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Motives and challenged of IPOs: A study with reference to Ethiopian companies

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Abstract

Equity financing is a one way of obtaining capital that entails giving up a partial interest in the company to investors by selling equity shares. Initial public offering (IPO), as one way raising equity capital so as to finance firm's operation the main objective of this study is to identify factors motivating companies going public and challenges they have faced in the process. Examining motivational factors for firms IPOs and challenges faced is vital in pointing out issues that may require the scrutiny of policy makers. Our research is descriptive in its nature it only tries to explain what is there only. We have collected our data using structured questioner. After coded the data has been analyzed using SPSS version 20. We used descriptive statistics such as frequency and percentages, mean, and one sample t-test. We have found that the leading cause for establishing the company is the prevailing demand- supply gap on the product or service it is going to produce; high financial demand of the project, lowering coast of capital and enhancing bargaining power, broadening the public base of the company, are the leading factors motivating companies to issue shares so that they can raise required capital and start operation. With respect to challenges, investors low interest, low potential to invest in shares, and their poor understanding about investing in shares, absence of trained stock brokers and stock exchange are the four highly rated challenges in the IPO process.

Keywords: Motives, Challenges, Initial Public Offerings, Ethiopia

1. Introduction

Financial capital is a very important factor of production. It makes starting a business and keeping it operational much easier to (Montgomery *et al.*, 2005) [1]. When firms are not capable of raising external equity by issuing shares, they might face financial constraint as a result their profitability will be affected considerably.

In their research, which examine the relationship between capital growth and profitability, Fu *et al*. (2002) [2] have identified that there is a significant positive relationship between capital growth and profitability. They further categorize capital growth due to increase in equity and debt, and find that capital growth as a result of equity growth has a significant positive impact on the profitability of a firm while debt is negatively affecting it.

The most common problem faced by firms in general and those that are operating in developing countries in particular is lack of credit in order to finance their operation and growth (Van Biesebroeck, 2005) [3]. In such moments, raising funds by issuing equity is the next best alternative that remains at hand.

Corporate investment is constrained by the accessibility of internal or external funds to finance it. Accesses to financial market, which enable to raise external finance, help firms have greater opportunity to finance investments. Financing constraint is a major bottleneck and its impact is greater on small firms than those are large ones (Lee & Islam, 2011) [4].

Access to external finance is a key determinant of a firm's ability to develop, operate and expand. Equity financing does not require collateral or increase probability of financial distress; the number of firms raising finance using equity, and a number of IPOs appear are used as a means of raising equity capital in a number of countries in the world (Carpenter & Petersen, 2002) [5].

Equity financing is a one way of obtaining capital that entails giving up a partial interest in the company to investors by selling equity shares. The ownership situation that investors obtain in exchange for their funds usually takes the form of stock in the company. The primary benefit of equity financing is that it does not involve a direct compulsion to repay the funds on a specific date in the future as debt financing does. Instead, it provides an opportunity for equity investors become part owners in the company, and thus are able to exercise some extent of control over its operation.

The development of financial market help gaining information and firms will benefit from availability of list cost external finance. Whereas when financial markets are under developed and external financing is costly, a firm's investment is constrained by lack of required finance.

Selling stock to the public is one important method by which firms are able to raise equity capital. If the firm sells stock for the first time to the public, it is called initial public offering (IPO) (Hutagaol, 2005) [6]. Firms' investment decision is associated with the methods in which funds are raised in capital market to generate future cash flow and provide a return to investors.

Initial public offering (IPO), as one way raising equity capital so as to finance firm's operation Ritter & Welch (2002) [7], is the process through which a privately held company issues shares of stock to the public for the first time. Also known as "going public," an IPO transforms from private ownership into being held by the public (IPO) (Hutagaol, 2005) [6].

Initial public offering, Das & Das (2012) [8], as a means of raising funds in the form of Equity capital, channelizes Long-term saving into long-term investments by mobilizing household saving into corporate investment. It transfers the current purchasing power in the future and thus enables companies to raise funds to fiancé their investments in real assets.

From the observations for many years, several reasons are identified for companies to go for public. These several reasons have been explained why entrepreneurs sell share of their firms to the Public. Bennining *et al*., (2005 p. 116) [9] have proposed, as one of the reasons could be to finance investment opportunities; though this can be replaced by either bank loan or private placement.

Public ownership (Deloitte, 2012) offers significant advantages such as: improved access for capital, enhanced financial positions, and greater ability to raise equity.

