An Introduction to Depository Receipts

BY GIA SINGH

In recent times there has certainly been an appetite for merger and acquisition activity on our local market. While the M&A fever has created some excitement in the market it has also brought about some possibilities for investors. One such possibility is the listing of a financial instrument that is new to the market. The instrument to which I am referring is a Depository Receipt (DR).

In a presentation designed to inform the public of the synergies and transaction details of the proposed merger between Royal Bank of Canada (RBC) and RBTT Financial Holdings Limited (RBTT), it was stated that RBC would look at the possibility of issuing Depository Receipts on the Trinidad and Tobago Stock Exchange (TTSE). In doing so, it is RBC's intention to further demonstrate its commitment to the region, while giving local investors a chance to invest in the global financial services institution.

While there are no guarantees that the proposed merger or listing of DRs will come to fruition, I believe that knowledge is power and it is always good to be educated on topics which may affect us. So, in this article I will provide an introduction to this type of investment vehicle and highlight some of the benefits and possible implications for investors.

So what exactly is a DR? It is a type of negotiable or transferable financial security that is traded on a local exchange but represents a security, usually equity, issued by a foreign publicly-listed company. DRs are quite common in the International Markets, with the first one being introduced by JPMorgan as far back as 1927 for the British retailer Selfridges&Company.

The most common type of DR in issue is the American Depository Receipt (ADR), which is basically a negotiable certificate issued by a U.S. custodian bank representing a specified number of shares (or one share) in a foreign stock that is traded on a U.S. exchange. Other DRs include: Global Depository Receipts (GDRs), International Depository Receipts (IDR), European Depository Receipts (EDRs) and a recent addition-Chinese Depository Receipts (CDRs). Indeed, this type of financial instrument has spread across the globe.

The popularity of this instrument stems from the fact that there are benefits to be derived for both the issuers and investors in the DR. In the first case, the advantages for the Company issuing the DR include: expanded market share through broadened and more diversified shareholder base which can lead to greater liquidity of the share; enhanced visibility and image for the Company's products and services in a marketplace outside its home country; in addition to being a flexible mechanism for raising capital and a vehicle or currency for mergers and acquisitions.

Investors on the other hand are continuously in search of investments which allow them to diversify their portfolios. DRs not only provide diversification of securities it also provides geographic diversification. They also diminish the obstacles which are often

faced by investors who wish to invest internationally, such as: costly currency conversions, unfamiliar market practices, confusing tax conventions and investment policies. Since the DRs are listed on local markets: trade, clearance and settlement procedures are more familiar to the local investor. Additionally, DRs usually pay dividends in foreign currencies (typically U.S. dollars) which can lead to competitive exchange rate conversions.

In the proposed transaction between RBC and RBTT, the acquirer (RBC) has offered to pay RBTT shareholders TT$40.00 per share (60% in cash and 40% in RBC common shares). Therefore, the simplest way for RBC to convert the 40% of each RBTT share to RBC common shares would be through the use of Depository Receipts.

The process would most likely be as follows: Once the exchange ratio is determined on the close of the transaction, the necessary number of RBC shares will be deposited in a local custodian bank. After which, RBC's depository bank will issue the Depository Receipts to the shareholders. Once the DRs have been issued and have passed all requirements for listing, they would then be traded on the Trinidad and Tobago Stock Exchange. Since this has never been done on our local market it would mean that the Trinidad and Tobago Securities and Exchange Commission (TTSEC) would have to create rules and regulations to cover issues such as reporting requirements and the currency for dividend payments. There was no mention in the document as to what would happen to the shares held on the other regional exchanges, so at this point I will prefer not to make any comments on the same.

An important factor that must be taken into consideration is the impact of the DR listing on the local market capitalization. Once the transaction is closed, RBTT would have to be de-listed from the market; this would mean that the third largest market capitalization on our market would be removed. Indeed, this takes a big bite out of the total market capitalization. The DRs would not replace the RBTT shares on the First Tier Market since they are a different type of security and as such would probably be listed on a new market- e.g. the DR Market.

While the First Tier Market will be significantly affected by this fall in capitalization value, all is not lost. By creating a new market for the DRs, the exchange would in fact be opening the doors for other multinational companies to list locally, thus increasing the breadth of our market. Another positive note would be that the listing would indirectly allow RBTT shareholders to continue to hold a stake in the once Caribbean owned bank.

In conclusion, I would like to reiterate that certain statements above are forward looking statements and that readers should not place undue reliance on these statements as a number of important factors could cause results to differ materially from the beliefs, plans, objectives, expectations, anticipations, estimates and intentions expressed in such forward looking statements.

Gia Singh
Senior Research Analyst