

# GOING PUBLIC IN ROMANIA: A REVIEW OF IPO ACTIVITY, COSTS AND PRICING

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*Abstract: This paper analyses the process of going public in Romania via initial public offerings of shares to investors. Various features of the domestic IPOs that took place over the period from 2002 to 2007 are discussed, with an emphasis on the volume of new listings and its explanatory factors, the costs of going public and the initial returns of the IPOs.*

*Keywords: Initial Public Offerings, IPO Underpricing, Bucharest Stock Exchange*

## Introduction

Going public is an important step in the life of a company, because it provides access to a large amount of equity for an indefinite period of time and helps the company to raise finance for its expansion. Moreover, it brings indirect benefits such as increased trustworthiness and reputation for the company, higher value for employees that enables their involvement and their willingness to participate in the future development of the company, and the ability to obtain more and cheaper finance through new securities issues or even bank loans, given the higher transparency of the company which regularly provides information on which it is evaluated.

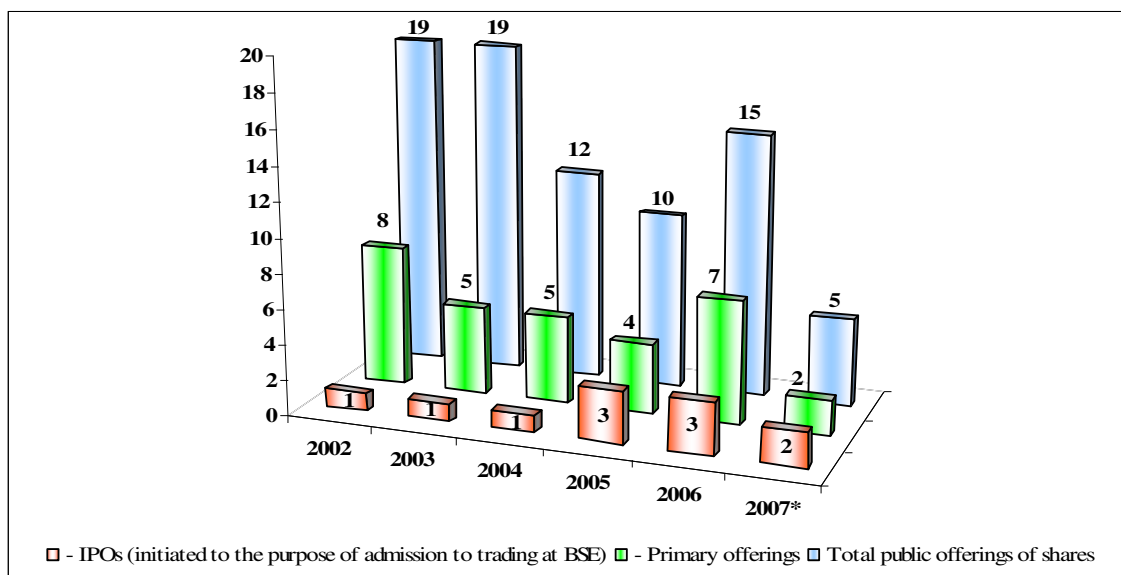
Most companies that go public do so via an initial public offering (IPO), which is a commonly used term for the primary public offering of shares by a company related to its entry to the stock market and the listing of its shares on the stock exchange.

Given the benefits of being public, an increasing number of companies around the world consider the IPOs as an important way to raise financing for new investments. Over the past five years, the IPO markets have witnessed an unprecedented level, with a record of \$246 billion in 2006 in the amount of capital raised worldwide by companies going public (Ernst & Young, 2007: 5). The growth of IPO markets is a global trend reflected by all the main regions in the world – Europe, America and Asia. However, a further analysis at country level shows large discrepancies. For example, the IPO activity in Europe is mainly driven by deals in the most prominent European exchanges, with London Stock Exchange, NYSE Euronext, BME and Deutsche Borse as leaders by the number and offering value of the new listings, while, on the other side, Central and Eastern European primary markets, with the exception of Poland, are lagging far behind those from the most developed European countries.

## Overview of the IPO Activity in Romania

The Romanian IPO market, as most of the EU NMS markets, is underdeveloped. According to the statistics provided by the Romanian National Securities Commission (NSC), over the period 2002 - 2007, only 80 prospectuses for public offerings of shares were approved by NSC, most of them secondary (62%), which gives support to the idea that going public is not a real option for the Romanian companies in need of financing.

Figure 1 shows the total number of domestic public offerings of shares over the past six years (2002-2007) by pointing out the number of primary offerings and, among these, the number of the initial public offerings initiated with the goal of listing the company on Bucharest Stock Exchange (BSE).



