SCREENING FOR GROWTH ABROAD: ADRs AT A REASONABLE PRICE

By Kenneth J. Michal

An ADR is a negotiable certificate issued by a U.S. commercial bank, priced in U.S. dollars, representing shares of a non-U.S. publicly traded company. Their purpose is to make investing abroad both simpler and less costly for the individual investor.

One of the first principles of investing is to reduce portfolio risk by diversifying among different kinds of securities. One tactic to ensure you are investing in different kinds of securities is to add some degree of exposure abroad—investing internationally.

Individual investors can easily access the foreign markets via international mutual funds. But if you want to invest in individual stocks, an excellent route overseas is to purchase shares of international companies in the form of American depositary receipts (ADRs). A depositary receipt is a negotiable certificate that is issued by a U.S. commercial bank and represents shares of a non-U.S. publicly traded company. They are priced and pay dividends in U.S. dollars.

This article explores the characteristics of ADR stocks and how a growth-at-a-reasonable price screen could be applied.

SOME BACKGROUND

ADRs are usually highly correlated with their home stock market. Performance of the ADR will mirror very closely that of the underlying stock traded on a foreign exchange. For U.S. dollar-based investors, ADRs are also subject to the same currency risk as the underlying stock in the foreign market when the value of the dollar changes relative to the native currency. For example, if the U.S. dollar appreciates against the French franc, the real return to a U.S. dollar-based investor will be less than the return to a franc-based investor because of the stronger dollar. This currency risk makes the returns on ADRs more volatile. ADRs were introduced in the 1920s to address many of the difficulties of trading foreign stocks, not to mention the high and variable per share costs involved.

VITALS AND STATISTICS

According to the Bank of New York, the world's leading depositary bank for ADRs, there are currently over 1,600 ADRs from over 60 countries available to U.S. investors. Most of these are not listed, but trade over-the-counter. AAII's fundamental screening software program, *Stock Investor Pro,* tracks 291 exchange-listed ADRs.

Table 1 presents an industry breakdown of ADR stocks tracked by *Stock Investor Pro* versus non-ADR stocks. ADRs have generally been represented by the most widely held, actively traded non-U.S. issues and are mostly categorized as large-cap stocks. These types of firms have traditionally become ADRs for two reasons: first, to enhance their image as a world-class stock while increasing company exposure and second, to satisfy the need for raising equity capital in markets outside of the firm's home country.

Basic materials and energy are the two sectors with the highest proportions of ADRs relative to the non-ADRs. Basic materials and energy make up 11.3% and 7.2%, respectively, of the ADR universe. In contrast, basic materials make up 5.9% and energy just 3.8% of the non-ADR stock universe. Other segments that make up a larger percentage of ADRs relative to

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TABLE 1. SECTOR BREAKDOWN: ADRs VS. NON-ADRs

	ADRs		Non-ADRs	
Sector	No. of Firms	Percent of Total	No. of Firms	Percent of Total
Basic Materials	33	11.3	439	5.9
Capital Goods	13	4.5	438	5.9
Conglomerates	7	2.4	30	0.4
Consumer Cyclical	21	7.2	407	5.5
Consumer Non-Cyclical	20	6.9	276	3.7
Energy	21	7.2	280	3.8
Financial	27	9.3	1,304	17.6
Healthcare	25	8.6	728	9.8
Services	63	21.6	1,621	21.9
Technology	38	13.1	1,555	21.0
Transportation	11	3.8	158	2.1
Utilities	12	4.1	177	2.4
TOTAL	**291**		**7,413**	

Source: AAII Stock Investor Pro/Market Guide Inc.

non-ADRs are conglomerates, consumer cyclical and consumer non-cyclical, and utilities.

In the non-ADR group, the financials and technology sectors have proportions significantly higher than the ADR universe—outweighing the ADRs almost 2-to-1 in both sectors. Technology is mostly characterized by high-growth, small-cap firms, and in the financial sector, the United States is currently the leader in managing the financial markets.

The 291 ADRs in *Stock Investor Pro* are spread throughout 41 countries. Some of these countries may have only one or two stocks representing their country in the U.S. markets, while others have dozens. The greatest number of ADR totals come from the UK (66), Mexico (23), and Japan (22). The complete country breakdown is shown in Table 2.

TABLE 2. ADR COUNTRY BREAKDOWN

Country	No. of Firms	Country	No. of Firms
Argentina	11	Italy	9
Australia	14	Japan	22
Brazil	8	Luxembourg	1
Canada	2	Mexico	23
Chile	18	Netherlands	8
China	10	New Zealand	5
Colombia	1	Norway	1
Denmark	3	Papua New Guinea	1
Dominican Republic	1	Peru	2
Finland	2	Portugal	2
France	16	Russia	3
Germany	10	Singapore	2
Ghana	1	South Africa	2
Greece	3	South Korea	3
Hong Kong	3	Spain	3
Hungary	1	Sweden	6
India	1	Switzerland	5
Indonesia	1	Taiwan	2
Ireland	11	UK	66
Israel	6	Venezuela	2
		TOTAL	**291**

Source: AAII Stock Investor Pro/Market Guide Inc.

