DECIDING TO IMPLEMENT AN IPO: THEORY AND PRACTICE IN THE POLISH CAPITAL MARKET

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ABSTRACT

The objective of this article is to compare the theoretical approaches to decisions about IPO-oriented corporate financing with the results of the empirical research conducted in the Polish capital market, which can be described as the most developed in the Central and East European region. Achieving the research objective required, firstly, to collect and analyze secondary data represented by the results of theoretical and empirical research done to define the factors involved in the IPO-related managerial decisions. The second step involved a collection of primary data by a questionnaire-based survey in companies that have completed an IPO in the Polish capital market. The collected data was processed using statistical methods appropriate for its type and quantity. In the third step, the attitudes of the managers in the issuing companies were compared with the theoretical models described in literature. The empirical results suggest that the theoretical models of the IPO process are fully applicable in the conditions of the Polish capital market. However, the respondents' viewpoints indicate that there is a need to articulate additional precepts that would complement and expand the existing theoretical models. The results of this comparison represent a valid contribution to the present knowledge of corporate financing strategies.

Key Words: Corporate Finance, Going Public, Initial Public Offering, Decision Making, CEE Region, Polish Capital Market.

1. INTRODUCTION

In the theory of corporate financing, deciding on an "Initial Public Offering" (IPO) is seen as one of the most important junctures in the life cycle of a company. A number of theoretical and practical studies examined the factors that influence the actions of managers in Initial Public Offerings. Some of these were authored by Helwege and Packer (2003), Brau, Francis, Kohers (2003), and Boehmer and Ljungqvist (2004). Their research was based on the data found in issuers' prospectuses and annual reports, or obtained from publicly available data bases on the issuers.

A secondary analysis of data published in Web of Science and SCOPUS citation data bases reveals a lack of questionnaire-based research in those companies that have completed an IPO on the Polish capital market. This method of research allows comparing the attitudes of managers in the issuing organizations with the theoretical approaches described in literature. The Polish capital market is regarded as the most developed in the CEE region, which is evident from the number of IPOs it absorbed in recent years (330 IPOs in the years 2008, 2009 and 2010). The Warsaw Stock Exchange now ranks among the European bourses which handle the largest volume of IPOs. In fact, Poland is the only capital market in the CEE region that is conducive to quantitative research.

This article presents partial results of project GAČR No. 402/09/P134 entitled "Decision-Making Model of Corporate Financing by Means of IPOs". The intent of this article is ***to compare the theoretical models of corporate decisions about IPO-based financing with the results of an empirical research conducted in the Polish capital market.*** The results of such comparison will hopefully contribute to a better knowledge of strategies deployed in the quest for corporate financing.

2. MATERIAL AND METHODOLOGY

Achieving the survey objectives required the following steps:

1. Collection of secondary data, i.e. the results of theoretical and empirical research into the factors underlying managerial decisions about IPOs.
2. Collection of primary data in the companies that have completed an IPO in the Polish capital market.
3. A comparison between the attitudes of managers in the issuing companies and the theoretical approaches described in literature.

In formulating the theoretical approaches to IPOs, the method employed was a secondary analysis of the relevant data. The source of the secondary data was primarily foreign professional literature, especially from the English language domain. The sources of information were mainly professional books (monographs), technical papers and articles appearing in scientific journals, or presented at international conferences and included in the proceedings.

The empirical survey was quantitative in nature and was carried out in the form of a questionnaire-based inquiry in companies that have completed an initial public offering of shares in the Polish capital market. The sample covered the companies that had entered the Warsaw Stock Exchange general market through an IPO in the years 2007-2009. The rationale for the time limitation of the capital market entry through an IPO was to obtain meaningful information from the executives who have had a recent personal exposure to the IPO process. The list of respondents, compiled from the information available on the web pages of the Warsaw Stock Exchange (www.gpw.pl, Jan. 2011) and from publications authored by Paleari et al. (2008; 2009; 2010), comprised a total of 107 companies.

The questionnaire in the Polish language consisted of five separate parts:

- reasons to enter the capital market through an IPO,
- factors influencing IPO timing,
- pricing the shares below their value (underpricing),
- signaling the issuer's quality,
- IPO-related disadvantages.

