

IPO: PROBLEMS AND PERSPECTIVES

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Abstract: This article discusses the basic concepts and procedures of the IPO, as well as all related problems and prospects of the financial instrument in Russia.

Initial Public Offering (**IPO**) is the Company's first issue of shares on the market [1].

Depository Receipt (**DR**) is freely circulating receipts on foreign shares, deposited in a bank, issued receipt, or in a bank-agent; DRs have been the accepted form of trading foreign shares in the United States since 1927; the receipts grant the same rights as shares and are quoted in US Dollars or Euros on stock exchanges and the OTC market; depositary receipts programs can be sponsored by issuers to stimulate broader share circulation. The most common types of depositary receipts are – American Depository Receipts (**ADRs**) and Global Depository Receipts (**GDRs**). ADR are circulated and traded on United States' markets; whereas, GDRs are circulated and traded on European markets [1].

Lead manager is the bank which organizes and guarantees the loan; represents interests of the syndicate of creditors and guarantors [1].

Pre-market dealings are trades of securities that occur before the official opening of a stock exchange session [1].

An IPO presents an array of organizational, legal and financial procedures that must be successfully completed by a range of players involved in the process. The IPO involves not only the Company and potential investors, but also a set of the deal participants. The interests of the main participants in an IPO are not always fully aligned; during the course of preparing for and carrying out an IPO, each of the participants faces problems and must resolve their own challenges. Nonetheless, each of them is interested in each other and interested in ensuring that the IPO has taken place. Therefore, all complex IPO

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problems should be considered from multiple different points of view, i.e. those of the Company-issuer, investors and the deal participants.

The most urgent questions that a potential issuer must consider include: choosing the scheme of the IPO, selecting a trading platform (country) for the share placement, deciding on an underwriter, carrying out a set of corporate actions related to re-structuring and disclosing corporate information both during and after the IPO. The Company's overall IPO objectives include: attracting the maximum volume of long-term financial resources and creating and maintaining the status of a public company. It is vital to minimize costs for preparing and carrying out an IPO.

In the West placing shares on the stock exchange has been (for an extended period of time) a key tool for financing corporate development. Funds generated by an IPO allow listing companies to acquire assets required for expansion; these assets cannot be purchased with own funds and often would be unprofitable if the Company needed to take credit (to make the purchase).

An IPO allows the Company to tap into cheaper capital sources (at the cost of increased levels of publicity for the Company) and decreases the cost of attracted financing. An IPO promotes capital structure optimization and allows more effective access to capital markets, including Western ones, and also opens new possibilities for business development and market consolidation.

For many domestic companies with participating foreign capital, an IPO is a priority focus for foreign shareholders who are looking to increase profits and diversify risks connected with share sales.

Due to various requirements of public companies, such as information disclosure to shareholders, the existence of a transparent structure, high growth rates and a successful credit history, only a limited number of Russian companies from various industries will be able to realistically consider an IPO as a method of attracting funds during the next two years.

This number includes already mentioned companies with participating foreign capital (Western investors initially make investments only in fast-growing businesses where they later adjust and upgrade processes based on Western best practice standards), as well as the most advanced domestic companies, primarily operating in the raw materials and telecommunication sectors. The remaining Russian companies will require a bit more time to go public.

Which trading platform is best for an IPO?

Over the last few years, most Russian companies completed their IPOs on the two domestic Russian stock exchanges – RTS and MICEX. However in the years to come, these companies plan to enter international capital markets. According to some experts, this desire to penetrate into foreign markets can be explained by the fact that a limited number of financial tools are used on the Russian stock exchanges – negatively impacting liquidity.

When choosing a listing stock exchange, it is necessary to consider first of all, which countries are primary consumers of the Company's products. However, very few potential issuers consider foreign stock exchanges as a platform for an initial placement due to higher IPO costs in the West – both direct monetary costs and costs related to information disclosure.

However, according to analysts benefits from participating on international markets exceed costs. Foreign stock markets tend to be significantly more stable than the Russian market. The probability of speculative activity is lower and there are greater possibilities to attract a large volume of financing.

Potential foreign platforms for domestic companies to consider include: the LSE (London Stock Exchange), the NYSE (the New York Stock Exchange) and NASDAQ¹. The above-mentioned platforms already trade shares of Russian companies that have participating foreign capital (Golden Telecom, Peter Hambro Mining, Trans-Siberian Gold) and are interested in further cooperation with Russian companies.

