Problems of Company Financing via IPO in the Czech capital market

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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. The paper aims at analysing major causes of the low interest of Czech companies in financing their activities through IPOs, assessment of IPOs that were conducted in the modern history of the Czech capital market, and an outline of perspectives of further development in this area. To achieve the specified aims, secondary research into relevant literature was carried out as well as primary research in Czech companies.

Research into the causes of low IPO number in the Czech Republic

The specialized literature sources, e.g. [2], [11], [12] 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.

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This paper is the outcome of my PhD research that dealt with IPOs in the Czech capital market.

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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 uncertainly 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 the literature source [2], [11] - 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 in the period from July till September 2007 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”,

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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 results of this research are presented in chapter below.

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

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3 If all prerequisites, determined for the illustrative example contained in my dissertation, are valid.
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.

Research into implemented IPOs in the Czech Republic

Research into implemented IPOs in the Czech capital market is another objective of this paper. The research aims at analyzing major characteristics of IPOs that were done in the Czech market in its modern-time history as well as at understanding approaches, views and experience of individual companies that did the IPOs. In order to meet the objectives,
secondary research was conducted into sources dealing with the above issues and primary research was carried out into companies that did an IPO in the Czech capital market.

**Analysis of major characteristics of IPOs in the Czech Republic**

Based on an analysis of IPOs that were done in the Czech capital market, it may be argued that:

- IPOs were done exclusively by *multinational holding companies* that carry out their activities on the territory of the Czech Republic while their parent companies are based abroad – in a country where companies are used to making use of the capital market to acquire the necessary financial resources,
- IPOs were mostly done as *dual share listing* in the domestic as well as international markets,
- The majority of IPOs were *combined IPOs* within which the investors were offered both primary and secondary shares. The offer of *secondary shares* was mostly linked to venture capital funds retiring from the company, and to revaluation of its investment via the sale of shares on the stock market. Financial means obtained in the sale of *primary shares* were used to further develop the company issuing shares and to redeem its debts,
- *institutional investors* constituted the major group of investors and were mostly from EU countries. Their interest usually exceeded the number of offered shares to such an extent that it allowed the underwriter to apply an *option to subscribe more shares*,
- *the number of shares* that the investors were offered, including applying options to subscribe more shares, hardly ever exceeded 50% of the fixed assets of a company,
- *total direct costs of an IPO* were 6.6 – 7.3% of the volume of the issue. The highest cost item was the underwriter’s commission which ranged from 2.96 to 5.0% of the volume of the issue,
- It is not possible to draw a definite conclusion regarding the extent of underpricing of the issue price that is referred to as an *indirect cost of an IPO*.

**Qualitative research into issuers in the Czech Republic**

This chapter presents the findings of qualitative research that was carried out via interviews with financial directors of the surveyed companies. All issuers who have done an IPO on the Czech capital market, more specifically on the Prague stock exchange, were addressed in a cover letter. The letter is part of the appendix. Structured interviews were conducted with three issuers who conveyed their approaches, information, and experience regarding this kind of financing. As the companies did not wish to be named, the findings are presented in general terms without specifying which company is being referred to.

The surveyed companies agree that entering the capital market through an IPO is an extremely challenging process preceded by preparations lasting several months. In the course of these, it is necessary to get the company ready to meet all conditions that are imposed on those companies whose securities are traded on the public capital markets. It must be ensured that International Standards of Financial Reporting have been applied by the company, that it focuses on core business, that it has transparent owner relationships and management structure that concentrates on the increase in company value.

One of the companies argues that while deciding whether or not to do an IPO, the potential issuers should become aware of all disadvantages linked with IPOs first, and only after they

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5 Situation on 01.11.2007
are willing to accept them, it is possible to start analysing the advantages linked with this type of financing and make decisions regarding whether or not do an IPO.

As for the financial disadvantages linked with IPOs, the surveyed companies agree that an IPO is accompanied by high costs for the outside advisors, for in-house human resources and for processes inside the company. The issuers emphasize that total costs for an IPO, which are usually given as percentage of the volume of the issue, do not exceed a lump sum for raising funds as is the case in credit funding. IPO costs entail the underwriter’s commission, the financial consultants’ fees and the financial auditors’ fees, as well as fees linked with acceptance of issues for trade on the stock market, regulatory fees, and presentation costs including what is known as road show. There are other expenses related to introduction of new processes in the company, especially to the new obligation to report regularly, which is stipulated by the law for companies whose shares are traded on public capital markets.

Inasmuch as entering the capital market requires transparency in current as well as past records documenting the company’s activities, the surveyed companies agree that their management spent most of their time preparing an IPO, which resulted in some slowdown of the as yet developing business activities of the company. It must be realised that an IPO constitutes a retrospective appraisal of the company’s activities as well as thorough inspection by lawyers and financial inspectors. When doing an IPO, legal as well as accounting reliability of all companies in the group that the issuing company belongs to is essential.

The surveyed companies state that another challenging activity is compiling the prospectus where the issuing company’s past as well as present is depicted while its future is outlined. It is necessary to be aware that all data in the prospectus must be based on provable facts. After the prospectus has been compiled its presentation to investors must be arranged, which means that a new department for company-investor relations is established. The company must get ready for a roadshow, which is a series of meetings with prospective investors, in particular institutional investors.