General source: Romanian National Securities Commission Annual Report 2006

Source (2007): List of the prospectuses for shares sale offerings approved by NSC in 2007 (NSC website)

**Figure 1. Number of public offerings of shares in Romania (2002-2007)**

As data from figure 1 clearly shows, only 11 of the primary and secondary offerings approved by NSC since 2002 were initiated to the purpose of admission to trading at the stock exchange, which supports the previous statement about the insignificance of the domestic IPO market. Moreover, when considering only the companies that were actually listed on BSE, following their IPO, the previous number contracts significantly by 33%, since two IPOs closed unsuccessfully and other two postponed this further step.

Table 1 reports the companies that listed on Bucharest Stock Exchange between 2002 and 2007, following an IPO, and the main characteristics of their offers.

**Table 1. Initial Public Offerings\* in Romania (2002-2007)**

Company (trading symbol)	Year of subscription	Total value of offering (RON)	Intermediation		Subscription level
			Method	Costs	
S.N.T.G.N. Transgaz (TGN)	2007	225,963,537.28	Best efforts	2.09%	2,791.88%
Alumil ROM Industry (ALU)	2006	28,750,000	Best efforts	1.65%	1,647.45%
C.N.T.E.E. Transelectrica (TEL)	2006	123,140,421.60	Best efforts	2.25%	646.31%
Flamingo International (FLA)	2005	35,190,000 - 46,920,000	Best efforts	n/a	322.59%
Vrancart Adjud (VNC)	2005	17,475,000	Best efforts	1.31%**	128.96%
SSIF Broker Cluj (BRK)	2004	8,956,902.85	Best efforts	0.6%***	287.24%
Grupul Editorilor si Difuzorilor de Presa (GDP)	2003	1,401,099	Best efforts	2.95%	76.16%

Source: IPO Prospectuses ([www.kmarket.ro](http://www.kmarket.ro))

\* Only the IPOs that closed successfully and were followed by the company listing on Bucharest Stock Exchange

\*\* Total costs including the NSC and BSE fees

\*\*\* Includes only the NSC and BSE fees, since the underwriter was the company itself

The scarcity of IPOs in Romania can be explained by several factors, such as the “historical inheritance” of the privatization process, the competition from other stock exchanges and institutional investors, and the “perpetual” lack of knowledge about financing through primary capital markets.

The mass (or “voucher”) privatization program (MPP), carried out in 1995-1996, was one of the major methods used in Romania in order to increase the speed of privatization. In order to create liquidity for the newly issued vouchers, the MPP was followed by a massive listing on the Bucharest Stock Exchange of most of the privatized companies (6000), which determined an “overcrowd” effect that deterred more companies to access the capital market. This approach was very different from Poland’s privatization program that focused mostly on IPOs and helped to create an IPO culture.

The competition from other equity providers is another factor that can be used to explain the rarity of domestic IPOs. Over the past years, many firms from Central and Eastern Europe, including Russia, were raising funds on other European exchanges, among which London Stock Exchange was the main destination. Nevertheless, with only one local company, A&D Pharma, listing on the Alternative Investment Market (AIM) of LSE, the stock exchange competition doesn’t quite help to understand the current situation in the Romanian IPO market, although it can be considered as a real factor in the near future, since many domestic firms expressed their interest for foreign capital markets. The competition is not limited only to stock exchanges, but to other equity providers as well. The small number of domestic IPOs can be attributable to institutional investors, such as venture capital and private equity funds that developed a strong presence in the financing of firms from emerging countries.

On the cost side, the average IPO intermediation fee is less than 2%, well below the “seven percent solution” first documented by Chen and Ritter in 2000, and is mainly a reflector of the low level of involvement of investment firms, given the prevalence of the fixed-price mechanism and the best efforts method. Even when considering the indirect costs - the NSC fee following the approval of the prospectus (0,1% of the offering value), BSE fee for trading the shares on POF Market section (0,09% of the value of the sales), and BSE fee for the admission and promoting to trading (RON 1200, excluding VAT), the IPO cost is beyond any doubt an incentive for domestic companies to go public.

## IPO Pricing in Romania

The topic of pricing is one of the most studied areas in the IPO literature. A well-accepted result is that, on average, the IPOs are underpriced, which means that the first closing price or the closing price observed a few days after the initial trading is much higher than the IPO price.

The first documentation of the underpricing can be traced back in ’70s in the studies of Stoll and Curley (1970), Reilly (1973), Logue (1973) and Ibbotson (1975), that found a systematic increase from the offer price to the first day closing price (Welch and Ritter, 2002: 10). Since then, this ‘underpricing discount’ has averaged around 19% in the United States, although it fluctuated significantly, averaging 21% in the 1960s, 12% in the 1970s, 16% in the 1980s, 21% in the 1990s, and 40% since 2000 (Ljungqvist, 2004: 1).

The underpricing is not specific only to the US IPOs, but to all countries with primary capital markets, with no exceptions (Welch and Ritter, 2002: 10). A recent survey of European IPO markets shows that the average initial underpricing amounts to 22% over a pan-European sample of 2000 companies between 1995 and 2004 (Gajewski and Gresse: 2006: 2), which is close to the level found for US markets. However, when observed in each of the 15 countries in the sample, the level of underpricing varies notably from one domestic market to another, with the lowest average initial return of 5.36% in France and the highest of 46.68% in Greece (Gajewski and Gresse: 2006: 32).