The data was collected in two stages. In the early 2010, a questionnaire accompanied by a cover letter was sent to all companies on the survey list. The individuals who participated in filling out the questionnaire held the position of Chairman of the Board or Chief Financial Officer. The respondents were asked to indicate, on a scale of 1 (unimportant) to 5 (very important) how important were the specified reasons for the company management/owner in making the decision to proceed with an IPO. A completed questionnaire was returned by 8 companies. To improve the response rate, the questionnaire was given an electronic form and, in April 2010, sent by e-mail to the people who had not responded the first time around, with a request for completion. This approach yielded another 13 completed questionnaires, so that the return rate from the selected group of respondents reached 19.6%.

The data from the survey was analyzed by statistical methods appropriate for its type and quantity. The basic evaluation was done by statistical descriptive methods. Statistica.CZ Version 9 program was used to perform the statistical processing.

3. SURVEY FINDINGS

3.1 Reasons for Conducting an IPO

Ritter and Welch (2002), who studied the reasons to implement an IPO, concluded that there were three kinds of reasons to start trading shares publicly. First, companies seek external capital for their continued growth. This reason is supported by earlier papers as well, like those published by Modigliani and Miller (1963), Scott (1976), and Myers (1984), who do not concentrate solely on the IPOs. These authors argue that there is a certain optimal composition of capital, and that companies act to achieve it. Companies have a preference for the least expensive source of money and opt for more expensive financing only when the cheaper source has been exhausted. The companies following this model would presumably execute an IPO at a stage of their life cycle when additional external capital could help achieve such an optimal capital structure.

The results of this empirical survey suggest an agreement between theory and practice in some respects while highlighting certain differences in others (table 1). The respondents in the issuing companies, in accordance with the theoretical precepts, identified the raising of external equity to finance developmental investments as the main reason for executing an IPO (average significance level for this reason: 4.86; relative frequency of respondents expressing agreement with the rating: 95.24%). The second most important reason for implementing an IPO is the availability of publicly traded shares for future mergers and acquisitions (3.81; 76.19%). This level of significance is surprising given the limited theoretical interest in that particular aspect. The newly issued shares thus allow the issuer to become either an acquirer or a target, especially in stock-financed transactions. Other important reasons for doing an IPO include publicity and corporate image enhancement (4.00; 66.67%), greater attractiveness of the company as an employer (3.71; 61.91%), and an establishment of company market value (3.71; 61.91%). The issuing companies typically do not see the IPO as a tool for direct reduction of the company debt (2.38; 61.90%), but as an instrument to strengthen the negotiating position in dealing with prospective providers of outside capital (3.71; 66.67%).

Table 1: Reasons for conducting an IPO - the theory and practice in the Polish capital market

Reasons for conducting an IPO from a theoretical perspective	**Level of significance from the empirical research perspective**		
	Low	**Medium**	**High**
Raising external capital for developmental investments *(Ritter and Welch, 2002; Paleari et al., 2006)*			×
Availability of publicly traded shares for future acquisitions and mergers *(Brau, Francis, Kohers, 2003)*			×
Good publicity, company image enhancement *(Maksimovic and Pichler, 2001; Ježek, 2004)*			×
Greater attractiveness of the company as an employer *(Haubrok, 2006)*			×
Establishment of the company market value *(Ellingsen and Rydqvist, 1997)*			×
Stronger bargaining position toward providers of outside capital *(Rajan, 1992)*			×

Reducing the cost of capital *(Rajan, 1992)*	×		×
Reducing the company indebtedness *(Paleari at al., 2006)*	×		
Diversification of existing shareholders' equity portfolio *(Pagano, 1993)*	×		
Exit of the venture capital from the company *(Black and Gilson, 1998)*	×		
Solving a problem of succession *(Black and Gilson, 1998; Mello and Parsons, 1998)*	×		

Source: own study

3.2 Factors influencing IPO timing

The work of Ibbotson and Jaffe (1975), as well as Ritter (1984), demonstrates that initial public offerings have a cyclic nature. There are three theoretical explanations for the phenomenon of IPO timing. The first postulates that companies enter the capital market under favorable economic conditions which support their continued growth and development (Loughran and Ritter, 1995; Ritter and Welch, 2002). The second theory asserts that companies initiate IPOs at a time when other businesses also enter the capital market (Choe, Masulis and Nanda, 1993). The last explanation for IPO timing is derived from the company life cycle theory. It is based on the idea that companies issue shares when they reach a certain point in their life cycle and need capital for further growth (Choe, Masulis and Nanda, 1993; Lowery, 2002).

