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GLOBAL COMPETITOR

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EQUITIES Distribution

By John C. Edmunds

There's a new game in town—cross-border portfolio investment. Multinationals that learn how to play the game—by issuing stock in subsidiaries' home markets—stand to become the big winners.

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Sime Darby's founders probably never envisioned a future as a diversified multinational corporation when they established the plantation company in Malaysia in 1910. But by 1987, the company was dealing not only in tropical commodities but also in motor vehicles, insurance, and engineering. And further diversification into manufacturing and property development was clearly visible on the horizon. It took money—lots of it—to diversify in such an aggressive way, and Sime Darby found the cash it needed in unlikely places—emerging stock markets.

To gain access to a larger group of investors, Sime Darby established a policy of selling stock in its Philippines, Singapore, Hong Kong, and Australian subsidiaries on local exchanges (the parent company's shares are traded in Kuala Lumpur, Singapore, and London). And that policy paid off. Between 1987, when it began selling shares in subsidiaries and the end of 1992, Sime Darby's sales went from 2.092 billion ringgit to 6.197 billion, pretax profits went from 181,800 million ringgit to 755,400 million, and assets nearly doubled from 3.6 billion ringgit to 6.55 billion.

Royal Dutch Shell is another believer in putting its stocks in more than one market, and it's been pursuing this policy since 1907. Since then, it has cross-registered two different issues in the stock exchanges in the major industrial countries: Royal Dutch shares and Shell Transport (U.K.). More recently, the company has gone even farther. It has taken subsidiaries in Malaysia, Singapore, Taiwan, and the Philippines public. It retains a controlling interest—for example 75 percent in Malaysia—and then sells the remaining interest to investors on the local exchange

Sime Darby and Royal Dutch Shell are leading players in the new game of cross-border portfolio investment. And other multinational companies might profit enormously if they learn the rules. They can earn much higher profits for their stockholders by turning their strong reputations into blue-chip securities in as many national stock markets as they have subsidiaries.

Those that issue financial products in rapidly growing markets will not only raise funds, they will also establish a presence and build name recognition. Before they can do this, however, they must change their view of the foreign subsidiaries they own. Instead of viewing them only as operating divisions, they need to view them as issuers of securities in local markets.

And there's an increasingly strong market for these issues. Middle-class investors, and the professional portfolio

managers who serve them, no longer look only to London, New York, and Tokyo—the leading markets—for equity investments. In at least 30 countries, stock markets are getting larger relative to debt markets. This fact has an immediate strategic implication: Middle-class consumers are also investors, and they are increasing their purchases of investment products faster than their purchases of traditional consumer goods.

A macro perspective

The impact of securitization has only begun to be felt, and only a few multinational companies, including Sime Darby, Royal Dutch Shell, Volkswagen, and Unilever, have reoriented their financial strategies to take advantage of its potential. That potential can be estimated as follows. World GNP in 1993 was approximately $39 trillion. The value of all capital assets is twice that figure, $78 trillion, if the assets are not securitized. But the value rises to three times that figure, or $117 trillion, if they are securitized. The average degree of securitization in the world is around 30 percent, so there are stocks and bonds in circulation with a value of $35 trillion.

This means that 70 percent of the income-producing properties in the world are not taking full advantage of the benefits of financial intermediation. These are worth $55 trillion in their current state, unlevered, illiquid, and indivisible. If they were securitized, they would be worth $27 trillion more than they are worth today.

From that crude calculation it can be seen that if the average degree of securitization in the world is raised from 30 percent to 50 percent, $7.8 trillion of new wealth would be brought into existence. (For reference, U.S. annual GNP is about $6.6 trillion.)

This $7.8 trillion of new wealth is the gain from packaging income-producing properties into convenient, transferable, medium-sized units, tailored to the needs of investors. The new wealth is value added in processing whole properties and businesses into stocks, bonds, options, mutual funds, and the gamut of derivatives, just as a meat packer adds value to a steer by processing it into steaks, roasts, hamburger, sausage, and leather.