Other researchers have identified some other reasons, Leland & Pyle (1977) [11] explained it as Enterprises also go for public to increase their market values of share as markets are characterized by information differences among buyers and sellers and that will result in diversified information among investors of the firm. So the market valuation of well-informed investor could be compensated with by those not-well informed investor.

Liquidity requirement is another reason that motivate companies to issue shares Amihud & Medelson (1991) [12], as firms issue shares this shares become a very liquid assets in the hands of investors so that investors don't have any reservation as to the liquidity of their investment; this enhanced liquidity Ritter (1998) allows the company to raise more capital on more favorable terms than if it had to compensate for the lack of liquidity associated with a privately-held company.

Paulson & Stegemoller (2008) [13] argued that the need for the change in ownership structure that emerges from the prevalence of greater growth opportunity could also be one reason for firms to go for public.

All suggested reasons for going public exhibit some trend of relationship between the benefits of going public and the associated costs (Bennining *et al*. 2005) [9].

Though it is backed by these advantages there is also associated risk with going public including heighted market scrutiny, decrease control, and increased management demand all need to be weighted (Deloitte, 2012).

The share company (also known as Corporation or Publicly Traded Company) is one from of business organization in recognized under the 1960 commercial code of Ethiopia and stated as "a company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets of the company " article 304(1). The prime feature of these kind of business organizations is that they are capable of raising huge sum of money from the market by issuing equity securities and invest it so that they will enhance productivity in the economy.

2. Statement of the problem

"Why do companies go Public?" this question has been raised and discussed for decades. The seminal work with this respect has been Pagano *et al*., (1998) [15], they have deeply investigate the leading causes by empirically testing vast number of Italian companies went public in the years 1982-1992 and identified companies go public to rebalance their account after high investment and growth. The likelihood of an IPO is positively correlated with the size of the company and industry level market to Book value ratio.

In recent years, there is a recognizable change that companies are choosing Initial public Offering (IPO) as their main source of finance in Ethiopia due to the recently the registered economic growth in the country. Public Offerings are predictors of the Economic development (Das & Das 2012) [8]. Currently there are many companies both, which were operating in other form of business organization, and new to the business, are going for public by using IPOs as their mainly option. However, there are other ways such as: roll-ups, sells-outs, reserve leverage buyouts (RLBOs) and reverse Merger (RM).

Brau & Fawcett (2006) [16] surveyed 336 CFOs of firms which have gone public and found that the most important factor is acquisition, which lead them to refute the traditional explanations such as lowering of cost of capital and pecking order theory of finance. There is also a high linkage between the prevailing technological innovation and the number of firms going public. Hus (2014) [17] a high level of industry technological innovation is followed by more IPOs. However, this conclusion is not in line with the findings of Hewlege & Liasng (2004) [18], which states that there is much concentration of industries in Hot and Cold market for many industries occur at the same time. Rajan (1992) [19], has argues that IPOs increase firm's financial flexibility and strengthen its borrowing power which leads to a reduce level of cost of credit.

The extensively researched and documents issue in relation to IPOs is the theory of underpricing, Ibbotson & Jaffe (1975) [21], Ritter (1984), Beatty & Ritter (1986) [20], Lowery *et al*., (2010) [22]; which require the existence of secondary market. This is not the idea to be dealt in this research, since there is no function stock exchange in Ethiopia.

In this research, we are interested to conduct a survey to investigate what motivate companies to go public; and what challenges companies face while they are going public. Though there are few researches conducted in the area of IPO and stock market in Ethiopia their focus is very limited. Nigus, (2010) has surveyed the economic contributions made by share companies and their major challenge. Tikikle, (2011) [23], has raised and discussed the issue of IPO regulation. His view is highly focused on the legal aspect and do not examine the leading causes and the major challenges faced by investors and issuers. Alemineh (2015) has investigated Ethiopia's readiness to establish stock exchange, and had identified that there are problems faced by investor as a result of absence of stock exchange since they are unable to liquidate their investment and there also no visible commitment from the government side to establish the market. Asrat (2003) [24], Mebrhatu (2014) [25], and Dassalegn (2014) [26] have also examined the potential opportunities and problems pertaining to establishment of Secondary market in Ethiopia. However, the data source in these studies is limited and they primary used interview with officials as a primary source. Our researches goes a bit further and collect data from founders themselves in the structured questionnaire exhaustive list of variables in relation to IPOs.