In terms of total dollar trading volume as a percentage, the UK leads all countries with 23%, followed by the Netherlands with 14% and Brazil with 10%. Volume data for the top countries, taken from a recent Bank of New York report, is provided in Table 3. Table 4 on page 29 lists the most actively traded ADR stocks and includes total share trading volume and total dollar trading volume; the companies are ranked on total dollar trading volume. International telecommunications maven Nokia tops the most active list.

SETTING UP THE SCREEN

An investor looking for an aggressive, high-growth portfolio would have to look beyond the world of ADRs. However, applying a screen searching for steady growth at a reasonable price coupled with strong price momentum may highlight some foreign companies in this group that warrant further research and analysis.

Before developing the screen, the sample data set needed to be established. Our first screen reduced the 9,189 company universe down to 303 ADR stocks. We then excluded the non-listed, over-the-counter (OTC) ADRs to come up with our 291 ADR stock universe. These smaller, OTC-traded ADR stocks are eliminated because of the limited availability of meaningful data.

ADR QUIRKS

Once the ADR stock universe was established, further screens selected firms that are more growth-oriented but reasonably priced. However, before looking any further at the screens, it is important to understand a few minor quirks that are characteristic of ADR data when quoted as per share numbers.

Any and all share statistics for

TABLE 3. TOTAL ADR DOLLAR TRADING VOLUME BY COUNTRY

Country	ADR Dollar Trading Volume (%)
UK	23
Netherlands	14
Brazil	10
Finland	9
Mexico	6
Argentina	5
Ireland	5
Sweden	5
France	4
Italy	3
Germany	2
Japan	2
Korea	2
Others	10
TOTAL	**100%**

Sources: Adapted from data provided by the Bank of New York

Data from January 1, 1999, through June 30, 1999

ADR companies—including price-earnings ratios, earnings per share growth rates, and shares outstanding—are somewhat difficult to interpret unless you understand the special rules used in the calculations.

This is due to two ADR-specific data reporting principles: a per share conversion ratio and a minimal financial statement requirement that ADRs report on a yearly basis.

The conversion ratio indicates the number of shares of the underlying foreign security that are equivalent to one ADR share. For example, ADR stock British Steel, the second largest steel producer in Europe and the fourth largest in the world, has a conversion ratio of 10-to-1—so a single ADR share in this case represents 10 shares of the underlying foreign stock. This ratio varies from ADR to ADR.

Another issue concerning ADR share statistics is how the data is reported—either in the shares of the ADR or in shares of the foreign security. In the *Stock Investor Pro* program, shares outstanding, for example, is reported in the foreign stock equivalent. Again, using the same company as above, British Steel has 19,800 million shares outstanding of the underlying foreign stock and its ADRs trade in the U.S. with each ADR representing 10 shares of underlying stock. The ADR equivalent shares outstanding is then 1,980 million (19,800 million ÷ 10 = 1,980 million). How this type of data is reported might vary between data vendors, so be sure to check how ADRs are handled.

Data on shares outstanding is included in financial statements that must be filed with the Securities & Exchange Commission on a yearly basis. The report filed by exchange-listed ADRs is a 20-F report.

PRICE-EARNINGS RATIOS

Table 5 presents the results of the growth-at-a-reasonable-price screen. The price-earnings ratio, which is computed by dividing the current stock price by the firm's earnings per share for the most recent 12-month period, provides a quick feel for market valuation of a stock. Stocks trading with high price-earnings ratios are generally trading with high expectations of future earnings growth. A perfect example of this is CBT Group, whose price-earnings ratio of 67.0 is tops in this group. CBT is an interactive, educational/

TABLE 4. THE MOST ACTIVELY TRADED ADRs

Company Name	Ticker	Sector	Country	Total ADR Share Trading Volume (000)	Total ADR Dollar Trading Volume ($000)
Nokia Corp.	NOK	Technology	Finland	260,600	27,864,840
BP Amoco p.l.c.	BPA	Energy	UK	197,126	19,695,274
Vodafone AirTouch PLC	VOD	Services	UK	103,706	19,699,200
Royal Dutch Petroleum Co.	RD	Energy	Netherlands	311,650	16,144,337
Telefonos de Mexico, S.A.	TMX	Services	Mexico	197,319	13,052,972
LM Ericsson Telephone Co.	ERICY	Technology	Sweden	488,521	12,727,383
Elan Corp., plc	ELN	Health Care	Ireland	158,870	8,932,640
YPF Sociedad Anonima S.A.	YPF	Energy	Argentina	218,798	8,163,140
Unilever N.V.	UN	Consumer Non-Cyclical	Netherlands	94,686	6,759,196
Koninklijke Philips Electronics	PHG	Conglomerates	Netherlands	75,473	6,013,697

Sources: Adapted from data provided by the Bank of New York; AAII Stock Investor Pro/Market Guide Inc.

