

**CHALLENGES OF INITIAL PUBLIC OFFERINGS: A CASE STUDY OF THE  
NAIROBI SECURITIES EXCHANGE**

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**ABSTRACT**

As an instrument of privatization, NSE has provided an avenue of liberalization of sectors previously dominated by the government and facilitated by public divestiture of its shares in public enterprises. According to the World Bank Capital Market Integration, in 2003-2005, the NSE experienced robust activity and high returns on investment. The NSE accounts for 90% of market activity in the East African Region and is a reference point in terms of setting standards for the other markets in the region. As an emerging capital market, the NSE has faced challenges in its development and growth such as economic depression and political uncertainty among others. The study set out to determine the challenges of Initial Public Offerings (IPO). The study was guided by the pecking order theory, trade-off theory, expected utility theory, signaling theory and the efficient market hypothesis. The research used a case study approach of 28 companies listed on the NSE for the period 2004-2008. Data was collected through questionnaires and interviews with the Chief Finance Officers (CFOs) from the 28 companies. Both quantitative and qualitative data was used. CFOs exhibited mixed responses to some of the factors, the study findings indicated that: Issues and motivations that influence the decision to undertake an IPO; Company/ industry characteristics that influence the decision to undertake an IPO and how a company can enhance success of the IPO were either very important or important. The factors are therefore significant in the going public decision. The study recommends that companies should list their shares in the NSE to raise capital as opposed to using debt. In addition, the study recommends that before making/ considering the decision to undertake an IPO, the company should understand its internal and industry characteristics that are likely to affect the IPO. Observing and analyzing performance indicators of previous IPO issues is crucial to a company's decision to go public.

**Key words: Equity, debt, capital markets and privatization**

**Introduction**

The Initial Public Offering (IPO) literature has documented dramatic fluctuations in IPO activity over time (Lowery and Schwert, 2002). A common explanation for the fluctuations is that firms time their offerings to take advantage of high market valuations, whether such valuations are rational or otherwise. Filing for an IPO and engaging an underwriter creates this call option, while selling shares if price discovery yields a high offer price amounts to exercising the option (Busaba, 2006).

The IPO accords the general public to have ownership rights over listed enterprises thus helping to reduce large income inequalities through the sharing of profits made by these enterprises, thereby facilitating the redistribution of wealth. NSE facilitates improved corporate governance. Wagacha (2001) proposes that public companies tend to have better management records than private companies because of the improvement of management standards and efficiency to meet the demands of shareholders and the NSE under its corporate governance rules.

Busaba, Benveniste and Guo (2001) consider reasons why firms withdraw their IPO offerings and find that leverage is a major factor. Their findings suggest that firms often use leverage rather than equity because of the valuation of their equity, and would withdraw an offering if the price appears to be too low. A more recent theory developed by Ellul and Pagano (2006) posits that post – IPO spreads and asymmetric information measures increase with under pricing because under pricing is a compensation for illiquidity costs expected in the after – market.

The number of firms in Kenya seeking to use IPOs to raise capital has been on an increasing trend. Between 1980 and 1999 only twelve firms were listed in Nairobi Securities Exchange four of which were part of the government privatization process of the parastatals (Ngugi and Njiru, 2005). Between 2000 and 2011, 10 firms raised capital through initial listing in Nairobi Securities Exchange. This shows an increase in the usage of IPOs as source of raising capital in Kenya.

Going public allows the firm access to the public capital markets for the first time in its life, and hence may have important implications for a firm's product market and

performance as well. However, while the going public decision has generated considerable theoretical research in recent years (for example Chemmanur and Fulghieri 1999; Maksimovic and Pichler, 2001), empirically it is one of the least studied issues in corporate finance.

### **Statement of the Problem**

Financial equity markets play an important role in the global economy. They present the public with an opportunity to be 'part owners' in major companies, as well as serve as a platform for flow of funds in the market from investors who have excess funds to the companies seeking for funds by offering the company shares. In the world over, investors have traded in the stock markets and for over 100 years and market investments trends are changing over time. Kenyan investors are still hooked on to the notion that the IPO issues are one of the best ways to invest (Loita, 2010).

Since the KenGen IPO offer in 2003, the Kenyan equity market at large has experienced a phenomenal increase in subscriptions in IPO issues. The KenGen IPO performed well in terms of returns to investors, maybe even better-than-expected by the general Kenyan public and consequently investors since then have exhibited a keen interest into the equity market investments. Despite the subsequent not-so-good performing IPOs such as Safaricom, Eveready and Mumias, eminent risk of incurring losses is real but the average. During the past years the global equity markets have been characterized by increased interest into IPO issues, with investors in the Kenyan market experiencing over-subscriptions when it comes to IPO applications. From an investors' point of view, the IPO issues are an opportunity to maximize gains and profits as they penetrate into the equity investments. In reality however, the equity market is characterized by uncertainty and unpredictability, as market conditions cannot always be judged with the help of standard financial measures and tools. Market participants have for a long time relied on the notion of efficient market and rational investor behavior when making financial decisions. However, the idea of fully rational investors who always maximize their utility and demonstrated perfect self-control is becoming inadequate (French, 2008).