This study will give a due contribution in the study of the driving forces for companies' decision of going public and related problems in Ethiopian context. It also tries to identify the level of investors' perception on share investment and factors they take into consideration by taking data from those primary sources using primary data collection methods

3. Objective of the study

The main objective of this study is to identify factors motivating companies to issue shares to the public and challenges they face in the process.

The following are specific objectives:

- To identify what contributes for the establishment of the company
- To examine factors motivating companies to issue shares
- To study the challenged of IPOs of companies

4. Literature review

Motives for IPOs

Going public is one of the most important events in the life of a firm. However, it is not a stage that will be accomplished by every firm during its growth. Firms that choose to undertake an IPO vary in age, size, financial characteristics, ownership structure, and industrial attributes. Their IPO decisions can be driven by different motives. Two of the most important reasons are financing constraints and exit plans (Röell 1996) [28].

There are list of motives for going public by companies

Financing Growth

Theoretically, a firm's IPO fund raising amount if mainly determined by its current net profit and growth rate. A firm with a high profit & growth potential is anticipated to raise more money through IPO (Long & Zhang 2014) [27]. Moreover, most of theoretical models reflect on Company's decision to go public is driven by the need for additional source funds to finance their growth and expansion (Mayur & Kumar, 2006) [29].

Huyghebaert & Van Hulle (2005) [6], examined the driving forces of companies' decision to be quoted in a stock exchange using a sample of 95 Belgian IPOs over a period of 17 years 1984-2000. They found that firms which are younger, smaller, with substantial growth opportunity, high pre-IPO investment activity and limited internal cash flow generation have a tendency to issue large portion of their primary shares.

Market Valuation

Pagano *et al*. (1998) [15] thoroughly test the relative power of several possible determinants of IPO volume, and confirmed that companies are more likely to have IPOs when the average market-to-book (MB) ratio of publicly traded firms in their respective industry is higher.

Boubaker & Mezhoud (2012) [31], have examined 152 French companies goes public during the years 2005 to 2010 and indentified that companies that are characterized by a high-market –to book value ratio are motivated to be admitted in the stock market.

Acquisition and Facilitate take over

Baru & Fawcett (2006) [16] have studied the motivation behind going public by conducting a survey from 336 chief finance officers (CFOs) of various companies going. Acquisition is found to be the most important factor that leads companies to go public as per the view of CFOs participated in the survey.

Celikyurt *et al* (2015), using a 20 year (1985-2004) data concerning post-IPO with the conclusion that majority of IPO firms are an active participant in acquisition and their volume of activity with merger and acquisition by far exceed the combined amount of capital expenditure, and research & development (R&D).

Facilitate takeover

Companies mainly do have three alternatives in their life-time: remain private, going public, or to be taken-over by a publicly traded company. Once a firm goes public it will be so easy for them to acquire or be acquired in stock deal (Baru et al., 2003) [33]. Rosen *et al*., (2005) in their study of what motivate banks to go public, have identified that there has been a high tendency of being acquired or become acquirer of those went public.

Technological Innovation

Firms tending to be a leading in technological innovations and invest in it early may gain a competitive advantage in the product market. Early IPOs occur in industries which are perceived to be viable by the market, low relative primary stage cost, and where the probability of being displayed by more technologically advanced rivals is low. If firms with the new & existing technology went public at a time, the later one will succeed (Maksimovich & Pichler, 2000).

Hsu (2014) [17] has examined the resultant impact of industry wide technological innovation on the volume, timing and post-performance of initial public offerings. IPO. He has identified that high level of industry technological innovation is followed by more initial public offerings.

Reducing cost of capital and enhancing bargaining power with bankers

For the external equity, the choice between private and public equity partly depends on a trade-off between the risk premium for a lack of diversification and the costs of information production (Chemmanur and Fulghieri, 1999) [35].

Rajan (1992) [19], argued that firms always try to enhance their bargaining power over banks and going public is one way of developing such potential.

Cash-out Insiders

The usual answer given for the question "why do companies go public?" is the desire to raise equity capital for the firm and convert founders' wealth in to cash which is referred as "cash out" function (Ritter & Welch, 2002) [7]. Liquidating current holders is the third most frequently stated reason for going public according to Mikkelson *et al*. (1997) [36] Insiders opportunistically sell shares in the IPO for personal gains. It is a withdrawal strategy for venture capitalist (VCs) providing an attractive harvest strategy. Mello & Parson (1998) [37] argued for the relevance of ownership structure in enhancing firm's efficiency and state that going public will increase the value of the firm so when the company become public existing shareholder are going to transfer their share to the new ones.

