Analysis of the Issuers' Main Risks during the IPO

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Abstract. The paper analyzes the key risks that accompany the company during the preparation and direct placement of its shares on the exchange through IPO, are offered the most effective methods of influence\effects on various risk groups and examples of evaluating the economic efficiency of measures designed to manage risk.

Key-words: Initial Public Offering, sources of funding, efficiency, risk management

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1. Introduction

Until recently, the main sources of funding for corporations were shareholders' equity, bank loans, bonds, notes or budget funds and state loans. But with the development of globalization process and increased mobility of capital it has become more urgent the way to raise funds through an IPO (Initial Public Offering, IPO).

IPO has several advantages over other sources of funding and could be the beginning of a new stage of dynamic development of the company. The most important its advantage lies in the fact that the company gets access to long-term capital on favourable terms – the borrowed funds must not be returned to investors for their use and is not required to pay interest. Companies, whose shares are traded on the exchange, acquire a market value and their market capitalization increases, resulting in the companies that undergo IPO often cost more than their competitors. The current financial condition of the company, in case of successful IPO, often improves. Shareholders' equity increases due to growth of the share capital by selling shares, and by obtaining additional capital due to share premium.

An important advantage is the fact that after the IPO procedure, the issuing company has a history on the public financial markets, increases its overall status, credit rating, improves its image and creates prospects for attracting investment in the future on favourable terms. Besides that the company receives additional benefits - increased level of corporate culture, the owners are able to use the IPO as a tool for cost to get out of business, because competent IPO allows the owners to get the maximum price for their shares.

However, once the companies get access to the stock market arises the need for significant change. Preparing the company to listing requires a careful analysis of all aspects of business, and after getting on the public market companies should consider the regulatory require-ments of the stock exchange and the need to match the expectations of analysts and investors.

Besides the above mentioned, there are several negative factors, the main ones being: the need for "transparency" of the company and significant costs. The most "sensitive" areas on which the company is obliged to "shed light", include: the list and structure of the company owners; the level, size and amount of wages, benefits, compensations and rewards of management personnel; financial information, which characterizes the current state of the company's affairs.

Despite the fact that the issue of shares is not accompanied by debt relief for the company, it still requires the exercise of placing high costs inherent in this method of raising capital. In particular, these are the costs for the services of a financial advisor, stock exchange, registrar, underwriter, lawyers, auditors and others, as well as for marketing and informational support. When placing the shares at the IPO, there is also the danger of losing some control over the company.

Taking into consideration the above mentioned, the decision of acquiring the status of a public company, must be taken in the context of the goals and objectives of the company. In many cases, with careful planning and effective assistance from experienced and qualified consultants, the above shortcomings can be minimized.

As the access to the public market, as noted earlier, requires the company to make significant changes in corporate governance and in financial and economic aspects, implementation of public market quotation, like any other activity, is subject to various risk factors. Without enumeration and risk assessment is impossible to conduct an effective placement of shares on the exchange.

2. The main risks factors during IPO

In order to meet the challenges of qualified risk management aimed to maximize the effect of entering the IPO market is needed to carry out the next steps:

- ✓ identify important indicators that affect the efficiency of IPO;
- ✓ determine the level of risk of identified indicators;
- ✓ determine the impact of risk on the effectiveness of placement;
- ✓ develop risk management techniques;
- ✓ establish control over the implementation of activities, smoothing the identified risks.

It should be mentioned that the effectiveness of quoting the company on the stock exchange is influenced by two main factors: external, related to market conditions, and internal, which forms a willingness of the issuer to enter the public market. Accordingly, the risks can be divided into operational, related to the preparation of an IPO, and market, related to the situation on stock markets. In this connection, can be distinguished the following classification of factors (table 1).

Table 1. Classification of risk factors

External factor	Internal factor
Risk of cancellation IPO (the average in western areas cancellation of IPO is in the process of application is in 20% of cases)	Operational risk, including the risk of rates' failure, the corresponding to the requirements of a wide range of investors, and regulators as a result of faults or errors of managing business processes (we estimate 40% of the company's commitment to public status does not meet the existing requirements)
The risk of underestimating the value of the shares by the market, i.e. quotation at the bottom of the price range (in 24% of cases in Russia is by placing the bottom edge)	Financial risk, including credit risk, liquidity risk of the company, etc.
Liquidity risk at the expense of both, current adverse situation in the stock market and speculative games, etc. (in 36% of cases the value of the companies' shares within a month after the quotation is lower than the offering price)	Business risk, including the risk of shareholders' actions, management, reputation risk, the risk associated with the strategy of the company, etc.
The risk of poor investor base, resetting the shares of the issuer immediately after quotation, thereby bringing down the prices of companies' shares	The risk associated with corporate governance, including financial and information transparency of capital structure, management quality, etc. (in some cases increasing the cost by about 20%)
The risk of market capitalization reduction (in 5% of cases there is a decrease in capitalization of the issuer or its value does not change)	

Source: developed by the author.

