

CORPORATE FINANCIAL STRENGTH SUSTAINABILITY POST PO: EVIDENCE FROM BALTIC EQUITY MARKET

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Abstract

When providing funding for the company, which makes IPO or PO, investors expect the enterprise to post the same earnings growth as it is before the event and even higher as the entity can leverage its growth on the additional funds attracted. However, as the analysis of the Baltic IPOs and POs demonstrates the reality diverges from the investors' expectations and valuation multiples, being high once public offering is made rapidly decrease. The profitability of the companies declines in the first two years after the funds attraction. The solvency position strengthens right after the event but in the second year it reaches the level of pre-IPO financial stability. One of the reasons to explain this phenomenon of financial underperformance is weak earnings quality before the fund attraction event, which is clearly shown by high level of accruals. Another explaining reason is low motivation of the management to keep company attractive for investors, which can be characteristic trait of developing equity market where investor relations culture is just emerging.

Keywords: Baltic equity market, IPO, PO, financial analysis, quality of financials, ownership structure, earnings plausibility.

Introduction

According to Ernst & Young data, the value of initial public offerings (IPO) in financial year 2010 is set to beat previous record of 295 billion USD reached in 2007, mainly driven by the booming Asian markets. The owners, who choose IPO as an exit strategy or are attracting funds through equity markets, enjoy the benefits offered by the equity markets: higher liquidity, highest value, larger fund amount availability, increased public awareness. During an IPO preparation stage, which is usually quite lengthy and may take up to 6 months, the companies make itself look as attractive as possible and, thus, expose themselves to earnings manipulation techniques.

Therefore, the question regarding company's financial attractiveness and its sustainability in the post-IPO phases emerges. The managers of the public companies still have strong motivation and lots of reasons to make the company a "dainty morsel" for investors: stock options, remuneration depending on the market capitalization of the company, stock ownership, higher stock price to prevent hostile takeover, higher prestige, and higher goodwill of the company to receive lower interest rates for loans. However, these motivation drivers, probably, are not enough to sustain the pre-IPO financial quality of entity, as the majority of studies conducted on company's operating performance after IPO suggest the deterioration in financial condition.

Moreover, it is also not a rare phenomenon that share price performance is unsatisfactory after the public offering and price to earnings ratio (PE) tends to decline in the following years. Unjustifiably high PEs at the moment company starts to be quoted are often explained by the overly high expectations about the future growth of the company.

The most common reasons for the financial underperformance afterwards when the company becomes public are increased agency costs in the post-IPO period as well as artificially inflated figures, which are definitely not sustainable. Besides, the companies tend to make POs when they go through the favourable operating period, when they are able to post promising growth in the figures and disclose grand development projects for the future. These factors, mentioned as influencing on financial performance after the listing, were developed in the late 90-ties. However, modern financial markets are driven by the investor behavior, sentiment, and other psychological issues. As a suggestion, one can consider significantly lower motivation of the managers in the post-IPO period and especially this is true for emerging markets, where remuneration with stock or stock options is not common. Also the influencing role of stock exchange is small yet and, thus, company cannot gain a lot of goodwill by being quoted.

Public offerings in the Baltic States are becoming popular mainly due to the higher awareness of population of financial markets as well as active capital accumulation phase. For instance, for the last 6 years there were 13 IPOs (initial public offering) and POs (public offerings) on the Baltic equity markets, which

added a third of the current market in terms of number of companies and significant part of the current market in terms of market capitalization. The disappointing fact is that in the majority of cases the share price showed an underperformance due to very high initial price because of high investors' expectations regarding companies' future and willingness of the owners to earn more as usually stock markets offer the highest possible value for the company if chosen as an exit strategy.

The authors of the present research decided to conduct the study on the companies raising funds on the Baltic stock market with the aim to understand how sustainable is the financial health of the company after it makes public offering and whether high PEs are justified.

Thus, the authors propose the hypothesis that public Baltic companies are not able to sustain the quality of financials after the public offering. The main objective of research, therefore, is to conduct thorough financial analysis before and after the company becomes public and find out whether the quality of the company is maintained after the change in shareholder structure and gaining access to large capital inflows.

The methods chosen for conducting a research are mainly quantitative, which include comparison of the results to the relevant benchmark, statistical, descriptive.

Sustainability of Financial Performance after PO across the World

A number of studies conducted on international equity markets document strong evidence in the decline of financial performance of the listed companies after they make IPOs. The decline usually is observed in longer term period, which takes 3 years in average. The deterioration in financials is spotted in all types of equity markets - developing and developed.

