

RESEARCH INTO THE CAUSES OF LOW INTEREST OF CZECH COMPANIES IN FINANCING THEIR DEVELOPMENT THROUGH IPOs

Tomáš Meluzín

1. 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. To achieve the objective, quantitative primary research was conducted in Czech companies.

2. Main Part

In the past, unfavourable conditions resulting from legislature and the institutional environment were considered the major cause of the long-

-term low numbers of initial public offerings in the Czech Republic. The results of the analysis of legislative barriers to carrying out IPOs imply 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 adherence to 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 between July and September 2007. The research focused on the causes of the companies' low interest in financing 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:

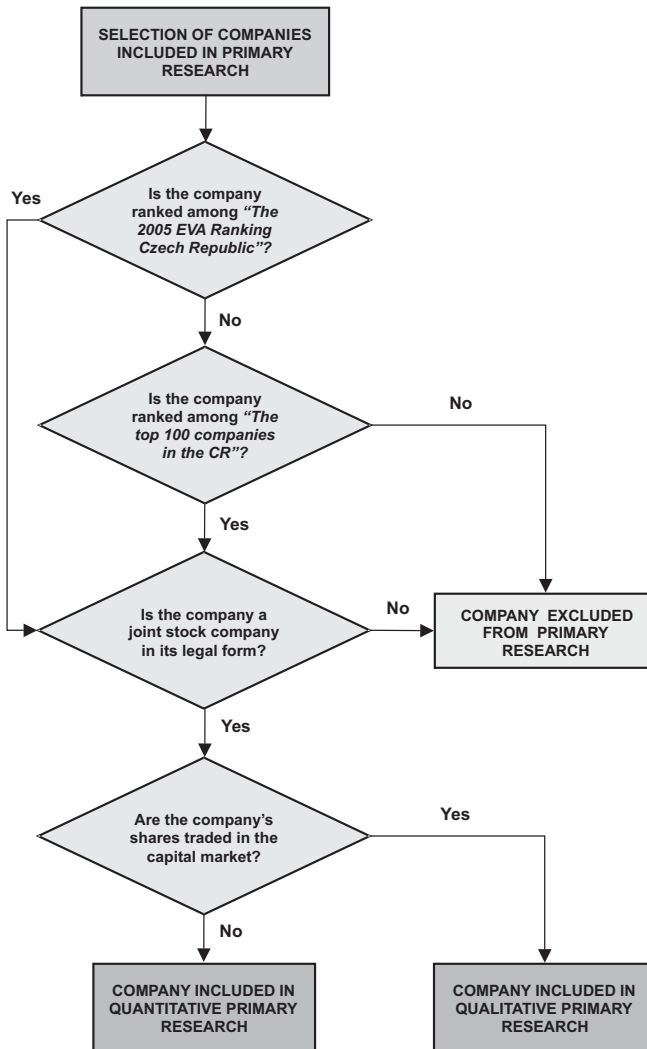
1. the company ranks among (one of) the two below:
 - a) „The EVA ranking Czech Republic“,
 - b) „The top 100 companies in the Czech Republic in 2006“,
2. the company's legal form is a joint-stock company,

3. the company's shares have not yet been traded in the Czech or foreign capital markets.

Provided the company was a joint stock company whose shares were traded in the capital market, it was included into the **qualitative primary research**, which was conducted by means of face-to-face interviews with the representatives of the companies. The following figure shows the way the companies were included in the research.

The project „**The EVA Ranking Czech Republic**“ has been in existence since 2000 and every year it identifies 100 companies that create the highest economic value added (EVA) for their owners. It is the first study of its kind not only in the Czech Republic but also in Central and Eastern Europe. The EVA index gives evidence of whether the companies create added value for the shareholders or whether they, on the contrary, destroy the value added

Fig. 1: The chart showing the way companies were included in the primary research



Source: Own compilation

by investors. The rating involved 1700 Czech companies in 2005.

The basic criterion to measure the company's performance following the EVA concept is residual income, which remains after subtracting all costs from the net operating profit after taxes. The basic structure of the EVA index may be expressed by the following formula:

$$EVA = NOPAT - C \times WACC,$$

where

NOPAT = Net Operating Profit After Taxes,

C = fixed Capital,

WACC = Weighted Average Capital Costs (in the shape of an index).

In order to be able to state that a company was successful, $EVA > 0$ must hold true. Only if that is the case, the shareholders' assets will increase as the shareholders will gain more than they invested while the creditors have been satisfied. If $EVA = 0$, the investment efficiency equals the average costs of the capital invested. If $EVA < 0$, the shareholders' assets (shareholders' equity) decreases as the investment efficiency is lower than the costs of the capital.