Analyzing the IPO market in 2011, we note that almost 90% IPO, which the companies planned to organize in Europe in the current year, proved to be a failure. Companies decided not to quote any shares or the securities rate began to fall immediately after listing on the exchange.

In the current year 25 companies planned to be listed on the European exchanges. Subsequently, 13 IPO were postponed or rescheduled. According to Bloomberg information on June 20 of the remaining 12 organizations, only two can say that Exchange listing was a success, because only their shares are traded above the initial value.

Financial News investigation shows that among the 13 companies, whose IPO is not held or been a failure, three – are solid organizations. Among them - the Danish concern ISS (cleaning and maintenance of offices), the French media giant Canal Plus. Firms refused from its IPO in mid-March because of excessive volatility of stock after the Japanese tsunami. ISS planned listing, which promised to be the biggest in Denmark over the past 16 years. Last week, refusing to place shares declared the supplier of building materials Cie de Saint-Gobain.

As a whole, the world situation is not good. Market goes on record - from 91 IPO 22 were cancelled, which is the highest rate in the last five years. Of the 69 placements 36 can not be called successful (stocks are trading below the initial value).

It is assumed that the fears of investors and companies regarding the shares are a risky asset, due to mistrust of the SEC, due to strong volatility. At a time when global inflation is increasing, rising prices for raw materials in Europe and America with a national debt problem, it is not easy to earn good money on IPO, states the analyst Julius Baer Christoph Riniker.

This situation indicates that issuers incorrectly assessed the risks associated with the placement of their shares on the stock exchange, or so overestimate their own capabilities and potential, which will ultimately have to move the date of placement at a later date. In some cases where investors do not have enough information about the business of the issuers of the industries, more profitable and cheaper is to abandon a public listing in favour of selling to a strategic investor.

3. Analysis of the risks that accompany the company during the preparation and direct placement of its shares on the Stock Exchange

In general, risks may accompany a company in the process of preparing for an IPO, and in the future, as handling the company's shares on the exchange. Here is an example of some types of risk (table 2).

Table 2. The list of risks that accompany the company during the preparation and direct placement of its shares on the Stock Exchange

Stages	Risks	Main reasons
Preparatory	• failure of the company to have the required parameters for effective placement of shares on the Stock Exchange (capitalization, profitability, etc.); • delaying the process of preparation, that may cause missing the favourable time of placement; • disagreement of owners on the packet size distribution and the issuance on the public market; • reduction of investment attractiveness of the company; • claims for regulatory bodies to the company; • potential litigation regarding the use of patents and technologies owned by third parties; • challenging the ownership rights for the purchased assets, etc.	• lack of funds for preparatory transformations; • dispersal of share capital; • unskilled management; • corporate conflict among shareholders; • lack of a full-fledged package of documents setting forth the right to property, intellectual property, etc.
Process of shares placement	• claims of controlling bodies registration of necessary documents; •deterioration of placement options due to changes in market conditions; • emergence of information prejudicial to the company's image in the eyes of investors; • changes in legislation governing the placement process and requirements for the company; • lack of interest in the company of the investment community; • inadequate allocation price.	• unskilled work of market participants IPO (underwriters, auditors, consultants, IR and PR services); • low-quality document preparation, in particular of the prospectus
Process of shares circulation on the exchange	• falling liquidity of the securities as a result of deteriorating issuer's indices; • reduction of the overall market conditions under the influence of macroeconomic factors; • adverse information which negatively affects investors' expectations;	• poor-quality work of the companies providing necessary information to a wide range of investors; • failure of investment projects, which led to a deterioration in financial economic performance of the company.

Source: developed by the author.

Each of the above risks, to various degrees, affects the performance of the IPO. Overall assessment of the impact of risk on the process of IPO, in our opinion, is to achieve the maximum amount of fund-raising.

In this regard, the influence of risk factors on the IPO process is as follows:

$$Vmax = Vmin + \Delta V \times Ir,$$

where *Vmax* - maximum amount of fund-raising; *Vmin* - minimum amount of fundraising; *ΔV* - difference between the maximum and minimum amount of involvement; *Ir* - risk index.