For a market to be efficient, investors need sufficient information in selecting their investment portfolios. However, a number of stockbrokerage firms have been rendered inadequate by the Capital Market Authority (CMA), while some such as Nyaga Stock Brokers and Discount Securities Limited have even been closed shop, yet these are the same kinds of firms that investors rely on to give expert advice on investment decisions. The recent IPO share issues in Kenya exemplify a situation which includes both unpredictability and irrational behavior. On average, the volume of shares traded under normal circumstances is Sh350 million, while during days of IPO issues and up to 2 months after the issues, the volume of shares traded stands at an average of 750 million indicating cases of over-confidence of investors during IPO share issues and cases of under-confidence in daily business non-IPO shares trading. The Kenyan investor confidence levels are to some extent shaped by their degree of fear of making losses from their investments and greed derived from miscalculated speculation to make quick money in the short term (IFC / CBK, 2009).

Given that the risks of going public are faced by each of the three major parties involved: issuer, investment banker, and investors. This research sought to investigate the decision to go public by companies and in turn provide knowledge to investors on the implication in their investment decision.

### **General objective**

This study sets out to focus on the determinants that companies consider in their decision to undertake an IPO.

### **Specific objectives**

Specifically, the research examined the following:

- i. IPO process issues and motivations
- ii. Company/ industry characteristics and how they influence the decision to undertake an IPO
- iii. How to enhance performance of the IPO

**Value of the Study**

The research contributes to the broadening literature on privatization as well as research into the factors influencing the success of Initial public offerings. The financing options available to Kenya's sector through the capital markets can enable the sector to position itself to exploit emerging opportunities - an example is the provision of value addition, outsourcing services. It is therefore important to understand our market, in order to make informed decisions as regards undertaking of IPO's.

The motivations of going public are also likely to differ across countries because of institutional differences and the developments of the capital markets documented in several studies such as Ritter (2002) and Jenkinson and Ljungvist (2001).

Arguably the most significant event in the life of a corporation is its transition from a private company to a public company through the initial public offering (IPO) process. The IPO provides a major source of capital to the corporation and allows the existing owners to have a liquid market for their shares. Firms rely on the IPO for either their survival or their ability to take advantage of growth opportunities. Several recent studies have examined the determinants of going public decision in different countries using surveys or empirical studies (Burton, 2006). Theories on information asymmetry and efficient market hypothesis go ahead to reveal more information on the going public decisions.

Chief Finance Officers (CFOs) of companies considering going public may assume that raising more money in an IPO helps the stock price. While it seems logical that a company able to find substantial support among investors would enjoy superior long-term stock performance, this may not always be the case. This is because a newly public company with significant IPO cash coming in and a large base of optimistic investors is likely to be overvalued and may suffer poor long-term performance. Firms use IPO proceeds for a variety of reasons, including repaying debt, compensating managers, or undertaking research and development. Investors react favorably to news of such capital expenditures; investors probably think that raising a lot of money in an IPO is good, as

long as the proceeds go toward capital projects. This study therefore allows insight into what investors can look at before and after undertaking an IPO.

### **Theoretical Review**

Maksimovic and Pichler (2001) developed models of the going public decisions of firms driven by product market competition between innovative private firms in an industry. In their setting, raising capital in the equity market by going public allows a firm which is an industry leader to raise external capital, thus allowing it to implement its project at its optimal scale.

### **Pecking Order Theory**

The pecking order theory of capital structure choice gives an additional insight into why higher profits should be followed by lower share issuance activity. It implies that equity finance through the stock market (external finance in general) is less desirable than internal finance. According to Graham and Harvey (2001), this is due to the fact that external funds are undervalued because of and in relation to the degree of information asymmetries between management and investors. This theory therefore advances that, equity finance via the stock market might provide a negative signal. In contrast however, Pastor and Veronesi (2003) report that IPO waves are followed by high aggregate profitability in the USA.

### **Trade-Off Theory of Capital Structure**

The theory advances that a company chooses how much debt finance and how much equity finance to use by balancing the costs and benefits. The classical version of the hypothesis considers a balance between the dead-weight costs of bankruptcy and the tax saving benefits of debt. Often agency costs are also included in the balance. An important purpose of the theory is to explain the fact that corporations usually are financed partly with debt and partly with equity Frank and Goyal (2005).