The concept of the economic value added is considered to be one of the most significant innovations in company finance for the past twenty years and it has proved to be an effective management tool to improve the performance and efficiency of a company and to create value for the shareholders.

The „**Top 100 companies in the Czech Republic in 2006**“ were listed on the basis of the economic data rendered by prominent Czech companies. The first top 100 were introduced to the public in June in 1995 together with the previous year's data. Besides direct economic indicators such as sales, added value, number of employees etc., the company CZECH TOP 100, a.s. also compiles ratio charts based on own cal-

culations. According to [14], this chart does not replace the official statistics but its informative value, accuracy and credibility allow it to be used for analytical purposes, for macroeconomic studies and for the individual companies' needs.

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.

The above table makes it obvious that out of the total number of 85 sent questionnaires, 50 were returned and subsequently interpreted, which generates 58,8% response rate. The highest response rate (80%) was achieved when face-to-face interviews with finance directors of surveyed companies were conducted.

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 per-

Tab. 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 |
| Response rate | 52,3% | 80% | 58,8% |

Source: Own compilation

tage 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.

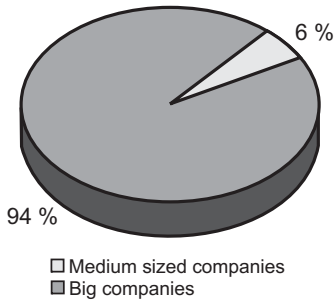
The following part of the questionnaire focused on determining the reasons why surveyed companies have not used IPOs yet to finance their further development. When evaluating answers to the questions, it was necessary to take into account that these questions were answered even by those companies that 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

Fig. 2: Classification of surveyed companies by size



Source: Own compilation

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.

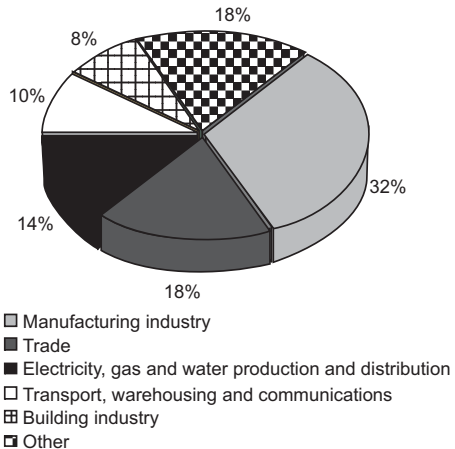
The last part of the questionnaire focused on determination of the company size, its main activities and on where the financial sources originate. As for the size of the surveyed companies, it was found out that an overwhelming majority (94%) belong to a category of big companies. As shown

in Figure 2, 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. As shown in Figure 3, 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 results are given in Figure 4, from which it emerges that 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

Fig. 3: Classification of surveyed companies in compliance with OKEČ

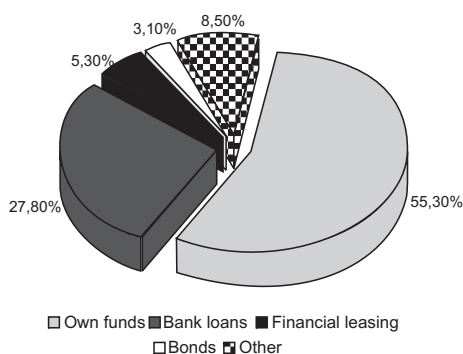


Source: Own compilation

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.

Fig. 4: Origin of financial resources of the surveyed companies



Source: Own compilation

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 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. This assump-

tion 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.

3. Conclusions

From results of analysis of the low IPO number in the Czech Republic it follows that nowadays there are no more any legislative or general economic barriers, designated as significant obstacles for IPO realization in the Czech environment in the past. Nowadays it depends mainly on approach of individual companies to this form of funding and on assessment

of not only all minuses, but also all the pluses connected with IPO. I think that distrust in the Czech capital market will disappear step by step and that the leading Czech companies will soon switch from their dependence on the credit funding and will enter into the Czech capital market through IPO. It has to be acknowledged that the companies diversifying their assets should utilize the multi-source funding in the same way, because it enables to compensate disadvantages of the debt funding, together with the limited creation of internal sources, by the advantages granted by IPO.

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ABSTRACT**RESEARCH INTO THE CAUSES OF LOW INTEREST OF CZECH COMPANIES IN FINANCING THEIR DEVELOPMENT THROUGH IPOs****Tomáš Meluzín**

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Key Words: IPO, capital market, financing, primary research.

JEL Classification: G32