Depending on the purposes and reasons for the placement, a company can select various IPO mechanisms, including: an ADR program, a domestic placement on one of the Russian exchanges and/or a placement on a foreign stock exchange(s). However, the basic criteria for choosing a listing platform and the placement mechanism remain:

- The placement price/potential share growth;
- Target group of investors (Russian/foreign, – strategic/institutional/speculative/funds, etc.);
- The Company's size;
- Share trading activity/share liquidity;
- Information disclosure requirements during and post placement and the level of required management responsibility for the IPO process;
- Period for realizing the project;
- Expenses associated with one or more placement mechanisms;
- Traditional markets on which peer group companies are traded;
- Reputation effects.

Listing on a stock exchange, however, does not mean that only a certain group of investors will be attracted. For example, assuming that international information disclosure and financial reporting standards are met, a listing on one of the Russian stock exchanges will still attract both Russian and international investors.

Selecting the deal participants for an IPO

The Company's primary participants during IPO preparation and during the course of placement on the selected stock exchange are the bank-underwriter² (the lead-manager, usually coordinates all aspects of the project on

¹ The National Association of Securities Dealers and Automated Quotations (NASDAQ) – a system of computerized over-the-counter quotations in the United States, which was organized by NACD in 1971; unites approximately 3,500 brokers and dealers and allows quotations to be received on 4,000 securities (for each type of security, there are to be registered not less than 2 dealers supporting the market); there are three levels: receiving the highest quotations; receiving all quotations; and dealers introducing their own quotations in to the system [1].

² Underwriter – professional consultants (banks, brokers and investment companies) that organize and guarantee the securities' placement on agreed upon conditions in return for special compensation [1].

The underwriter serves as the principal intermediary between the company and investors. The underwriter's objective is to carry out a successful IPO, which satisfies both the issuing company and investors who purchased company shares. The primary goals of the underwriter

which hinges, whether it will be possible for the Company to enter the market when it rises, the future ownership structure of the Company's shares and, hence, the stability of future trading), legal counsel, the independent auditor and the PR-agency. It is necessary to carefully select these partners.

When selecting an underwriter, it is beneficial to choose an institution which has a large client base and is well-known in the market where the placement will be made.

There are numerous criteria that the Company can use to select a bank-underwriter, including: the bank's estimate of the Company's value, the issue volume, the proposed structure and the location and placement period, as well as the compensation that the bank requests for services provided.

Placement terms at different banks may vary significantly – ranging from, for example, 6 months to 18 months. To accurately define the necessary period, significant work must be carried out to gather investors' private opinions and to prepare a detailed time-table³ for the project. As for independent auditors and legal counsel, it is possible and often necessary to select them in advance, since prior to an IPO, the Company is required to complete an audit report and have a legally transparent structure.

Stages of the initial share placement

1. Optimize internal corporate procedures. As discussed above, IPO preparation is a long-term process that requires advanced planning. The average period between making a decision on pursuing a potential initial placement and the launch of trading on a stock exchange for Russian companies is approximately four years. During this time, the Company must ensure that its legal structure is transparent; it must also earn a reputation as a reliable borrower (with promissory notes and bond programs) and it should also raise the Company's brand recognition. In other words, the Company needs to become a recognized player on the market where the placement will subsequently be made.

Required actions for an IPO are similar in many ways to what is required for a bond issue, including: carrying out an audit to International Financial Reporting Standards (IFRS), improving corporate governance and streamlining legal structures.

2. The Company's entrance on to the stock exchange. Approximately one year prior to the prospective IPO date, the Company should select an underwriter. Normally, a tender is held for this purpose. In some situations, the Company selects an underwriter that the Company has a relationship banking history with – for example, through a prior bond issue. The Company along

include: choosing the scheme for the IPO, analyzing the issuer, preparing and realizing all legal procedures, offering information support, attracting investors, organizing the work of all other participants assisting in the process of preparing and carrying out the IPO. The key moment in the underwriter's activity is determining and setting the share price of the offering. For almost any participant involved in the IPO, the financial result of the IPO is pre-determined. Therefore, building a reputation as a reliable partner frequently becomes the main focus for any intermediary.

³ A detailed plan with instructions for exact dates.

with the selected underwriter discusses preliminary details of the IPO project, such as: selecting the listing exchange, determining the possible share price range for the placement and considering the number of shares to be placed. The Company and underwriter also discuss desirable investor structures. If necessary, approximately three to four months prior to the IPO, the additional share issue is registered with appropriate regulatory/listing authorities.