The empirical results show (table 2) that the most important factor in choosing the right moment for an IPO is the current need of capital for continued company growth (average significance level for this factor: 4.38; relative frequency of respondents expressing agreement with the rating: 90.48%). In timing a public offering, the companies also take into account the conditions in the issuer‘s business sector (4.10; 80.95%), the macro-economic growth (4.14; 76.19%), the rising stock markets due to investors‘ optimistic mood (4.10; 76.19%) and the investors‘ interest in this type of business (3.81; 71.43%). They attach less importance to the interest in IPOs by other companies in the same business sector (2.62; 52.38%). A surprising discovery was the respondents' characterization of the interest in IPOs by companies in other business sectors as the least important factor in IPO timing selection (1.81; 80.96%).

Table 2: Factors influencing IPO timing: The theory and practice in the Polish capital market

Factors influencing IPO timing from a theoretical perspective	**Level of significance from the empirical research perspective**		
	Low	**Medium**	**High**
Current need of capital to finance further company growth *(Choe, Masulis and Nanda, 1993; Lowery, 2002)*			×
Conditions in the issuer's business sector *(Pagano et al., 1998)*			×
Macro-economic growth *(Loughran and Ritter, 1995; Ritter and Welch, 2002)*			×
Rise of stock markets due to investors' optimistic mood *(Ritter and Welch, 2002)*			×
Investors' interest in this type of business *(Paleari at al., 2006)*			×
Interest in IPOs by other companies in the same business sector *(Choe, Masulis and Nanda, 1993)*		×	
Interest in IPOs by companies in other business sectors *(Choe, Masulis and Nanda, 1993)*	×		

Source: own study

3.3 Underpricing

Loughran, Ritter and Rydqvist (1994) and Paleari et al. (2006), mention that companies frequently sell the IPO-issued shares at a price lower than what they priced at when first traded on the secondary market. This phenomenon is known as underpricing, and it is one of the most debated issues surrounding initial public offerings. Theoretical explanations of this phenomenon are mostly based on the existence of information asymmetry between the parties participating in the offering, i.e. issuers, investors and underwriters.

The survey results (table 3) document the respondents' belief that underpricing basically rewards the investors for the risk they assume when they buy shares in an IPO (average significance rating for this factor: 4.10, relative frequency of respondents expressing agreement with the rating: 90.48%). A greater probability of the IPO success (3.86; 66.67%), and an assurance of sufficient demand for the offered shares by investors, especially the institutional ones (4.05; 66.67%), were identified as additional reasons for lower pricing of these shares. The theories claiming that discounted pricing of the IPO shares brings about a reduction in the marketing costs received minimal support (2.14; 76.19%). The issuers also take a negative view of the notion that underpricing is a protection against future investor-driven litigation in case of a large drop in the post-IPO share price (2.43; 57.14%).

Table 3: Factors explaining the existence of underpricing - the theory and practice in the Polish capital market

Factor explaining the existence of underpricing from a theoretical perspective	**Level of significance from the empirical research perspective**		
	Low	**Medium**	**High**
Reward for risk assumed by the investors in an IPO *(Rock, 1986)*			×
An instrument to increase the probability of IPO success *(Oxera, 2006)*			×
Increased demand for shares from institutional investors *(Rock, 1986)*			×
Increased demand for shares from retail investors *(Rock, 1986)*			×
Attracting a large number of investors *(Brennan and Franks, 1997)*			×
An instrument to stimulate interest in post-IPO trading *(Boehmer and Fishe, 2001)*			×
Convincing a few early investors that buying shares is advantageous to trigger a "snowball" effect *(Welch, 1992)*		×	
A tool to reduce IPO marketing costs *(Habib and Ljungqvist, 2001)*	×		
To reduce the risk of investor-driven litigation due to a large drop in post-IPO share price *(Drake and Vetsuypens, 1993)*	×		
To compensate investors for a correct disclosure of the fair share price they are willing to pay *(Stoughton and Zechner, 1998)*	×		