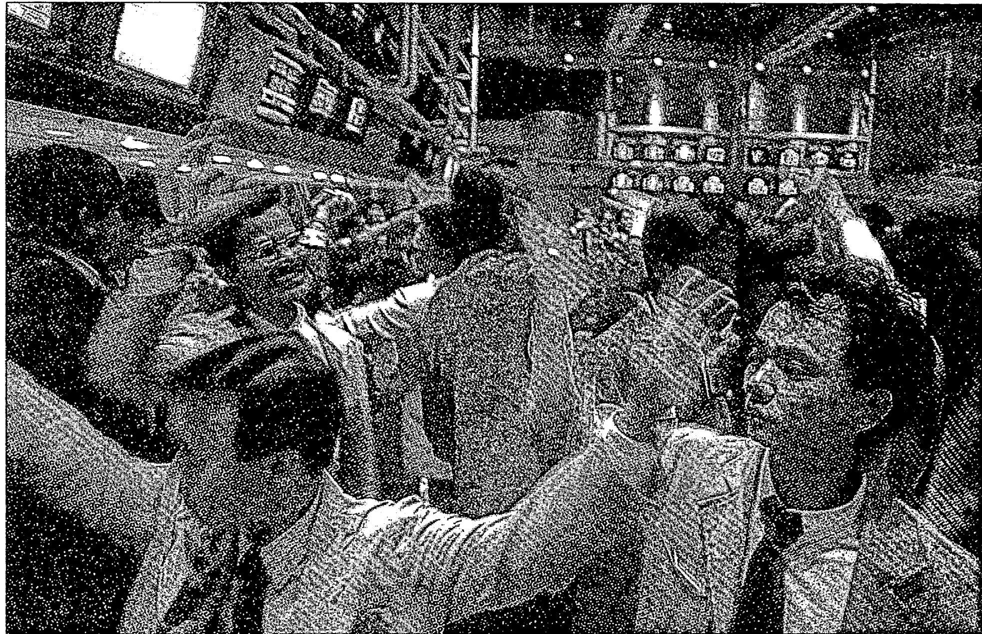

Photo by Anne Rippy

Both Sime Darby and Royal Dutch Shell trade subsidiaries' stocks on the Singapore Exchange.

If securities markets continue to grow faster than the economies where they are based, the firms that transform themselves into sellers of high-quality securities will prosper. The steps they must take are quite simple:

- Every multinational company should review its operating divisions to find any that is a suitable candidate to be taken public in its local stock market. If there is a candidate that needs a change in its capital structure, or a modified legal setup, the company should make those changes.
- Some of the proceeds of the sale of the subsidiary's equities should be used to purchase shares of other companies traded on the local exchange. Therefore, the company will need to hire people who are knowledgeable enough about local companies to select the less-known local firms in which the subsidiary will invest. It will also need to hire people who will handle relations with the investment community in the country where the flotation is to take place.
- Someone at headquarters must track the multinational's total risk profile, taking into account the new risks of stock market fluctuation, distinct from the more familiar operating risks.
- The finances of subsidiaries must be managed as if each subsidiary were a stand-alone company. Headquarters finance executives will continue to exert influence over finance decisions made by the subsidiary, but they will be careful to keep the subsidiary's finances in close accord with the norms of the country where the subsidiary is domiciled.

Cut the puppet strings

Few companies are structured to take advantage of the benefits of securitization. Today, multinationals perform a classical financial intermediary role by making use of one advantage they have over local firms: Their cost of capital is lower. They get money where it is cheapest and put it to work in countries where local competitors have to pay more for capital. This strategy calls for a

strong degree of centralization in the finance area.

Once upon a time, centralizing the finance function was essential. Local autonomy would have led to suboptimization, transactions at cross purposes, localized liquidity crises, a higher cost of capital, and perhaps financial catastrophe. But with modems, packet switching, and networked personal computers, a much higher degree of local financial decision-making autonomy becomes feasible. Every affiliate, whether large or small, can have its finance function as fully developed as it sees fit.

In a decentralized structure, each subsidiary could, for example, make known its preferences with regard to placing its excess cash balances: Should they be placed in the local money market, or in a foreign money market, and if so, which one? Although the funds can be placed in only one configuration in the firm's bank accounts, computers can track what would have been the result of placing them according to each subsidiary's wishes. And computers can calculate scaled rankings of funds' placement performance, for example, with losses weighing more heavily than gains of the same amount, to penalize excessive risk-taking. So the multinational can keep records and calculate performance ratings based not only on what was done with cash balances, but also based on what individual managers wanted to do with the cash.

One company, many enterprises

Multinational companies will also benefit from diversifying their external sources of funds. The ability to source funds in many markets is an advantage multinationals have over the new entrants who hope to gain market share by price-cutting. To press that advantage to the fullest, however, requires that established multinationals focus on taking advantage of the rapid growth of cross-border portfolio investment.

That means they should no longer treat subsidiaries solely as operating divisions. As far as production, logistics, and marketing are concerned, the subsidiaries should continue to be treated that way. But if they are viewed as financial entities, it is far more profitable for them to be turned into stand-alone enterprises, with shares trading on the local stock exchange.