Direct preparation for a stock exchange listing takes four to six months depending on if the listing will be on a domestic or international exchange. Analysts believe that the preferred strategy for any company considering a listing is to prepare to a maximum degree and to wait for favorable market conditions.

The principal factors influencing the timing of an IPO are the Company's readiness and ability to realize the project (the existence of a financing need, reporting to IFRS or GAAP standards and successfully completed re-structuring etc.) and market conditions. The readiness to accept new share issues depends on the market. So, it is not necessary to make a placement, if within the same week (when the Company's placement is planned), initial placements, for example, of 10 + additional companies, are also scheduled. On each stock exchange, there are typically «closed» periods, which are generally considered unfavorable for placement, for example, Christmas in North America and Europe, as well as the August holiday period in Europe. But, even taking into account external factors, market conditions can quickly change. Therefore, the IPO's success will remain uncertain till its completion.

Preliminary marketing plays a very important role as well in the realization of the IPO. This marketing generates feedback from investors to more accurately define the exact size and price range of the placement. The information received during preliminary marketing also helps the Company's management team more effectively prepare for the road show. The basis of pre-marketing (which was defined above) is analyst reports prepared by syndicate banks (and their analysts).

Post placement Communication with investors

All companies that have successfully placed their shares on a stock exchange state that an IPO only truly begins at this point in time. Routine work with investors, organizing the public release of regular reports, upgrading the corporate website and disclosing and correctly presenting essential facts about the Company and its day-to-day activities require the permanent work of IR⁴ Department. The Company must also be prepared to proactively address stock market speculation and be ready to deal with articles in the media or an overall market recession can lead to wide fluctuations in share price (10 or even a higher percentage). The presence of independent directors on the Company's Board of Directors and the careful observance of minority shareholder rights (which unfortunately is not a given at all Russian companies) lead to noticeable changes in the quality of business handling. Therefore, in Russia there is an

⁴ Investor relations – the Department for communicating with investors.

entire class of beneficiaries which do not consider IPOs as realistic possibilities. However, with time the number of these companies is continuing to decrease.

To sum up, it is worth mentioning that any corporate action to attract public funds either a bank loan or an IPO is selling of the Company's future, as the current proprietors foresee it. To ensure a successful transaction, it is necessary to formulate and clearly articulate to market participants purposes and strategy. Quite often, companies combine all their efforts to achieve short-term results which they believe the market expects from them. Proper management of investors' expectations will allow companies to realize their long-term plans.

The reliability of investing in Russian company shares

According to the research conducted by The National Agency for Financial Studies (**NAFI**), opinions were sharply divided regarding the reliability of private investment in shares of Russian companies: 22 % of respondents considered it to be a quite reliable investment. A slightly higher percentage of Russians – 30 % – believed that investing in IPOs is unreliable and risky. An additional 45 % of respondents saw IPOs as a neutral reliability investment, and a further 3 % of respondents were unable to estimate the reliability of purchasing shares in Russian companies.

It is striking that while estimating prospective investments in shares of IPOing companies, respondents' answers regarding benefits closely correlate with their answers on reliability. In other words, among respondents who considered share purchases the most favorable monetary investment (27 % of all polled respondents) are observed a large share of those who considered shares to be a reliable investment (73 % in total).

Thus, the original stereotype regarding perception comes into play. In the sphere of investments, as is well-known, investments with the greatest potential upside are also the riskiest. On the other hand, investments with a low profit margin tend to be the most reliable and protected from different types of risks. Most likely, the respondents' answers during our conducted research are a result of an insufficient degree of financial literacy and a lack of awareness of the basic principle: "The greater the reward, the greater the risk."

The Future of Russian IPOs

In Russia, there are approximately 200 non-public companies with market capitalization in excess of USD \$500 mln (per company) and each of these companies is potentially a candidate for the IPO market. According to experts, the volume of securities placements (both initial and secondary) over the last 3 years grew approximately 50 % per annum. More than 40 % of public placements for Russian companies were carried out on domestic stock exchanges.

Thus, according to experts, the development dynamics for public placements is, on the whole, positive and demonstrates significant growth potential. However, in the long-term, there is predicted growth in the share of placements on foreign exchanges.

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Ключевые слова и фразы: американская депозитарная расписка; андеррайтер; андеррайтинг; ведущий менеджер; глобальная депозитарная расписка; первоначальное публичное предложение (IPO); торговля ценными бумагами до официального открытия биржевой сессии;

Аннотация: Рассматриваются основные понятия и процедура проведения IPO, а также все связанные с этим проблемы и перспективы применения этого финансового инструмента в России.

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