

THE PROBLEMS OF DEVELOPMENT OF INITIAL PUBLIC OFFERING IN THE CZECH REPUBLIC

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Abstract

Funding development of the company through the “Initial Public Offering” has a high representation globally, the Czech Republic unlike, and belongs to traditional methods of raising funds necessary for development of business in the developed capital markets. Under the conditions of the Czech capital market this way funding of development of the company, connected with its entering into the capital market, is not very usual. The paper introduces the results of an analysis identifying the causes of the low numbers of IPOs in the Czech Republic. In order to reach the objective, the secondary research of the literature sources, focused on the issue in question and the primary research in the Czech companies was carried out. The paper was written with the financial support of the Czech Science Foundation (Grant Agency of the Czech Republic), grant project No. 402/09/P134 “Decision Model of Company Financing via IPO”.

Keywords: IPO, financing, Czech capital market.

Introduction

Funding development of the company through the “Initial Public Offering” has a high representation globally, the Czech Republic unlike, and belongs to traditional methods of raising funds necessary for development of business in the developed capital markets. Without the possibility to obtain the capital by this way the global financial system, the economic system alike, would be of a quite different shape than nowadays. In the United States of America, Japan and in the Western Europe countries the method of company funding through IPO has been applying for several decades already. The first public stock offerings began to be applied in these markets in higher volumes from the beginning of the 60th of the last century. From that period importance of IPO goes up globally and the initial public stock offerings begin to be applied more and more even in the Central and Eastern European countries. Under the conditions of the Czech capital market this way funding of development of the company, connected with its entering into the capital market, is not very usual. The Strategy of Sustainable Development of the Czech Republic considers this situation the weakness of the Czech economy, and its resolving has to be paid a due care. Analysis of the main reasons of low interest of the Czech companies in funding their activities through the public issue of shares is the very objective of this paper. In order to reach the objective, the secondary research of the literature sources, focused on the issue in question and the primary research in the Czech companies was carried out. The paper was written with the financial support of the Czech Science Foundation (Grant Agency of the Czech Republic), grant project No. 402/09/P134 “Decision Model of Company Financing via IPO”.

Main Body

When searching for relevant definitions of the term “Initial Public Offering” for which the abbreviation “IPO” is generally used, I have relied on foreign sources, in particular from the United States of America and Western Europe.

- The U.S. SEC defines IPO as the initial public offering of shares by a company heretofore not publicly listed.
- NASDAQ defines IPO as initial offering of shares of a private company to the public.
- Similar definitions can be found in works by Welche (2006) who defines IPO as a mechanism through which shares in companies not traded publicly first get to common investors.
- Ritter (1998) states in his publication that IPO occurs when securities are first sold to the broad public. According to Ritter, these can be both equity securities (shares) and debt securities (bonds).
- In Ross (1996), IPO is defined as the initial public offering of shares related to the company’s decision to become a public company.
- According to Carter (1990), IPO can be defined as the initial public offering of shares or bonds by an issuer previously not listed on the stock exchange or other similar organized public market.

- Giudici (2005) believes that IPO is the initial placement of securities, in particular shares, on the stock exchange.
- Khurshed (2000) defines IPO as the initial offering of securities to the broad public or institutional investors by a company getting listed on the stock exchange at the same time.
- Ernst & Young (2008) defines IPO for the purpose of its analyses as initial offering of company shares to the public.

The above definitions show that when defining this term, most authors stress the fact that the company is offering its securities, generally shares, to the public for the first time, and at the same time is entering the organized public securities market, most frequently represented by the stock exchange as a supreme organization. What is important is that an IPO may only be effected by an issuer whose securities are not publicly traded on the market at the time. Most authors believe that IPO includes a public offering of securities of a company whose securities have been traded on the public market in the past, as long as the new issue meets the above requirements for an IPO.

In light of the nature of this article, the notion of “Initial Public Offering“ shall further be used in the more narrowly defined sense, and “IPO“ shall be deemed to be an abbreviation for the initial public offering of shares.

Reasons of Low IPO Number in the Czech Republic

In the conditions of the Czech capital market, funding of company development through an IPO is not very common as yet. No initial public offerings of shares (within the meaning of the above definition) have been launched in the Czech Republic until 2004. Only as of 2004, several companies can be identified on the Prague capital market, or rather the Prague Stock Exchange, that have undertaken this form of financing over time.