Expand ownership and gaining Publicity

IPOs usually will result for a business in increased public awareness, which may lead to new opportunities and new customers. Gaining publicity particularly for those firms with the new technological innovation is beneficial as it may result in competitive advantage so firms with such statue consider this move as a strategic move (Maksimovich & Pichler, 2000)

Shah & Thakor (1988) [38] suggested that public incorporation of firms will facilitate an augmentation of aggregate investment. The perception is that sale of equity to the public will result in a well-diversified ownership of a firm so that investors tend to ignore abnormal risks attached to the assets and future investments.

5. Methodology of the study

5.1 Data sources & collection methods

Both types of data sources Primary and Secondary have been used. The primary data has been collected using structured questioner designed on 5-point likert scale for various variables, Secondary data are collected from sources such as Journal articles, books, websites, and various published & unpublished materials.

5.2 Sampling method

For this research, purposive sampling has been used. Companies went public from the year 2011 to 2015 have been selected since it has been a period of high IPOs ever. Around 136 companies went public in those years.

5.3 sample size

From companies went public in the study period, 31 companies has sampled. This makes the sample size to be about 23 percent. Since the questioner was self-administered all questioner was usable.

5.4 Data analysis tools & methods

After the distributed questionnaire has been collected, coded entered into MS-Excel and edited, it has been exported to SPSS version 20 for further analysis. Various descriptive statistics measure such as frequencies, mean, median, standard deviation & variances have been calculated.

6. Results and discussion

6.1 Leading cause for establishing the company

We have investigated what are the most significant factors given priority and importance for issuing shares. There are many motivational variables for the establishment of the company. Some of them are new product innovation, identification of natural resource potential, demand & supply gap in the country or in specific area and the like. We have examined what are the motivations for the establishment of our sample companies.

Table 1: Motivation for establishment

	Frequency	Percent	Cumulative Percent
Demand & Supply gap	22	71.0	71.0
discovery of Natural resource	6	19.4	90.3
Innovation	2	6.5	96.8
Other	1	3.2	100.0
Total	31	100.0	

***Source*:** researchers own computation

As depicted on Table 1 above most companies are established by observing the demand & supply gap in the country. In recent years the Ethiopia has become the one of the fast growth economies in Africa this growth. Economic growth will tend to motivate consumption so that there will be an upward shift on the aggregate demand on the nation this increase in demand has instigated companies to see opportunities and established to fill that gap. Though they are a few, there are also companies which are established as a result of discovery of natural resources.

6.2 Motivation for going Public

As it has been discussed in various literatures, companies do have a number of motivations for going public. To mention some huge financial requirements of a new investment opportunity, technological innovation, product market geared expansions.

In these research companies Founders were asked to rate the major driving forces that let the company to issue shares in order to raise thee required finance.

Table 2: Motivation for going Public

Descriptive Statistics			
	N	Mean	Std. Deviation
high financial demand of the project	31	4.68	.791
Lowering cost of capital	31	4.61	.495
to broaden public base	31	4.58	.564
hot market condition	30	4.37	.669
to create market value for the company	31	4.10	.978
difficulty of getting loan	27	3.89	1.013
future Acquisition & Capital Expenditure	30	3.47	1.008
to create good will for the company	24	3.33	1.049
cashing out venture capitalist & former owners	29	3.17	1.227
better legal advantages as compared to other forms of business organizations	31	3.13	1.284

***Source*:** researchers own computation

In table 2 above, we have presented the average level of which motivational factors for going public have been rated. As it can be seen, the variable which is rated on the top is the higher requirement of finance is the leading motive and considered the most contributing factor which lets companies to issue shares.

The variable rated second with a 0.07 difference only is lowering cost of capital. Rajan (1992) [19] has argued that companies are interested issuing shares in order to enhance their bargaining power with borrowers. Our finding here also supplements the arguments stated by Rajan.

The third level motivation of going public is to broaden the public base. Companies may sometimes going public to enhance their public base; so that, it will create the market potential and make the company well-known among the public.

Companies usually go public when the market is hot. In various studies the IPO varies from time to time depending on the market condition. IPOs usually move in wave. In our study companies have rated the market condition as the fourth important factor for going public decision.