Source: own study

3.4 Signaling the issuer's quality

The theory of signaling the issuer's quality is likewise based on the existence of information asymmetry between the issuers and the investors. Leland and Pyle (1977) claim that the sale of employees' shares and the sale of a large portion of the basic business capital via the IPO send a negative signal to potential investors. Other authors focus on the factors viewed as positive signals by the investors. In general, working with reputable underwriters (Booth and Smith, 1986; Carter and Manaster, 1990; Carter, Dark and Singh, 1998), with reputable accounting and auditing firms (Titman and Trueman, 1986; Beatty, 1989; Michaela and Shaw, 1995), and utilizing a venture capital support (Megginson and Weiss, 1991; Barry et al., 1990) serve as strong signals or assurances that the entity poised to engage in public trading of shares is of high quality.

The literature mentions three more examples of positive signals. First, Welch (1989), Allen and Faulhaber (1989), and Chemmanur (1993) argue that only "good" issuers can afford to send a signal to the investors, by means of sizeable underpricing, that it is precisely this company that can afford such a discount and allow the first investors to realize a capital gain by selling the shares after only a few days of trading on the secondary market. Second, Courteau (1995), and Brau, Lambson and McQueen (2005) believe that a commitment of the issuing company and its shareholders not to sell their shares for a sufficiently long period of time after the IPO signals a conviction about the quality of their own company, thereby increasing its credibility with the investors. Finally, Teoh, Welch and Wong (1998) claim that a history of high profits is a signal of a good performance in the future.

The survey results show (table 4) that the respondents considered a presentation of very good economic results in the period preceding the IPO (average classification: 4.48, relative frequency of respondents expressing agreement with the rating: 90.48%) and the management's commitment not to sell its stake in the company for a certain time after the IPO (4.33; 85.71%) to be the most important positive signals for the investors. In terms of working partners to implement an IPO, the selection of a reputable underwriter and an auditing firm (3.86, 3.71; 66.67%) gives the transaction the greatest credibility. Conversely, the sale of a large portion of the basic capital through an IPO has been marked as conveying a negative signal about the quality of the issue (1.95; 76.19%).

Table 4: Activities signaling the issuer quality - the theory and practice in the Polish capital market

Activity signaling issuer's quality from a theoretical perspective	**Level of significance from the empirical research perspective**		
	Low	**Medium**	**High**
Presentation of very good results of financial management in a period before the IPO *(Teoh, Welch and Wong, 1998)*			×
Management's commitment not to sell its stake in the company during a certain period after the IPO *(Courteau, 1995; Brau, Lambson and McQueen, 2005)*			×
Using the services of a reputable issue manager *(Booth and Smith, 1986; Carter and Manaster, 1990; Carter, Dark and Singh, 1998)*			×
Using the services of a reputable auditing firm *(Titman and Trueman, 1986; Beatty, 1989; Michaely and Shaw, 1995)*			×
Sale of the company management shares *(Leland and Pyle, 1977)*		×	
Using the services of a reputable legal counsel *(Grinblatt and Hwang, 1989)*		×	

IPO as a way for a venture capital investor to exit the company *(Megginson and Weiss, 1991; Barry et al., 1990)*		×	
Setting the share issue price below the market price *(Welch, 1989; Allen and Faulhaber, 1989; Chemmanur, 1993)*		×	
Sale of a large portion of the basic capital *(Leland and Pyle, 1977)*	×		

Source: own study

3.5 IPO-related disadvantages

This part of the survey sought to determine what importance the issuing companies attach to the individual aspects characterized in literature as IPO disadvantages. A desk research of relevant information sources reveals that the main disadvantages associated with IPOs are (Ježek, 2004; Paleari et al., 2006, Yosha, 1995):

- Costs incurred in IPO preparation and execution,
- Expansion of the company ownership structure with additional shareholders,
- Loss of decision-making autonomy,
- Risk of strategic information leakage,
- Compliance with a periodic reporting duty.