The financial structure of each major local subsidiary has to be brought

Sell Shares, Not Products: The GU Indonesia Story

Suppose that Global United, a hypothetical multinational company based in London, has a 100 percent-owned subsidiary that operates in Indonesia. This company, GU Indonesia, is a strong and well-known player in the local economy. Its products are widely known and are closely identified with the company. It has 20 years of successful operations in Indonesia, and it has been advertising its products on local TV and radio for 15 years. GU Indonesia's annual sales are $100 million equivalent, and its annual profit for the most recent year was $4 million equivalent after local taxes. Currently, Global United stock trades on the London stock exchange at 15 times earnings, and GU Indonesia's earnings are consolidated into the parent company's income statement. The total market value of Global United's stock in London is presumably $60 million higher because of GU Indonesia, assuming that buyers on the London market apply the price/earnings ratio of 15 to all of Global United's consolidated earnings.

Now suppose Global United decides to offer 20 percent of the shares of GU Indonesia on the Jakarta exchange. There would be costs and taxes to pay in order to set up the offering. But suppose that the 20 percent block is floated on the Jakarta exchange, and the block is taken up by 5,000 investors, including 500 foreign investors from Singapore, Malaysia, Hong Kong, Tokyo, London, and New York, who immediately buy half the issue. Assume that after the flotation, GU Indonesia shares trade at 12 times earnings, a lower multiple than the one paid in the rich country. After costs and taxes, Global United gets $6.7 million equivalent in local currency.

Suppose also that this money is left in Indonesia to be invested by GU Indonesia. GU Indonesia does not invest it in machinery, but instead uses the money to buy shares of local companies. It buys shares of companies that are well-run but little known abroad. Some of these companies' shares are already listed on the Jakarta stock exchange, and others are going to be listed in the near future. Those that are listed are trading at nine times earnings, and the ones that are not yet listed will trade at six times earnings.

This sale of stock and subsequent purchase of shares in local firms will bring profits to Global United, and to the shareholders of GU Indonesia. The profits are from securitization. Consider these aspects of the impact these transactions will have on securities markets:

- *The shares of GU Indonesia become an instant blue chip. The company's strong name and lengthy operating history immediately qualify it to be bought by conservative investors both in Indonesia and abroad.*

into conformity with the norms of the country where the subsidiary operates. That makes the subsidiary a credible issuer of common stock in the local market. This is the step that will draw the multinational company fully into the next phase of its development. The multinational can become an organization that caters to the growing market for high-quality securities.

If the parent company's shares are already traded on major exchanges, why bother issuing shares in subsidiaries? Because securitizing an asset makes it more valuable. A rule of thumb is that a business is worth 50 percent more if there is a liquid market for its shares. You pay six times cash flow if you buy an entire company, but you pay nine times cash flow for a share of stock in the same company. (That assumes the company is being managed for the benefit of the shareholders, and it also assumes that the majority shareholders are prevented by law from defrauding or undercompensating the minority shareholders.)

Not only can securitization increase value, it can also lower risk. When multinational companies operate in countries where foreign exchange is rationed, the binding constraint on the scope and growth of their activities usually is not the size of the internal market, but rather the scarcity of foreign exchange. There has to be enough foreign exchange to pay for imported machinery and inputs and to provide a return on the initial investment. Dividends, royalties, licensing fees, and other cross-border payments from subsidiary to parent, or from affiliate to affiliate, are often taxed, delayed, or embar-

Managers of companies with strong images in many countries should be thinking more about selling securities and less about selling products.

● The shares of the less-known companies are brought to the attention of a wider investing public. The market for them has been made more liquid, and the vote of confidence from GU Indonesia adds an aura of credibility.

● Because of the GU Indonesia offering and the trades the subsidiary makes with the proceeds, the volume of transactions on the Jakarta exchange has been increased—at least by the amount of these transactions. This makes investors more willing to buy, because they have greater confidence that they will be able to sell when they want to.

The impact of these transactions on the consolidated income statement of Global United will be positive if any of several valuation advantages are obtained. For example, Global United will benefit if the income from the shares of the less-known companies is higher than the income from the 20 percent of GU Indonesia that Global United no longer owns. There can also be an improvement in the multiple that investors pay in London or Jakarta. It is particularly likely that the shares of the little-known companies will benefit from an increase in their market multiples. If that happens, Global United can earn capital gains on GU Indonesia's purchases of these companies.