The specialized literature sources, e.g. (Asociace, 2001), (Komise, 2001) or (Komise, 2004) identify different reasons of the low interest of the Czech companies in funding their activities through the public issue of shares. Individual authors are unable to agree what cause is the crucial one. This fact leads to the knowledge that the core reasons of the current state cannot be found, because it is not a single problem, but several interactive problems which could be perceived differently in the past by individual companies considering IPO. All important reasons of the low IPO number in the Czech capital market can be divided into the following four groups:

- economic reasons,
- barriers of legislative character,
- barriers on the issuers' side,
- other reasons.

Economic Reasons

Based on carried out analysis of economic reasons of the low IPO number we can state that the selected method of state property privatization, low degree of capital market regulation and protection of investors, preference of debt funding through bank credits, ownership structure of the Czech companies and the overall state of economy of the Czech Republic at the beginning of the 90th of the last century contributed materially to the fact that till the year 2004 not a single initial public share offering was realized in the Prague Stock Exchange.

Barriers of Legislative Character

The unsatisfactory legislation was considered by many specialists the material barrier for successful IPO realization in the Czech capital market in the past. The Czech legislation, in particular the Commercial Code and the Securities Act, contained a number of provisions which made the whole procedure of increase of the registered capital through the public issue of shares very difficult and extended the whole process materially, thus creating the legal uncertainty for IPO realization. This is why I have investigated individual legislative barriers that complicated the process of public issue of shares in the Czech capital market in the past (mainly before the year 2001). These barriers were compared with the current legal status in order to establish whether or not suitable legislative conditions for realization of the public issue of shares exist at least nowadays.

From the carried out analysis of the legislative barriers it follows that nowadays all greatest legislative barriers, which were designated the main reason of the low number of the initial public offerings in the Czech capital market in the past - see sources (Asociace, 2001) or (Komise, 2001) - have been eliminated fully. The existing legal regulation concerning IPO can be considered conforming to the situation in the developed capital markets. Strengthening of trust in the Czech capital market and protection of public interests and investors is the objective of the existing regulatory measures. The main reason of a still low number of the initial public share offerings in the Czech capital market therefore had to be searched in another group of obstacles and barriers, i.e. on the side of prospective issuers.

Barriers on Prospective Issuers' Side

Further obstacles for increase of the low number of the initial public share offerings in the Czech capital market were awaited on the side of the prospective issuers. This is why I realized the primary research in the Czech companies, focused on the reasons of low interests of the companies in funding their activities through the Czech capital market.

The primary research, which was quantitative in its nature, was conducted by means of questionnaires. These were completed by a representative sample of companies that investors might see as prospective candidates for IPOs. The companies were selected to meet the following criteria:

1. the company ranks among (one of) the two below:
 - a) *"The EVA ranking Czech Republic"*,
 - b) *"The top 100 companies in the Czech Republic in 2006"*,
2. the company's legal form is a joint-stock company,
3. the company's shares have not yet been traded in the Czech or foreign capital markets.

Based on the above criteria, 85 companies were selected, addressed as part of the quantitative primary research either by means of a letter with a questionnaire to be completed by finance directors or by means of a face-to-face interview with the directors. The table below shows the frequency of the individual methods including the response rate.

Table 1. Number of questionnaires used in primary research and response rate

| INQUIRY DATA | METHOD OF ADDRESSING SELECTED COMPANIES | | TOTAL |
|-----------------------------------|---|------------------------|-------|
| | Letter | Face-to-face interview | |
| Number of questionnaires sent | 65 | 20 | 85 |
| Number of questionnaires returned | 34 | 16 | 50 |

The questionnaire used in the primary research consists of three separate sections. The first section comprises questions related to the possibility to finance companies through the Czech capital market. The second section focuses on the major reasons for refusing financing of the company through an IPO. The third section facilitates identification of the size of the company, its activities and current distribution of finances.

Next, a summary of results is presented as they were obtained from a questionnaire survey. The survey focused on the causes of companies' low interest in financing their activities through the Czech capital market.