In Romania, given the small number of IPOs that actually reached the goal of listing on Bucharest Stock Exchange, the data sample is limited to only seven companies which makes very difficult the process of drawing significant information about the pricing of local IPOs. Therefore, no conclusive studies focused on the underpricing of local initial public offerings. However, some descriptive empirical results can be computed and this can be considered as a first step for a further more insightful analysis.

In order to determine the level of underpricing, two measures widely employed in the IPO literature will be used (Gajewski and Gresse: 2006: 27):

- **the raw initial return**, determined as the difference between the post-IPO equilibrium price (EP) and the final offering price (OP), divided by the offering price:

$$U = \frac{EP - OP}{OP} = \frac{EP}{OP} - 1$$

- **the initial return adjusted for a market index return**, determined as the difference between the raw initial return and the market index return:

$$U_m = \frac{EP - OP}{OP} - \frac{I_1 - I_0}{I_0} = \frac{EP}{OP} - \frac{I_1}{I_0},$$

where  $I_1$  is the market index closing price on the first trading day and  $I_0$  is the index closing value the day before.

To address the problem of first day of trading market illiquidity that affects the process of obtaining the equilibrium, I will use as the equilibrium price (EP), the closing price observed in the first day, but also over a five, ten days and one month horizon.

Moreover, Bucharest Stock Exchange Composite Index (BET-C) will be used as the market index proxy.

**Table 1. Initial returns of IPOs in Romania (2002-2007)**

Company symbol	Raw initial returns (%)				Adjusted initial returns (%)			
	1 <sup>st</sup> day	5 days	10 days	1 month	1 <sup>st</sup> day	5 days	10 days	1 month
ALU	95,65	80,43	76,09	73,91	93,93	79,07	72,92	73,21
BRK	158,71	164,52	172,90	205,16	159,05	169,28	171,18	200,72
FLA	5,22	4,35	3,04	7,39	5,72	0,08	-0,93	-0,85
GDP	42,86	233,33	161,90	68,57	41,24	233,63	157,67	58,80
TEL	35,71	58,93	66,67	69,05	35,95	56,66	64,01	64,46
TGN	43,03	42,77	34,59	25,57	40,87	38,38	36,47	26,00
VNC	10,00	3,33	-1,33	-10,67	9,89	-0,62	-4,59	-17,75
<i>Mean</i>	55,88	83,95	73,41	62,71	55,24	82,35	70,96	57,80
<i>Standard deviation</i>	54,11	85,61	70,51	71,08	54,10	88,22	70,33	71,73

The table reports a substantial underpricing of Romanian IPOs, irrespective of the used measure - raw or adjusted initial return. The mean return on the first day of trading for the companies composing the sample is about 54%, which is a very large value when considering other empirical evidence about IPO initial performance in Europe. Only few studies documented similar values, such as Goergen et al. (2003) that found a 1<sup>st</sup> day initial return of 86.07% for Dutch companies that went public between 1996 and 2000 (also using a small sample of only 11 companies), Levis (2004) – 60,1% for 240 UK IPOs or Gajewski and Gresse (2006) – 46,68% for 183 Greek firms that listed following an IPO between 1995 and 2004.

These abnormal raw and adjusted returns do not disappear in the short run. In fact, they grow significantly in the first trading week and stay at high levels until the end of the first month of listing in more than half of the cases. At the same time, standard deviations are almost equal to the mean values, proving the heterogeneity of the IPO initial returns.

The most important negative effect of the IPO underpricing consists of “money left on the table by issuers”, defined as the number of shares offered multiplied by the raw initial return (Ritter: 2006: 1).

On the positive side, the huge initial returns of the domestic IPOs, together with the oversubscription level (842,94% in average and increasing over the years) are an indicator of the financing potential of the Romanian capital market. Nevertheless, this is not an argument that going public is a sure thing in Romania. It depends also a lot on company financial data and perspectives, as suggested by the IPOs that closed unsuccessfully over the analyzed period.

## Conclusion

Based on data from companies that listed on Bucharest Stock Exchange following an initial public offering, the paper analyses briefly various features of the Romanian IPO Market.

First, with only seven companies that issued new shares between 2002 and 2007, IPOs play an insignificant role in the financing of domestic companies.

Second, the costs of going public are very low, mainly because of the use of fixed-price mechanism and best efforts method by the underwriters (SSIFs), and also because of the efforts of financial markets institutions to reduce the indirect costs.

Third, the Romanian IPOs are highly underpriced and oversubscribed, which strongly suggest the increasing interest of the investors and the potential of the local primary capital market of financing the domestic companies.

As Romania's economy will continue to grow and the activity of the Bucharest Stock Exchange will increase, there is a positive expectation that more and more companies will see the advantages of raising additional financing through an IPO and will access the primary markets.

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