The next step is to seek cross-registrations for GU Indonesia's shares on the exchanges in Singapore, Sydney, Kuala Lumpur, Hong Kong, Taiwan, and Tokyo. After the cross-registrations, Global United can float an additional 20 percent of GU Indonesia. Broadening the market for the shares may increase the multiple that investors pay for them, and it will also improve their liquidity.

The cross-registration process will have the additional benefit of turning shares of an Indonesian company into collateral that can be pledged for loans outside of Indonesia. These loans would be denominated in hard currency. The shares of GU Indonesia, once they are cross-registered, could be used to support arbitrage among national capital markets. An individual in Kuala Lumpur could buy the shares, pledge them against a low-cost dollar loan, and then invest the cash in Indonesia, earning the higher rate of return that is normally available.

This process of capital market arbitrage would not continue until the difference in rates of return is eliminated, because part of the difference is due to risk, but it would raise the amount of dollars entering Indonesia. The money entering would be new inflows of portfolio investment. Its arrival would ease the foreign-exchange constraint on growth, so the Indonesian economy would be able to grow faster. And as it grows faster, the earnings prospects for GU Indonesia improve, and its stock price has yet another reason to go up. —J.C.E.

The best and the worst of the emerging stock markets

Country	Mkt. Capitalization (U.S. $M) June 1993	Monthly Value Traded (U.S. $M), June 1993	% Change in IFCG price indexes over 12 mo. ending 6/93	Ann. mean return (%, U.S. $ for 5 yrs ending 6/93)	Market Outlook
Argentina	26,968	725	–26.27	85.92	P/E multiples expected to fall in1994; financial services, food industry, and construction companies look good.
Brazil	76,023	4,434	57.01	42.48	With the economy still unsettled, those looking for short-term gains beware; long-term investors should analyze specific offerings carefully.
Chile	34,725	196	–13.31	32.40	P/E multiples expected to fall; largest sectors are electric power, telecoms, and petrochemicals.
India	59,016	1,122	–31.44	14.16	A scandal shook the Bombay market in December, but foreign investor interest remains high; construction, finance, and textiles show great potential.
Indonesia	17,100	693	8.71	–2.04	Several Indonesian stocks have been among the 10 best performing in the emerging markets; investors typically choose larger companies' stocks to ensure liquidity.
Korea Rep.	118,839	26,763	35.53	4.56	Government restrictions have been obstacles to foreign investors, so this market has grown slowly; construction and electronics are attractive sectors.
Malaysia	118,829	10,472	24.52	14.64	Smaller companies seem to perform better than larger, government-influenced companies; bank, manufacturing, and construction stocks look good.
Mexico	129,983	3.353	6.68	36.84	At the end of 1993, foreign investors had ploughed $8 billion in the market; financial services, food and beverages, and construction expected to gain.
Pakistan	7,078	123	–20.40	19.08	The Karachi market posted an all-time high in January, but this is not a market for neophytes; foreign investors stick with blue chips and multinationals.
Philippines	16,611	266	–9.30	15.84	Because the market is relatively volatile, investors concentrate in blue chips and a few second-tier stocks.
Thailand	62,162	5,108	27.23	18.96	A surge in foreign direct investment has fueled the economy and investor interest in the market; financial services offerings are touted.
Turkey	22,880	1,651	43.04	27.72	Declining short-term interest rates and foreign investor interest fueled market activity in late 1993; 4 Turkish companies were among the 10 best performing on emerging markets in January.
Zimbabwe	667	1	–32.4	–11.52	The government's liberalization of rules affecting foreign investment may increase investor interest in what has been the world's worst-performing market.

Sources: International Finance Corporation data; Margaret M. Price Emerging Stock Markets *(McGraw-Hill, 1994);* Financial Times.

goed because of the shortage of foreign exchange. The delays and taxes in turn raise the rate of return that investors demand for accepting the risk.

The rapid rise of stock markets in countries from Austria to Zimbabwe has made it possible for business growth to break free of this binding constraint. Stock market expansion, combined with international portfolio diversification, provide the means to leapfrog the foreign exchange constraint.

Cross-border portfolio investment can grow faster than trade in goods and services, and faster than the buying power of middle class investors. Indeed, it is already doing so. Investors everywhere are showing more enthusiasm for internationalizing their portfolios. This means that managers of companies with strong images in many countries should be thinking more about selling securities and less about selling products. They have everything that is required to become dominant players in this rapidly growing new arena of economic activity. All they need to do is to devote their full attention to the task, and redirect their financial organizations to seize the opportunity.