The degree of influence of risk can be represented by the following formula:

$$Ir = P \times L,$$

where *Ir* - risk index, *P* - probability of risk, determined in accordance with the qualifications of risk (in percentage points or degree of influence on the preparation of the company to IPO); *L* - value of the losses that may accrue to the issuer as a result of entering the IPO (as a percentage of failing to attract the planned amount).

As we can see the impact of risk on the size of the attraction has a single focus: the higher the amount of borrowing, the higher the degree of risk measures aimed at achieving the stated value and vice versa. In this aspect, the cost of achieving Vmin has some constant value (it is assu-med that if a company suddenly decides to enter the public market without making any changes, there sill exists a group of investors who will offer it some kind of a price taking into account the closure and non-public companies) and therefore, the risks of the issuer related to their not been realized on the Stock Exchange, in this case tend to zero. While further reforms of the company in terms of increasing capitalization, investment attractiveness associated with increased magnitude of the influence of risk index.

Therefore, the management impact on them by can improve the rate ΔV × Ir, which in turn provides the maximum amount of involvement by the issuer of funds from IPO. For example, at the fullest extent possible to attract $ 100 million the minimum amount is of 40 million. As a result, the difference in $ 60 million will be most exposed to risk.

In this regard, we note the following. It is believed that the difference between the closing price on the first day of trading in shares of the issuer and the offer price is 'headline earnings' share IPO, i.e. the shareholders have been under-collected in the process of placement. Thus, in the U.S. companies loose an average of $ 9 million. Such a significant difference, as might be expected, due to large speculative expectations of market players (this is especially seen in the undeveloped stock markets, and in cases of high demand for new securities), supporting the organizers of the placement, etc. In the future pricing, fairly objectively, shows the value of the company.

It appears that the level of risk exposure of these groups on the quality and level of accommodation can be represented as a table with assignment of a certain magnitude level. It should be noted that the ranking and rating the degree of influence is made by an expert, depending on the specifics of the business, industry sector, the availability of certain restrictions imposed by the state, as well as the readiness of the company in the process of IPO. We estimate the degree of risk, on a scale from 0 to 1. The 1 represents no impact on the magnitude of the risk of raising funds, and 0 describes a high impact.

Thus, in general, the degree of impact of identified risks on the amount of involvement in the IPO process can be represented in table 3.

Table 3. The influence of risk on the amount of fundraising

Types of risk / stage	Internal factor (risk of corporate management)	Internal factor (operational risk)	External factor (political risk)	Internal factor (financial risk)	Internal factor (business risk)	Other
I	Low (1)	High (0,1)	Low (1)	Low (1)	High (0,1)	Low (1)
II	High (0,1)	High (0,1)	Low (1)	Low (1)	Average (0,5)	Absent
III	High (0,1)	High (0,1)	Low (1)	Low (1)	High (0,1)	Absent

Source: developed by the author.

An evaluation of the impact of a risk to the process of release to the public market may be noted that it may vary depending on the stage of IPO. As we can see, the most significant, in terms of allocative efficiency on the Stock Exchange, is the internal factor (operational and business risk and corporate governance). This group is closely correlated with each other, because it reflects the company's capabilities and preferences of investors.

Since we broke the process into three stages, then to analyze the impact of a risk we can apply the average rate, calculated as follows:

$$Irmidl. = (Ir\ (1st) + Ir\ (2\ st) + Ir\ (3\ st))\ /\ 3$$

Thus, we can assume that the measures aimed at levelling all risk groups, will contribute to maximizing the amount of attraction and improve the capitalization of the company, and vice versa, the individual risk would lead to the minimum amount of involvement and reduce the company's market value.

In other words, if the index *Irmidl.* will tend to unity, then the company's ability to attract the maximum amount of resources and increase their capitalization increase, and if zero - then decreases. In addition, depending on the stage IPO effect of each risk category will vary. Therefore, in order to assess its needs, is required a careful consideration of all risk groups for each of the issuer with the determination of its effect on the outcome.

The risk of loss of control (especially in cases where other than shares, traded on the market, there is a 10-15% minority stake, sprayed across a wide range of shareholders) are necessary steps that could neutralize or at least control the financial risk. One of these steps may be the formation of reserves

in the form of liquid assets (cash, securities, etc.) in order to quickly implement countermeasures aimed at buying the necessary shares and bringing its stake to the control group.
In this case, to compensate the risk of losing control of the company must determine the amount of reserves needed to restore the "status quo", which can be expressed as follows:

$$R = (B - A)\, P \times q,$$

where R - amount of the reserve; B - reference value of the package (usually a 50% + 1 share); A - controlled stake in the issuer's principal shareholder; P - value of shares on the Stock Exchange; q - market volatility relative to the value of shares of the issuer.