- The research has shown that the majority of surveyed companies (68 %) do not see the Czech capital market as a potential source of financing their development.
- It has been determined within the research that 48 % of interviewed companies have considered entering the Czech capital market through an IPO in the past. The same percentage of companies has not considered this form of financing yet.
- The majority of the surveyed companies (62 %) state that their management has sufficient information regarding possibilities to obtain the necessary funds through the capital market.
- The conducted research has shown that 72 % of the interviewed companies think that to obtain funds through the Czech capital market is more complicated or less advantageous than through bank loans.

- The majority of the companies under investigation (82 %) assume that the expenses incurred when obtaining a bank loan or issuing bonds are lower in the long run than expenses incurred when issuing shares.
- It was found out within the research that 36 % of the interviewed companies got to the stage of considering an IPO within the company, 8 % of them started informative talks with financial institutions and only 4 % of the interviewed companies got down to negotiating on a more advanced level.

The following part of the questionnaire focused on determining the reasons why surveyed companies have not used IPOs yet to finance their further development. When evaluating answers to the questions, it was necessary to take into account that these questions were answered even by those companies that have not considered an IPO yet. Nevertheless, even those companies quoted certain barriers which, in their opinion, were related to a low number of IPOs in the Czech capital market. This is why the research results are always presented from two perspectives. These are:

a) answers of all surveyed companies,

b) answers of those companies that at least considered financing their development through an IPO.

- The research has shown that the fear of restriction of control or possible loss of control over the company as a result of issuing new shares was one of the reasons why most surveyed companies (56 %) have not yet carried out an IPO with the aim to fund their further development. If, however, we take into consideration only answers of those companies that really considered conducting an IPO in the past, it may be claimed that the fear of restriction or possible loss of control over the company was one of the reasons why financing through an IPO was refused in almost 80 % of cases.
- The conducted survey has shown that the lack of information about possibilities of financing company development through public offerings was not the reason why the majority of surveyed companies have not conducted it yet. There were affirmative replies by only 12 % of all companies, or by 4,2 %, respectively, of those companies that really considered an IPO in the past.
- The research results make it obvious that the majority of the surveyed companies (56 %) regard the obligation to report, which the companies whose shares are traded in the public capital market (stock exchange) have to meet, as a reason for not conducting an IPO to finance their further development. If we take into account only replies of those companies that really considered conducting an IPO in the past, then the percentage of affirmative replies was even higher, 66,7 %.
- It has been found out within the survey that in the majority of companies that considered conducting an IPO, the lack of potential investors or the lack of their interest did not constitute a reason to reject this form of financing. Only 8,3 % of companies that got down to a more advanced stage of considering or discussing new share issues in the public capital market quoted the lack of potential investors or lack of the investors' interest as a reason to discontinue this process.
- The research results also show that legislative barriers were not a reason for not conducting an IPO in most surveyed companies. Only 16 % of all companies, or 16,7 %, respectively, of the companies that considered an IPO in the past have stated that the legislative barriers were one of the reasons why they did not utilise an IPO to finance their development. When detailing the barriers, the companies quoted the inability to issue shares on being paid the purchase price, and the long time it takes to enter the new amount of basic capital in the trade register.
- It has been found out in the research that for the majority of the surveyed companies (54 %, or 75 % respectively), administrative barriers, similarly to legislative barriers, do not present a major reason for refusing to finance development through an IPO. When giving more details, those companies that replied in the affirmative stated that the whole process was complicated and time-consuming.
- There is evidence in the research that 42 % of the surveyed companies regard costs related to introduction of a share issue in the public capital market as one of the barriers to implementation of an IPO. As for companies that considered an IPO in the past, 62,5 % of them consider costs related to its implementation a reason for refusal of financing their development via an IPO. When

characterizing such costs, the companies listed especially lead underwriter's fee and expenses related to legal counselling and other types of counselling.

- Within the research, only 8 % (12,5 % of companies that considered an IPO in the past, respectively) of the surveyed companies stated that they had encountered other problems when deciding about implementing an IPO. For instance, the surveyed companies did not consider themselves to be good candidates for an IPO, they belonged to a foreign group which decided about the way of financing, or they were afraid of a possible failure of the issue, which could seriously damage their reputation.