Jain and Kini (1994) made a research on 682 US IPOs in the period from 1976 to 1988 and documented erosion in profitability of assets as well as operating cash flow return on assets, which is clearly seen for the following three to five years after the IPO. The findings were adjusted on the industry basis and the returns cannot be negatively influenced by the decline in sales or cutbacks, as the researched sample exhibited strong growth in sales and capital expenditure.

Teoh, Welch and Wong (1998), who also focused their research on US equity market, found significant earnings manipulations, which significantly depress the operating results after the company becomes public: median return is significantly positive in the IPO year and significantly negative in the year 4 after the IPO was made.

Coakley et al. (2004) researching sustainability of UK IPOs' performance state that erosion in firms' financials should not be surprising as the short- and long-term IPO investment performance has also a declining trend.

Studies on the developing market bring up the similar findings: declining financial performance in the post IPO period as well as significant earnings manipulation before the IPO takes place. Hong Kong University researchers Kao, Wu and Yand (2009) discovered strong dependence of post-IPO profitability on the pricing-period accounting performance: the higher is the accounting performance the larger are the declines on the Chinese equity market. It is interesting that market penalizes with lower first-day stock returns and worse long-run post-IPO performance those companies which make overly optimistic earnings forecasts.

Declines in financial performance have been also found on the Malaysian and Turkish stock markets by Ahmad-Zaluki (2008) and Kurtaran and Er (2008) respectively. They relate the declines of the firms' profitability primarily to pre-IPO weak earnings quality, which is certainly not sustainable and the firms cannot boast with high profitability over several years in a row.

Apart from the problem of the creative accounting in the IPO preparation stage, the two other reasons are pointed out in this connection. The first one considers favourable timing as the period, when company makes an IPO, usually is promising in terms of investor's sentiment on the stock markets as well as in terms of companies' financial state as it is very doubtful that company can attract any money when it undergoes financial distress. Ritter (1991), Brav and Gompers (1997) and Benning et al. (2005) prove that the majority of companies employ the opportunity of good timing to enter the public market. Intuitively one feels that the company cannot sustain its excellence for longer term. The exceptions probably are the "Great Companies" identified by Jim Collins and his team (2001), which stayed great for over 50 years but still not all of them survived till now. According to the research made by the CE Services company (2004) in average company can sustain its outstanding quality for not longer than three years.

The second reason for the financial underperformance in the post-IPO stage is the increased agency costs after the company becomes public. Going public typically leads to the major change in ownership structure and former owners/managers have significantly reduced (if at all) ownership. This usually creates agency problem, when managers undertake non-value maximizing projects. The negative influence of agency theory on the firms' performance after the IPO is supported by the Jain and Kini (1994) and Kutsana et al. (2002), while some are rejecting it (Mikkelsen et al. (1997)).

Research Methodology

The present study analyzes 13 cases of IPO and PO which took place on the Baltic stock market from FY 2004 till FY 2008, while the analysis period is from 2002 till 2010. Prior public offerings are not considered as they were mainly realized for privatization purposes, therefore raising capital was not the primary goal.

Quality of corporate financials is assessed two years before and three years after the public offering. However, data for three years after IPO were not available for the majority of the companies, so the research mainly focuses on two years after the company became public.

The data for the research needs were extracted mainly from the online resources provided by Nasdaq OMX stock exchange as well as from corporate web-sites.

Financial Condition evaluation

The basic set of fundamental ratios is employed in order evaluate the quality of corporate financials, which includes three groups of ratios: profitability, solvency and market valuation ratios.

The dynamics in earnings has been also considered in the research process, while the authors needed to adjust it for the inflation figures to avoid unjustifiably high growth in sales and earnings. Besides, the figures have been adjusted for GDP growth as the significant economic recession had abnormally negative influence on the figures of the enterprises.

Earnings Quality Evaluation:

Authors understand the risk of creative accounting before the IPO process so earnings plausibility is done additionally, by checking level of accrual ratios, comparing operating cash flow to net income and detecting earnings manipulation techniques. The formula, which was used to assess the level of accruals, is as follows:

$$\text{Accruals} = (\text{NOA}_t - \text{NOA}_{t-1}) / [(\text{NOA}_t + \text{NOA}_{t-1}) / 2] \quad (1)$$

Net operating assets (NOA) have been calculated according to the following formula:

$$\text{NOA} = (\text{Total assets}_t - \text{Cash}_t) - (\text{Total liabilities}_t - \text{Total debt}_t) \quad (2)$$

Research Results

Financial Condition of the Baltic Companies before and after PO

The authors of the study employ five criteria to judge the profitability development of the Baltic companies before and after the PO was made. Two of them are attributed to the capital profitability, while the rest focus on operating profitability of the enterprises.