4. Methods of risks levelling

Of course, if we consider the risk matters levelling IPO, the companies need to develop measures aimed at neutralizing all of the above risk factors in the IPO. This requires the development and determines the most effective methods of exposure for each risk group. In our case, it can be presented as table 4.

Table 4. Interventions for risk

Type of risk	Methods of levelling
The risk of corporate management	• creating the service of public and investor relations; • preparation of necessary information for a wide range of investors in accordance with established regulations and standards; • publication of analytical materials and comments on the assessment of the company; • disclosure of information about the owners of the company; • saturation of the company's site with necessary corporate information; • signing of an agreement with the PR-agencies to improve the image of the company (possibly re-branding, etc.); • collaboration with specialized publications on the subject of lighting perspectives and return the industry, market sector of the company; • meeting with investment funds, professional securities market participants to highlight the company and making it popular; • participation in conferences, exhibitions and other activities, promoting the public presentation of information about prospects and successes of the company
Operating risk	• improve of financial and economic indicators by optimization of costs, elimination of duplicate functions, increase of profitability, improve of logistics, etc.; •implementation of active growth strategy; • improvement of credit rating; • use of bond and bill market to fund programs and projects of the company allowing to diversify into capital or increase market share, etc.; • revaluation of the company in case of undervaluation; •disposal of non-core and unprofitable assets, trends of business.
Business risk	• preparation of IFRS financial statements (Financial Reporting Standards); • having an independent representative in the board of directors; • adoption of a code of corporate governance; • development of company strategy enabling it to significantly improve their market position; • implementation of major investment projects; • timeliness of company release on the stock exchange; • payment of dividends; • implementation of measures aimed at disclosure of all company potential (the selection of individual long-term business trends, entry into other market sectors, etc.)

Source: developed by the author.

Economic evaluation of the designed activities can be represented as follows:

$$CE = \Delta V \times Ir1 - (\Delta V \times Ir2 + C),$$

where CE - cost-effectiveness of risk management; $Ir1$ - risk index based activities; $Ir2$ - without risk index of developed measures; C - the cost of the event.

For clarity, we are giving the following example. The maximum amount of company attraction amount is $ 100 million, the minimum - 40 million, the risk index - 0.4. Costs of implementation of risk management are 5 million, which ultimately will improve the risk index to 0.6. As a result, the economic effect will be

$$CE = 60 \times 0{,}6 - (60 \times 0{,}4 + 5) = 7.0 \text{ million}$$

Accordingly, this effect can be counted as a step in the preparation of a public offering, and the results of all three stages of the IPO. It should be also stated the fact that certain expenses of the issuer can be estimated precisely for the final result, and therefore require strict control over the implementation of tasks within the framework of risk management, that they contribute to achieving the maximum effect from entering the market IPO.

Not to mention, and risks arising after the IPO. It should be noted that in the world practice, there are many examples where companies are losing the status of publicity and are subject to delisting procedures. In particular, for the period 2000-2009, to this procedure were subject about 25% of companies. At the same time, in our view, risks to the issuer after the IPO, to a greater extent depend on the continued effective operation of the company and the situation on the market, rather than from the procedure IPO.

Of course, the status of publicity for the company imposes certain obligations on disclosure of financial and accounting information, the successful implementation of investment projects, etc. In this regard, the main task of the issuer is to maintain the liquidity and value of their securities. In this crisis on stock markets, industrial recession and other macroeconomic factors are unlikely to allow the company to remain at the proper level regardless of the actions by the company.

5. Conclusion

In conclusion I would like to dwell on this aspect, as financial risk, resulting in possible loss of the effect of costs incurred in preparing the company for an IPO. In particular, the costs of the company to restructure and directly IPO costs should lead to an increase in company value and obtaining the maximum amount of attraction. In this case, there will be a close correlation between the amount of spending to transform the company, and the result, which eventually will receive the issuer.

Generally, considering the problems associated with the impact of risks on the effectiveness of the IPO, it should be noted that, based on the fact that the IPO is considered one of the most expensive ways to attract financing, the issuer decides to raise funds using this mechanism, that should be preceded by the elaboration of a long-term development strategy in the context of its goals and objectives, examination of the current state of the stock market, deep and comprehensive analysis and assessment of the risks inherent in all the main stages of an IPO and elaborated a required set of measures for their timely elimination/minimization.

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