The last part of the questionnaire focused on determination of the company size, its main activities and on where the financial sources originate. As for the size of the surveyed companies, it was found out that an overwhelming majority (94 %) belong to a category of big companies. The remaining 6 % ranks among medium sized companies. Within the research, the companies' main activities were investigated, too. Based on the obtained data and in compliance with OKEČ, the surveyed companies were classified by their economic activities. The manufacturing industry was the most frequent among the surveyed companies (32 %), followed by trade (18 %), electricity, gas and water production and distribution (14 %), transport, warehousing and communications (10 %), and the building industry (8 %). The remaining companies operate in other industries, such as mining of other mineral resources or rental and real estate activities. The last data obtained within the primary research relate to where the surveyed companies' financial resources originate and what percentage of the resources it makes. The surveyed companies are largely funded from their own funds. Among external funds, bank loans are definitely prevalent; they participate in the companies' financial structure with 27,8 %. Financial leasing and issued bonds together amount to 8,4 % of the total financial resources. The remaining group of the financial resources comprises other sources, the most frequent being loans from the parent company.

Based on results of the primary research we can state that the majority of surveyed companies still does not consider the Czech capital market the prospective source for funding their development. Though the majority of investigated companies is persuaded that their management is informed very well about the possibilities of raising the necessary funds through the capital market, only a few companies moved in their history towards advanced negotiations about realization of the initial public share offering. All of them led to rejection of this form of funding afterwards.

The carried out research has proved that low interest of the Czech companies in funding their development through IPO is connected in particular with good availability of bank credits. Their granting is perceived generally as a simpler and more advantageous method than raising the funds through the initial public share offering. We have established surprisingly that the majority of surveyed companies insist on the opinion that the costs connected with acquiring the bank credit or bond issue are lower, even in the long-time horizon, than the costs connected with stock issue. The fact, that size of the needed funds does not lead to the adequate volume of issue of the new shares at which the IPO would be cost acceptable, can be considered possible clarification of this approach. It has to be acknowledged that with rising volumes of the issue the costs for IPO realization - in the relative reflection, i.e. in percentage of issue volume - real go down.

On the basis of personal interviewing certain representatives of the investigated companies I came to the conclusion that the IPO realization costs, expressed by percentage of volume of the stock issue, are sometimes compared erroneously only with the annual interest rate of the bank credit. Such thinking can be a further reason, why the majority of respondents consider the initial public share offering a more expensive source of funding even from the long-time horizon, compared with the bank credit. The carried out calculations show that IPO seems to be the more advantageous form of funding than the bank credit, namely both from the point of cash flow and from the point of its impact on economic results. This is valid even if the percentage reflection of the IPO realization costs of the issue volume reaches double the level of the annual interest rate from the bank credit. This is because from the long-time horizon the one-time costs for IPO are exceeded the accumulated level of paid interest for the whole term of the granted credit.

Fear of possibly lost or restricted control over the company due to issue of the new shares can be considered another significant factor playing an important role, when deciding IPO in the Czech environment. Such situation occurs, at even a higher level, in case of entry of the foreign partner into the company, which situation is a much more frequent phenomenon in the Czech environment. Within the scope of the initial public share offering the fear above can be eliminated to a certain degree by subscribing limited quantity of the shares representing only a certain part of the registered capital which will be traded in public

after IPO realization. Moreover, mainly the institutional investors, which usually do not intervene into company management, are interested in the initial public share offering.

I personally think that the argument against IPO shown above is partially also connected with the fact that activities of the company, in particular of its management, will be much more thoroughly and critically monitored by the public, i.e. investors, analysts, journalists, etc., after IPO realization. Negative approach to the public offer of the stock can thus be connected with fear of the “public control” of management activities, which must be absolutely transparent after the company enters the capital market. My assumption was confirmed indirectly by my personal meetings and interviews with certain representatives of the investigated companies.

Other reasons of the low interest of the Czech companies in funding their activities through IPO is connected with their negligible experience of this form of funding and also with their unwillingness to accept the duty of regular public reporting of its activities. This approach also supports partially the management fear of the “public control” of its activities. The increased risk of reveal of the business plans to the competition and/or the regularly repeating costs connected with fulfillment of the reporting duty can be considered the rational reason for unwillingness to participate in the reporting duty.