Data from January 1, 1999, through June 30, 1999

TABLE 5. GROWTH AT A REASONABLE PRICE SCREEN: PASSING ADRs

Company (Exchange: Ticker)	Country	Current P/E (X)	Earnings per Share: Year One ($)	Earnings per Share: Growth Rate (5-Yr) (%)	Earnings per Share: Est Grth Rate (5-Yr) (%)	PEG Ratio (5-Yr EPS Growth) (X)	Forecast PEG Ratio (Est 5-Yr EPS Growth) (X)	52-Week Price Range: High ($)	52-Week Price Range: Low ($)	Rel. Strength Rank: 13-Week (%)	Rel. Strength Rank: 52-Week (%)
Akzo Nobel N.V. (M: AKZOY)	Netherlands	19.5	2.18	20.2	7.0	1.0	2.8	63.69	31.56	60	41
Grupo Televisa, S.A. (N: TV)	Mexico	42.7	1.11	56.0	37.0	0.8	1.2	50.13	14.88	87	80
Volvo (M: VOLVY)	Sweden	17.7	1.70	25.9	0.0	0.7	na	35.50	19.25	62	59
Barbeques Galore Ltd. (M: BBQZY)	Australia	9.7	0.76	16.8	0.0	0.6	na	8.88	2.50	72	57
CBT Group PLC (M: CBTSY)	Ireland	67.0	0.38	109.1	30.0	0.6	2.2	63.88	6.69	84	8
TRICOM S.A. (N: TDR)	Dom. Republic	15.1	0.78	27.3	0.0	0.6	na	12.25	3.44	86	82
Luxottica Group S.p.A. (N: LUX)	Italy	15.9	1.18	29.8	14.7	0.5	1.1	17.38	7.50	64	62
British Steel plc (N: BST)	UK	14.2	1.82	35.5	10.0	0.4	1.4	26.38	14.06	77	74
DONCASTERS plc (N: DCS)	UK	9.3	1.92	34.9	13.5	0.3	0.7	30.38	8.13	66	24
Asia Satellite Telecomm. (N: SAT)	Hong Kong	12.6	1.87	65.6	17.4	0.2	0.7	23.56	9.75	90	84
Bouygues Offshore S.A. (N: BWG)	France	7.0	2.27	31.8	15.0	0.2	0.5	24.88	10.25	55	36
Denison Inter'l PLC (M: DENHY)	UK	11.1	1.47	65.1	12.0	0.2	0.9	19.88	10.88	64	41
Indigo Aviation AB (M: IAAB)	Sweden	8.2	1.09	37.7	22.5	0.2	0.4	12.75	5.75	73	44
Medians for Passing Companies		**14.2**		**34.9**	**13.5**	**0.5**	**1.0**			**72**	**57**

Source: AAII Stock Investor Pro/Market Guide Inc.

Data as of July 2, 1999

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

training software developer—a business segment characterized by high growth companies. Stocks with low price-earnings ratios generally have lower growth expectations or are perceived to possess higher risk.

When examining a firm's price-earnings ratio, some insight can be gained by comparing it against benchmarks, such as the price-earnings ratios for the market, for the company's industry, and even the company's own historical levels. The current market multiple can be found in such financial papers as the Wall Street Journal and Barron's. Industry multiples are a little bit harder to come by, but can be found in publications like Value Line Investment Survey or in software programs such as AAII *Stock Investor Pro*.

EARNINGS PER SHARE

Earnings per share growth is one of the main benchmarks used for measuring company performance. The range of five-year earnings growth rates for this group swings from 16.8% for Barbeques Galore to 109.1% for CBT Group. The 109.1% outlier may be an extreme value difficult to interpret; for example, high rates may occur because earnings in the base year used in the calculation were at an extremely low level or near zero. This is the case here, as CBT Group's earnings per share figure in the base year of the calculation was $0.05. Nonetheless, there are some solid growth numbers here with the earnings per share figures to help substantiate them—looking at the year-by-year figures helps assess validity and true trend.

The earnings per share growth estimate is the median of analysts' expected long-term growth rate in earnings. This number is a forecast of earnings growth for the next five years.