Creating a market value means making the company to be traded in the company. This objective can be achieved by issuing shares to the public. Companies most of the time will do these if they are intended to acquire or be acquired. Marketability will also simplify and facilitate merger and Acquisition by creating tradable value for the company. In this research, creating market value for the firm and enhancing marketability of the company has been considered as the fifth most important factor.

The sixth important factor considered in going public decision is that difficulty of getting loan. This finding coincides with previous our finding that companies consider going public as means to minimize their cost of capital by enhancing their bargaining power. Here also we have identified that when companies have difficulty of getting loan so they will go public to improve their bargaining power against banks.

The least rate as important factor is that motive of future acquisition and capital expenditure for the future. Since majority of the companies in our study are newly operating, their focus is on the current operation of the company so it is logical to rate future acquisition objective as a least important as compared to other factors.

The remaining factors such as creating good value for the company, cashing out of dividends and comparative legal advantages of share companies will not be discussed further since their average value is not statistically significantly different from the neutral value of three as per our one sample t-test.

6.3 Challenges faced by companies when they are going public

To investigate what are the most challenge faced by Ethiopian companies which issue share and their levels, we have enumerated a number of challenges and request company officials to rate them. As we have done in our previous parts we will first describe the descriptive statistics result based on the mean value computed we will determine which of the challenges are rated as more challenges than the others. And in the second part of our discussion we will discuss the regression result and determine the statistically significant challenge on the overall valuation of challenges based on it.

Table 3: valuation of IPO related challenges

Description	N	Mean	Std. Deviation
investors low interest & potential to invest on shares	31	4.61	.495
investors poor understanding about investing on shares	31	4.13	.957
absence of trained stock brokers	28	3.82	1.124
Absence of stock exchange	30	3.80	.997
problem with determining par value	30	3.27	1.230
Time consuming & lengthy legal Procedure	30	3.20	.925

***Source*:** researchers own computation

As per the result show in the table 4.14 above companies rated four major challenges they have confronted while they are issuing shares. We will pursue our discussion on individual variable according to they have been rated from high to low based on their mean result.

The first factor identified as a challenge is investors' low interest & potential to invest on shares. This is a very crucial challenge for the successful accomplishment of an IPO. If investors have low interest and potential to invest on shares selling shares and collecting the required finance for the project will be rarely possible. When promoters of start-ups going to consuming much time for selling all the shares to raise the finance, the potential benefit of the project may be wiped up for various reason. The identified demand- supply gap may be satisfied by other firms, new private firms may be entered into planned area of operation so that the product may be available in the market, and those investors who invest at early time may start to complain about the late or non-operating on the business. Therefore, investors' interest is so vital for the success of an IPO.

The second factor is again relating to investors. It is investors, lack of understanding cost and benefits of investing in shares. The impact of this challenge is related to what we have discussed on the previous paragraph. It prolongs the time required to raise required finance and extend the implementation of the project.

The challenge rated third is absence of trained stock brokers. As we have seen in the previous part of our discussion concerning how companies sold their share to the public, majority of them used their own resources and opened offices. This consumes significant amount of resource and even some of them where charging additional 7% services charge on investors to compensate costs incurred for opening offices and hiring of personnel for selling stocks. However, if there had been well trained stock brokers this cost will be minimized for economize of scale to be attained by organized stock brokers.

The fourth challenged is absence of functional secondary market. There are so many benefits to be gained such as facilitating pricing of IPOs, enabling smooth transfer of share thereby enhancing liquidity and investors' confidence; it is also a control mechanism serving as measure of governance by responding for good and bad act of the company in adjusting for share prices. Issuing IPO where there is no secondary market will be challenging as the mentioned and some other services will not be available for use by companies and investors.

The remaining two challenges: Time consuming & lengthy legal Procedure and problem with determining par value of shares will not be discussed as their average value is not significantly different from the neutral value of three as per out t-test result.

7. Conclusion

From the results, we have obtained in the survey we have concluded that companies are established due to the observation of existing demand & supply gap by the founders. High financial demand of the project, lowering coast of capital and enhancing bargaining power, broadening the public base of the company, are the leading factors motivating companies to issue shares so that they can raise required capital and start operation. With respect to challenges, investors low interest, low potential to invest in shares, and their poor understanding about investing in shares, absence of trained stock brokers and stock exchange are the four highly rated challenges in the IPO process.

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