the real sector continues to liberalize and foreign investors (both portfolio and direct) flock to Indonesia, the pressure to regularize the legal and accounting framework and disclosure requirements will mount.
Turkey

Turkey has recently experienced a period of relative prosperity coupled with high rates of inflation and strong government demands on the domestic credit market. At the same time, the government has been engaged in an economic reform program that has privatized several state-owned enterprises and altered significantly the regulation of the domestic capital markets. As a result, significant changes have emerged in the manner in which the Turkish private sector finances itself. These changes are apparent in Figure A-11, with discussion of the trends and significant events provided below.

Corporate Bonds

Since 1986, private enterprises have been able to issue bonds. The primary market in these bonds was quite active in the late 1980s, but the use of corporate bonds by the private sector has declined substantially in recent years. The decline follows increases in government borrowing to finance fiscal deficits, which have raised real interest rates in the market and both induced and forced private issuers to obtain financing elsewhere.

The domestic debt market is dominated by the government demand for credit; total public sector borrowing requirement is about 10 percent of GNP. Consequently, even with reasonable domestic savings rates, such strong demand has increased domestic real interest rates above international levels. This by itself would reduce demand for credit by the private sector, but demand has been further depressed by the manner in which new issues are regulated and by the tax treatment offered to them.

![Figure A-11. Turkey Primary Market](image-url)

Issues of corporate bonds must be approved by the government regulatory authority, the Capital...
markets Board (CMB), prior to issuance. Approval requires time, perhaps one month, but more importantly, the application must include the proposed interest rate for the issue. Currently, the CMB will does not approve interest rates that are substantially higher from those paid by the government on its own debt. As the risk level of most private issuers exceeds that of the central government, most investors are reluctant to purchase the private paper. This effect is compounded by the tax treatment given corporate bonds. Interest received by investors on private debt is taxed as income, whereas interest received on government debt is tax-free. Given the relatively small difference in interest rates between private and government debt, investors are induced to hold government debt by the after-tax yield differential exists. There is one exception to this. A number of tax-exempt foundations and mutual funds exist and these investors are able to ignore the differential tax treatment. Consequently, much of the private debt is sold to these tax-exempt investors, sometimes on a private placement basis.

The requirement that interest rates be approved prior to issuance subjects issuers to the risk of changes in market interest rates. While this could be eliminated by issuing bonds at a discount, discounts are in fact largely prohibited. The market has found a way around this problem through the payment of fees by issuers to their investment bankers, who subsequently pass the fees on to the bond holders. This use of fees also provides a means for circumventing the CMB restrictions on the level of interest rates.

The market for private corporate bonds was not always dominated by the government. Prior to the large current government demand for credit, the private market was active. Medium term credit was available to creditworthy issuers. Even today, prime issuers can obtain medium-term credit from the tax-exempt investors, but at very high rates by international standards.

Corporate bonds may not be issued with a maturity of less than two years, nor greater than seven years. Because of the fixed costs involved with issuance, companies prefer longer maturities, but economic conditions limit market demand for long-term instruments. Consequently, maturities of 2 years are most common. New issues are not subject to any formal rating process.

**Equity**

Public issuance of equity by the private sector has shown a remarkable rate of growth in recent years in Turkey. Prior to 1990, initial public offerings of equity were rare, a reflection of both market conditions, the wariness of outsider control on the part of family-owned enterprises, and a lack of regulation related to issuance. In 1990, events changed dramatically. Perhaps most importantly, the market rallied significantly in both 1989 and 1990, with a more than 800 percent total increase in those two years. While this price increase alone might have prompted much of the observed issuance activity, the CMB also contributed to the rally by improving the regulatory environment, which provided investors with more and better information on issuers, thereby increasing confidence in the market. On top of this, the government's privatization program itself contributed approximately half of the public offerings in 1990.

Interest in the issuance of equity has continued since 1990, but at a pace that reflects market conditions. A continuation of the market rally continuing in 1991 induced additional equity to be issued in that year. Declines in market prices in 1992 reduced the supply of new equity. The market rally that has occurred in 1993 should lead to further issues of equity.
Just as the government has used tax policy in order to induce investors to favor government over private debt, tax policy in Turkey favors publicly-listed over privately-held companies. By listing its shares publicly, a company's tax rate on earnings is reduced. The more shares that are listed, as a percentage of total shares, the greater the tax advantage; however, concentration of ownership also plays an important role in the net tax advantage. For privately-held companies the corporate tax rate on earnings is 46 percent. By listing 80 percent of its shares and having them held by at least 200 investors, a company reduces its tax rate to 30 percent. One effect of this policy is that the number of listed companies on the Istanbul Stock Exchange is quite large—1,238 in 1992—whereas only 145 shares were publicly traded.

The manner in which shares are issued also influences the appeal that they have to issuers. Approval of the issue, including the issue price must first be obtained from the CMB. Due to a lag between the date of approval and date of issue, the approved price might not accurately reflect market conditions. This price risk is reduced by setting the approval price significantly lower than the prevailing market condition, but that has the adverse effect of increasing the cost of any equity raised.

**International Issues**

The Turkish private sector has been relatively inactive in the international markets, both debt and equity. With the recent increase in domestic stock market prices, one can expect to see increased interest in the ADR market in the future.
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