THE PEG RATIO

The ratio of the price-earnings ratio to the earnings growth rate (PEG ratio) is often used to measure the balance between value and growth. The PEG ratio provides an indication of how the market values the firm relative to its historical earnings growth rate. When a firm's price-earnings ratio is high relative to historical earnings growth, its price has high expectations built into it relative to what the firm has been able to produce in earnings historically—and therefore might be overvalued. The flip-side—finding undervalued stocks—occurs when the PEG ratio is low and the investor is able to purchase historical growth at a reasonable price. A firm with a low price-earnings ratio may not be a bargain if the company has poor earnings growth prospects. Firms with higher growth prospects are attractive if you do not pay too much for the earnings.

As a general rule of thumb, firms with PEG ratios near 1.0 may be considered fairly valued, those with ratios less than 0.5 may be undervalued, and those with ratios above 1.5 may be overvalued. Luxottica Group's 0.5 ratio of price-earnings to earnings growth may mean that the stock is undervalued, whereas

Grupo Televisa's ratio of 0.8 points to a fairly valued stock.

For our first ADR filter, we screened the listed ADRs for companies with a PEG ratio less than or equal to 1.0, eliminating all ADRs with high PEG ratios, and then we screened for companies with PEG ratios greater than or equal to 0.2. This minimal level is specified to eliminate companies with extreme values that most often prove to be meaningless. The first PEG ratio ceiling criterion screened out a significant amount of the original 291 ADR data set, dropping the total to just 45 firms. The floor PEG ratio filtered our group down just slightly to 40 ADR companies.

The same valuation principles discussed above hold true for the forecasted PEG ratio, which uses estimated future earnings growth instead of historical. Checking these figures, it appears Indigo Aviation might be considered undervalued based upon future earnings growth forecasts, while a couple of passing ADRs seem to become considerably overvalued here when focusing on the future of earnings. Forecasted PEG ratio data is not available on some of these firms because not all stocks have expected long-term growth estimates.

PRICE MOVEMENTS

The high and low stock prices show the company's stock trading range over the past year. Over the last year and a half, there have been some dramatic swings. Grupo Televisa, a Spanish-language television programming producer and broadcaster, provides a good example of the wildness over the most recent 52-week period. Grupo Televisa started the period with a price of $37.63, hit a low of about $15 in September of '98, and rebounded to close at over $50 in early July.

RELATIVE STRENGTH RANK

The relative strength rank figure indicates how a company's stock price has performed relative to all other stocks in the complete *Stock Investor Pro* universe. A rank of 50% indicates that the stock's performance was better than 50% of all stocks. A rank of 75% reflects performance better than 75% of all stocks—or performance that places the stock within the top 25% of the universe. Investors seeking stocks showing price momentum often look for stocks with strong and improving relative strength ranks. The best way to do this is to check both a short-term relative strength figure and the performance over a long-term period. A high 52-week rank coupled with a more recent, low figure—say a low 13-week rank—points to a company whose relative price strength is weakening.

Grupo Televisa is a good example of a stock showing strong performance and surging price momentum. Grupo Televisa has a high 52-week relative strength rank of 80%, indicating that the stock has outperformed 80% of all stocks over the last 52 weeks. In addition, Grupo Televisa has posted even better performance more recently, with a 13-week relative strength rank figure of 87%. This stock performed well over 52 weeks and even stronger in the short-term—true price momentum.

Our relative strength screening criteria looked at establishing a strong relative performance group of ADRs, all exhibiting price momentum. Requiring 13-week relative strength rank to be greater than or equal to 52-week relative strength rank trimmed our group of ADRs down to 15 companies. A final filter forced 13-week relative strength rank figures to be at least at 50%, which provided our final set of 13 companies.

ABROAD AT HOME

The list of passing ADR stocks is not a diversified portfolio, nor is it a recommended list of companies to invest in.

This initial growth at a reasonable price ADR screen is meant only to be a starting point toward further detailed analysis. Throughout the year, the *AAII Journal* and the AAII Web site (www.aaii.com) present articles to illustrate how individual investors can analyze the prospects of specific stocks by applying a variety of secondary screens and demonstrating how these techniques might be useful. Applying screens to actual stocks enables individual investors to become familiar with the interpretation of financial data and the process of individual stock selection in a fundamental analysis framework.

Before making any investment decision, you should gather all pertinent information and understand the investment thoroughly—including its native country and market in some cases. Also, keep in mind that no one investment technique will be best in all market environments and that the techniques that worked in the past may not be as useful in the future.

One investment technique discussed in the beginning of the article has an excellent track record, however, and that is diversification. Maintaining a diversified portfolio of investments at a level of risk that you are comfortable with and taking a longer-term perspective are investment approaches that will prove the most valuable over time.◆