The changes in operating profit margin, which is viewed as one of the most important measure of profitability level before taxes throughout the 4 years, are as follows: 1Y before/2Y before +34%, Offer/1Y before -32%, 1Y after/Offer -38%, 2Y after/1Y after -28%, which are significant at 0.05 level.

The trend in profitability of Baltic public companies around PO event is shown in Figure 1. It is clearly seen that all of the ratios considered for analysis demonstrate growth in one year before the company attracts capital, while there is a declining trend in the following years. Absolutely the same trends are seen in Figure 1b., which provides the picture on capital profitability ratios (return on equity and return on assets): rising before the event and declining afterwards reaching almost zero profitability. The capital profitability decline in the first year after PO is explained by the inability in a short-term to invest received capital with maximum return.

It is also worth noticing that the operating cash flow margin (shown in Figure 1a.) is the only ratio which grew in the first year after the public offering, while its sharp decline by 35% in the year of the offer, increases suspicion about creative accounting practices used to artificially lift earnings before attracting new funds.

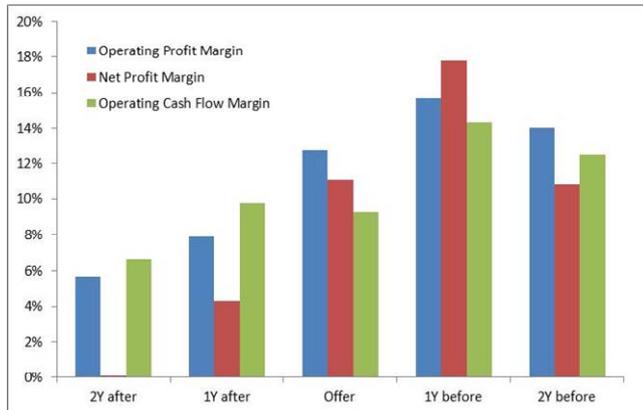


Figure 1a. Profitability Measure

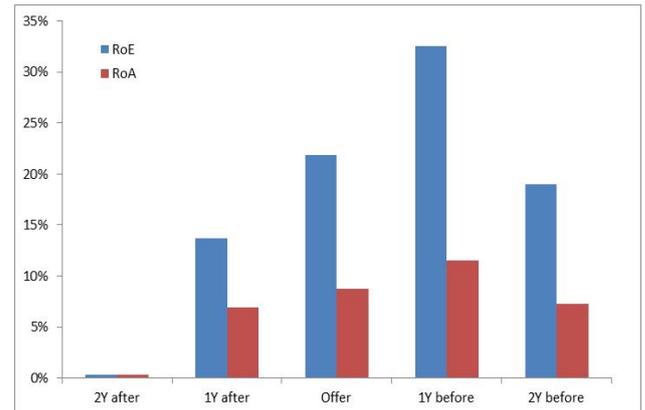


Figure 1b. Capital Profitability Measure

To make operating profitability ratio analysis as objective as possible, the authors adjusted the change in the companies' earnings for inflation and GDP growth (Figures 2.). This automatically makes the sample comparable through different regions and periods, especially economic recession years of 2009 and 2010.