The duty to report is a very significant factor affecting the investors’ trust in the initial public share offerings and in the capital market in general. It has to be acknowledged that for the issuing companies such trust is crucial, because they must be sure they are really able to raise the necessary funds through the capital market. Moreover, as proved by the studies from abroad, the companies from the countries with more complex requirements for releasing the information and with stronger regulation in the securities sector have, under otherwise identical conditions, lower costs for obtaining the necessary capital.

The interviewed companies identify the following barriers to IPO realization: time and organization complexity of the whole process, dissatisfaction with high costs for the issue manager and for other consulting companies and, last but not least, also the fear of possible public failure, which might affect the company negatively. Coincidence of these factors with the factors above leads to the fact that the majority of respondents consider IPO realization in rough terms only or even not at all.

Other Reasons

Besides the reasons of the low interest of the Czech companies in funding their activities through IPO there are even certain other reasons of this state. Absence of tax privilege and/or state subsidies for the issuing company and non-use of IPO for additional privatization of the state property are considered the most important ones.

Conclusions

It follows from investigations of the situation in IPOs in the Czech Republic that financing company development through IPOs, which are linked with entrance into the capital market, has not become common practice in the Czech capital market. Comparing the present situation with the situation in international markets, it must be stated that the Czech capital market shows anomalies not only with regard to advanced capital markets such as those in the USA or Japan but also in reference to markets in Central and Eastern Europe. The findings of the research into low numbers of IPOs in the Czech Republic show that the selected method of privatising the state-owned property had an adverse effect on the development of the Czech capital market as a place where companies can obtain necessary funds through issues of property securities or debt securities. Czech companies have not yet started perceiving the capital market as a source of financing their further development and small investors have not started seeing the capital market as an alternative to enhance the value of their temporarily free funds. In the past, unfavourable conditions resulting from legislation and the institutional environment were considered the major cause of the long-term low numbers of initial public offerings in the Czech Republic. It follows from the results of the analysis of legislative barriers to carrying out IPOs that in recent years, a number of steps were taken to draw the Czech capital market nearer to the European standard, at least formally. Laws were passed that determine the scope and regulations for entrepreneurial activities of individual subjects, and an independent authority was set up that kept an eye on the transparency of the market and compliance with the given regulations; there are institutional and technical prerequisites available that facilitate trade in securities. It is manifested in the research that all major legislative as well as economic barriers that in the past were considered the causes of the low numbers of initial public offerings in the Czech capital market have been removed. It is therefore

necessary to look for other causes of the low numbers of IPOs elsewhere, that is, with prospective issuers. In view of this, primary research in Czech companies was conducted. It focused on discovering the causes of the companies' low interest in financing their activities through IPOs. The primary research results show that even today, the majority of surveyed companies do not consider the Czech capital market a potential source for financing their development. Although the majority of the investigated companies are convinced that their management is well informed of the possibilities of raising necessary funds through the capital market, only a few companies started advanced negotiations regarding conducting an IPO. All the negotiations have finally resulted in rejecting this form of financing. The conducted research has shown that the low interest of Czech companies in financing their development through IPOs is linked with giving preference to debt financing, in particular through bank loans. To obtain bank loans is generally accepted as being easier and more profitable than raising funds through IPOs. Another significant element that plays its role when deciding about an IPO in the Czech setting is the fear of possible loss or restriction of control of the company resulting from the issuance of new shares. Research findings suggest that the argument against an IPO is partly related to the fact that company activities, activities of its management in particular, are to be monitored by the public in more detail and more critically after an IPO is conducted. The unfavourable attitude to IPOs may be linked to the management's fear of 'public inspection' of their activities that have to be completely transparent when companies enter the capital market. Further reasons of the low interest of Czech companies in financing their activities through IPOs are connected with their little experience with this type of financing and also the unwillingness to accept the duty to disclose information about their activities. This attitude supports the above hypothesis regarding the management's fear of public inspection. Further obstacles listed by the surveyed companies as those discouraging them from an IPO include the following: an IPO is labour-intensive and time-consuming, the payments for the lead underwriter and consulting agencies are too high, and, last but not least, there are fears of failure that could have an adverse effect on the company. For the reasons given above, IPOs are considered to be more hazardous than utilisation of alternative sources of company financing, which is closely related to the low popularity of IPOs in the Czech capital market.

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