The survey showed (table 5) that in deciding to undertake an IPO, the respondents took into account particularly the time and expense involved in the entire process (average significance level for this aspect: 3.24 and 3.14; relative frequency of respondents expressing agreement with the rating: 52.38% and 42.86% respectively). Among the aspects that had a lesser influence on the IPO decisions were compliance with the periodic reporting duty (3.29; 47.62%), ensuring transparency of the company (3.10; 42.86%) and fear of an IPO failure (3,00; 38.10%).

Another finding is that many of the aspects labeled as IPO disadvantages had little bearing on the decisions in the surveyed companies. There was no empirical support for the fear of limitation or loss of company control (2.62; 61.90%), the expansion of shareholder structure (2.33; 61.90%) or the fear of strategic information leakage and its misuse by competition (2.86;47.62%).

Table 5: Influence of IPO disadvantages on the decision to implement it - the theory and practice in the Polish capital market

IPO disadvantages	**Level of significance from the empirical research perspective**		
	Low	**Medium**	**High**
IPO-related demand on time *(Ježek, 2004; Paleari et al., 2006)*			×
IPO-related costs *(Oxera, 2006; Paleari et al., 2006)*			×
Compliance with a periodic reporting duty *(Oxera, 2006; Paleari et al., 2006)*		×	
Ensuring corporate transparency *(Oxera, 2006; Paleari et al., 2006)*		×	
Fear of IPO failure *(Ježek, 2004; Paleari et al., 2006)*		×	
Fear of limitation or loss of company control *(Maug, 1996)*	×		
Expansion of shareholder structure *(Ježek, 2004)*	×		

Source: own study

4. DISCUSSION AND CONCLUSION

The results of this empirical survey suggest that the theoretical approaches to the IPO process are fully applicable in the conditions of the Polish capital market. However, the respondents‘ inputs also indicate that there is a need for additional information to complement and broaden the existing theoretical models of IPOs. Based on the survey results, the following conclusions may be presented as new insights:

- In addition to raising own capital for continued company growth, enhancing its image, and gaining advantages for the existing shareholders, the availability of publicly traded stock for potential mergers and acquisitions is another significant reason to initiate an IPO.

- Completion of an IPO tends to strengthen the company’s negotiating position towards the providers of external capital. This can be expected to lower the cost of debt financing.

- In choosing the suitable time for an IPO, the companies take into account the current need of capital for further growth and development, the present and projected state of national and global economy, conditions in the business sector in which they operate, and investors’ interest in their type of business. They attach less importance to the interest that other firms operating in the same type of business may have in IPOs. And, in most cases, the interest that firms from other business sectors may have in that subject does not have an appreciable effect on IPO timing.

- Underpricing is perceived by the respondents primarily as a reward to investors for the risk they assume in buying the IPO shares. Other important reasons for setting a lower share price in an IPO may be the desire to increase the probability of IPO success and ensure a sufficient demand for the shares by investors in general and institutional investors in particular.

- The respondents indicated that the most important positive signals for investors is the evidence of very good earnings in the period preceding the IPO as well as the management's commitment not to sell its stake in the company during a certain period after the IPO. In terms of partners for an IPO, the selection of a reputable underwriter and a reputable audit firm definitely carries a positive signal to potential investors. A negative signal, from the investors' viewpoint, is a situation involving the sale of a large portion of the company's basic capital.

- The deliberation to undertake an IPO is very sensitive to the question of time and expense involved. The fear of limitation or loss of company control, the shareholder structure expansion, and the concern about strategic information leakage being misused by competition are not perceived to be negative externalities of an IPO.

- The survey results made it possible to formulate new insights as contributions to a better understanding of corporate financing strategies, particularly in the specific conditions of the CEE region.

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