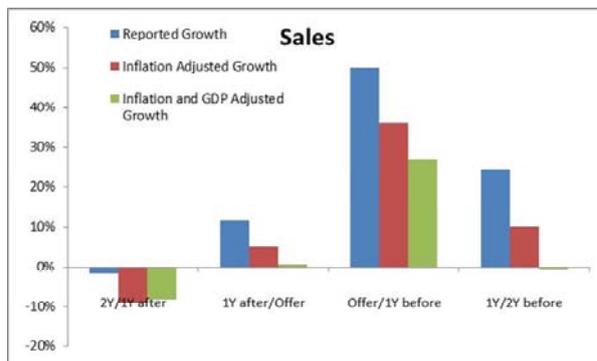


Figure 2a. Sales Dynamics

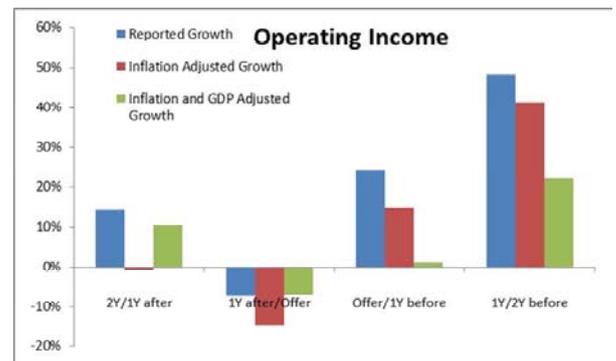


Figure 2b. Operating Income Dynamics

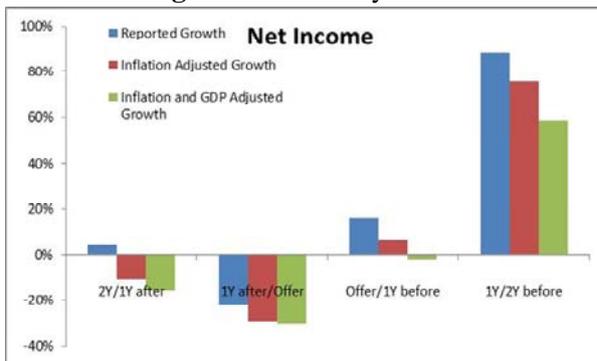


Figure 2c. Net Income Dynamics

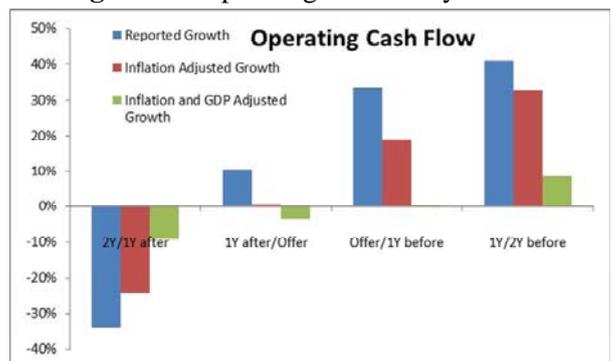


Figure 2d. Operating Cash Flow Dynamics

The adjusted results of the Baltic companies' earnings dynamic analysis shows that in not all ratio categories Baltic companies have been able to post an increase before going public. For example, real sales growth (Figure 2a.) as well as operating cash flow are almost non-existent if to compare 1Y/2Y before, while operating and net income showed significant increases in the same period. This can point to increases in companies' efficiency but also to earnings manipulation as indicated by inconsistent with income dynamics low growth of operating cash flow.

The authors made a second hypothesis that the firm as an operating system goes through an adaptation period after the raising funds on the stock market. The problem is that the funds attracted by the company often make significant part of its existing capital and sometimes exceed it several times.

So, it quite logical to assume that the business system needs time to absorb all the capital received. Though the company before raising funds issues a prospect with the structured plans how the received money will be spent and by how much the value of the company will be maximised (save costs, increase market share, expand sales base by capacity addition or regional expansion etc.), it is not a common case that the received money are invested to earn return. Vice versa investors should not be surprised to see attracted funds not used on the planned projects but are kept on the balance sheet, which sometimes comes across as disappointing phenomenon as cash is a non-earnings asset. For example, *Grindex* in 2005 raised 18 million EUR in order to acquire peer company in Poland, but the intention was not realized due to several reasons and money were kept on the balance sheet for several years until *Grindex* enlarged its manufacturing capacity and modernized its facilities.

When adding third year after PO analysis the results of the analyzed companies have clearly improved and the companies despite the crises were able to post positive earnings dynamic and as well as improvements in efficiency, which was observed in 75% of cases.

Considering the change in financial position of the firm after and before going public, the authors took into account the motivation of the firms to decrease their exposure to the debt payments, as in case of *Eesti Ehitus*. However, to a certain extent it is of questionable benefit because of weighted average capital growth (WACC). To analyse the financial stability and level of debt of the Baltic companies before and after PO was made, the authors employed medians of two most relevant ratios: equity ratio and interest-bearing debt to equity ratio (Figure 3.).



Figure 3. Solvency Position

It is worth noticing that the level of equity ratio two years after the offering is even lower than 2 years before the fund attraction. Decline in interest bearing debt relative to corporate equity after the public offering seems to be also just a temporary event, which is explained for some enterprises by the fact that the planned projects absorb much more than it was assumed and the companies are forced to attract financing also from banking institutions.