Once the prospective issuers are ready to accept the above disadvantages and meet all the essential conditions for an IPO, it is possible to deal with advantages linked with an IPO that represent the major reasons why an IPO should be done.

The issuing companies, in agreement with the above theoretical approaches to IPOs, have stated that one of the major reasons for doing an IPO was raising necessary capital without the duty to repay it. This allowed the companies to optimise the capital structure and cut costs to raise more funds, in particular debt capital. The companies attach significance to the fact that a successful IPO increased their credibility with bank institutions. They were offered more favourable credit terms including lower interest rates than before the IPO.

A significant impulse to do an IPO came from the owner of the surveyed companies, i.e. from the venture capital fund. The fund made use of the IPO to round off and revalue its investments. The companies specify that it was their long-term goal to see their shares traded on stock markets and they had been preparing for that step by step for a long time.

One more reason to do an IPO, which however is not highlighted in specialist literature much too often, is that having shares that are traded on the stock market is considered to be an attribute of a successful company and successful management. Entering the capital market goes hand in hand with increased publicity and direct or indirect familiarity with the
company’s products and services, which has an impact on the company’s reputation and goodwill. A company whose shares are traded on the stock market is usually looked upon as one of the most profitable and the most successful in the industry.

The surveyed companies have declared that the major reason for doing an IPO specifically in the Czech market was the fact that the Czech Republic represents a major market for their business activities. The market opportunity related to the low number of IPOs in the Czech capital market was also a reason.

The length of IPO implementation was specified to be approximately 4 months. Examining the legal matters and submitting financial reports in compliance with the International standards of financial reporting was identified as the most demanding part of the period.

The surveyed companies agreed that entering the capital market through an IPO should be part of the company’s natural development and it should not be seen only as an alternative source of raising necessary funds for a certain investment. When deciding about an IPO, it is not possible to take into account financial criteria alone as entering the capital market is an irreversible process compared to other forms of financings and the company must be ready for that.

**Final assessments of the investigated issues and an outline of perspectives of further development**

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.

The results of an analysis of IPOs done in the Czech capital market suggest that IPOs were done exclusively by multinational holding companies that carry out their activities on the territory of the Czech Republic while their parent company is based abroad in a country where companies are used to taking advantage of the capital market to raise necessary funds. It was found out that most IPOs were combined IPOs by their nature, within which primary as well as secondary shares were offered. The funds raised by selling the newly issued shares were utilized to further develop the issuing companies and to redeem their debts. The offer of secondary shares was largely linked with round-off and revaluation of the investment of the venture capital fund. The total number of shares offered in an IPO did not exceed 50% of the company’s fixed assets.

It follows from the calculations that total direct costs of an IPO in the Czech capital market range between 6.6% and 7.3% of the volume of the issue. The biggest cost item is the underwriter’s commission. This ranged from 2.96 - 5.0% of the volume of the issue. These
figures were confirmed by the individual issuing companies that were included in qualitative research. Its aim was to understand approaches, views and experience of the companies that did IPOs in the Czech capital market.

The issuing companies agree that entering the capital market via an IPO is a challenging process. It is preceded by several months’ preparations during which it is necessary to prepare the company to meet all the demands imposed on companies whose shares are traded on capital markets. This, however, was outbalanced by the advantages provided by a public offering and that is why the surveyed companies decided to do an IPO.

The major reason for doing an IPO was raising necessary funds without the duty to repay them, and optimising the capital structure, which allows the companies to cut the costs of raising further funds, in particular debt capital. A significant impulse to do an IPO came from the majority shareholder. In this case, the issuing companies were being prepared for their entry to the capital market for a long time. This was linked with round off and revaluation of the investment of the venture capital fund. Other facts that made the surveyed companies enter the capital market included marketing reasons, which are linked with an increase in familiarity with the public company’s products and services, and the standard of the company’s and the company management’s achievements.

The findings of the research further suggest that a typical Czech joint-stock company (in terms of its ownership structure) has not yet done an IPO in the Czech capital market, or rather on the Prague stock exchange. In my opinion, one of the first such companies might rank among those under consideration for privatisation through capital market.

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. 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.

References


Problematika financování podniků prostřednictvím IPO na českém kapitálovém trhu

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ABSTRAKT

Cílem tohoto článku je analýza hlavních příčin nízkého zájmu českých podniků o financování své činnosti prostřednictvím veřejné emise akcií, zhodnocení prvotních veřejných nabídek akcií, které se uskutečnily v novodobé historii českého kapitálového trhu a nastínění perspektiv dalšího vývoje v této oblasti. K dosažení stanovených cílů byl proveden sekundární výzkum literárních zdrojů zabývajících se uvedenou problematikou a primární výzkum v českých podnicích.

Klíčová slova: IPO, český kapitálový trh, financování.

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ABSTRACT

The present paper aims at research into the causes of the low interest of Czech companies in financing their activities through IPOs, research into implemented IPOs in the modern history of the Czech capital market, and an outline of perspectives of further development in this area. To achieve the specified aims, secondary research into relevant literature was carried out as well as primary research in Czech companies.

Key words: IPO, Czech capital market, Financing.

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