Earnings Quality of the Baltic Companies before and after PO

Several references to earnings manipulation possibilities regarding Baltic companies in pre-PO phase were made in this article already. Another strong incentive to make earnings quality analysis of the Baltic companies making POs was clear evidence of creative accounting discovered by a number of researchers: Cai and Wei (1997), Mikkelson et al., (1997), Pagano et al., (1998), Kutsuna et al., (2002), Chan et al., (2003), and Wang (2005).

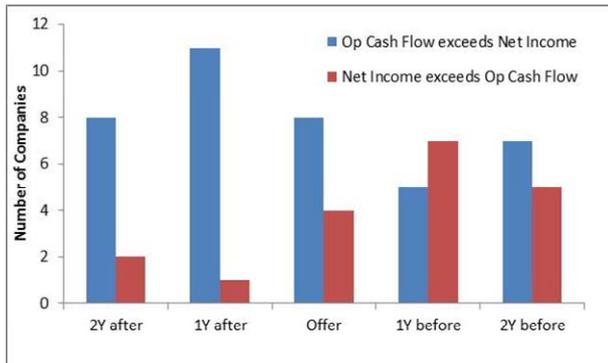


Figure 4a. Operating Cash Flow and Net Income Comparison

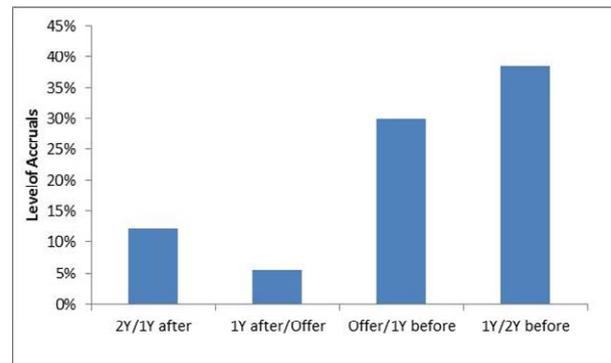


Figure 4b. Level of Accruals

The authors of the study tested earnings quality from two perspectives: comparison of operating Cash flow and net income (Figure 4a.) and accruals level (Figure 4b.). Figure 4a. indicates that in pre-offering stage significant number of companies used earnings manipulation techniques to window-dress their earnings as net income exceeds operating cash flow. Level of accruals is also highest when the companies were undergoing preparation stage, while it sharply declines after.

Conclusions

According to the results obtained, the hypothesis proposed by the authors was proved: Baltic companies are not able to sustain the quality of financials at the same level after the public offering as they were before the company raised capital on the stock exchange. The findings support the evidence of the deteriorating financials after public offering found on a number of developing and developed markets. The second hypothesis, that the company as a system has to adapt to severe changes in its structure and only after certain period is able to post good results, has been prove as well. It was found out that the adaptation period might be 2 years after the offering, after which there is a strong improvement in the results.

The range of financial ratios, which have been employed in the analysis, covered enterprise profitability, solvency, earnings growth dynamics as well as market valuation. It was discovered, that during the first two years after the public offering the majority of companies post declines in their earnings (exception – operating income during the second year) regardless of macroeconomic situation. The capital efficiency and profitability ratios provide a clear picture of strong declining trend for the two years after the public offering. It is interesting, however, that after two years of the PO the overall results regarding profitability improve, which seems to be a bit shorter period than documented for other equity markets, where the recovery period may reach 3 to 5 years.

The declining valuation ratios (PE, PB) after the offering demonstrate overstated expectations at the time when company started to be quoted. Though, lower earnings should lift PE, the underperformance of the stocks offset the effect of lower earnings.

Definitely, the solvency of the companies after fund raising improved, but in Year 2 after the PO the companies again increased their Interest bearing debt and lowered equity in total asset structure, which can point to the too ambitious projects undertaken after the POs.

The reasons for the financial underperformance after PO in Baltic exchange listed companies' case are weak earnings quality, which are proved by the high accruals in the year before capital raise, as well as low motivation of management to make the company as efficient as possible. Low motivation, even if the managers retain significant part of company's ownership, as a reason for deterioration in financials is very well explained on the emerging markets: insubstantial education and experience of the management regarding the equity markets and investor relations, not interested in receiving additional goodwill through reputation provided by stock exchange because of yet low influencing role by the latter, and absence of another fund raising event through stock exchange in the nearest future.

The authors of the research strongly recommend investors to consider the potential risk of both share price and financials underperformance after the PO, which, as study results prove, is very likely on the Baltic as well as on other equity markets. The companies, however, are advised to reconsider their investor relations practice. It is also advisable to repeat this study in several years as the results may change due to improvement in investment culture and additional IPO/POs.

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