### **Signaling theory**

This theory is based on the need to resolve information asymmetry in decision-making. Therefore, managers need to rely on other items (termed signals) to indicate that the

individual has the potential to be a productive member of the organization. The organization will therefore give out partial bits of information that are meant to indicate to outsiders that relevant and important resources and capabilities are present or obtainable (Zimmerman, Zeitz, & Coombs, 2004). As Clark, Cornwell, and Pruitt (2002) argued, "signaling theory revolves around the judicious use of signals that are consistent with the attainment or possession of a particular and valued attribute that, in the absence of the signal, would be very difficult to unambiguously convey".

### **Efficient Market Hypothesis (EMH)**

Was developed by Professor Eugene Fama. Information Asymmetry is usually assumed in most explanations of the under pricing of initial public offerings (IPO's). In Baron's (1982) model, the underwriter is better informed than the issuing firm concerning the demand for the IPO. The greater uncertainty associated with the demand would lead to a greater under pricing due to the enhanced value of the underwriter's expertise. In the case that the issuer is also an informed investment banker, Baron's hypothesis predicts no under pricing.

### **Factors that influence the IPO Decision**

#### **IPO Process Issues and Motivations for undertaking an IPO**

Brau, Francis, and Kohers (2003) compare firms that choose to conduct an IPO versus private firms that choose to be acquired by a public firm. Academic theory suggests four motivations for going public. First, firms conduct a public offering when external equity would minimize their cost of capital in an attempt to maximize the value of the company. Second, Mello and Parsons (2000) argue that an IPO allows insiders to cash out.

#### **IPO Timing**

Lowery and Schwert (2002) argue that recent first-day stock performance of firms going public leads other firms to decide to go public. Valuations of firms going public fluctuate due to three market components: expected profitability, required return, and uncertainty. Private firms seeking to go public realize this and delay their IPOs until market conditions are favorable.

### **Underwriter Selection**

Sherman and Titman (2002) show that when information is costly, underwriter ability to reduce underpricing could be substantially limited. In this scenario, the possibility of discriminating in favor of a particular group of investors allows underwriters to achieve lower under-pricing by lowering the expected returns of uninformed investors (Sherman, 1992). Agency based explanations, however, need to provide a rationale for issuing firms to participate in IPOs that are under priced more than necessary. Lughran and Ritter, (2004) provide one such explanation; they argue that part of the higher underpricing in IPOs, reflects changes in the objective function of issuers. That in many of the highly underpriced IPOs the issuing firm's focus was more on generating influential analyst coverage than on maximizing on IPO proceeds.

### **Underpricing in IPOs**

Numerous explanations for under pricing have been advanced. Habib and Ljungqvist (2001) argue that under pricing allows for cost savings in other areas of marketing the issue. Demers and Lewellen (2003) assert that under pricing brings attention to the stock on the opening day. Boehmer and Fisher (2001) demonstrate that under pricing increases the after- issue trading volume of the stock. Maynard (2002) and Griffith (2004) suggest that under pricing permits spinning—the enriching of executives of prospective investment bank clients. Aggarwal (2003), Fische (2002). The final explanation is a somewhat unique stand taken by Ritter and Welch (2002), who advance a behavior theory that suggests issuers are pleasantly surprised with the amount they can raise in the IPO (i.e., their new-found personal wealth).

### **Signaling in IPOs**

Due to asymmetric information between IPO insiders and potential investors, signaling theory continues to be an important component of IPO research. Signaling in initial public offerings is based on an equilibrium which separates high from low quality companies. When information asymmetries exist, however, the market price of the offering may reflect the value of an average quality firm because investors may not be able to differentiate between a low quality and a high quality firm. Thus, a high quality

firm would not receive proceeds that reflect its true worth. It is assumed that investors know that only the best firms can recoup the upfront cost of the underpricing signal from subsequent issues.

### **Company/ Industry Characteristics and IPO issuance**

The connection between IPO issuance is based on the premise that firms seek to minimize the cost of capital. Therefore, many IPOs are launched when share prices are high, when the costs of going public are low, firms can then maximize proceeds from issuing equity. This argument according to Lowery (2002) is based on the presumption that investors are usually overly optimistic and willing to pay more for firms than they are worth and that firms are able to time their share issues accordingly.

The initial public offering (IPO) of a firm's stock is a point of transition from the private to the public domain (Certo, 2003). Although firms preparing for an IPO often attract investors' attention, the attention often does not result in investment because IPO firms have little or no operating history, lack a publicly available record for their stock price, and are riskier than larger, more established firms (Beatty & Zajac, 1994). They face a liability of market newness (Certo, 2003).

### **Research Methodology**

In this research, a case study refers to research that focuses on issues of Initial Public Offerings with a comparison between decisions of companies listed on the Nairobi Stock Exchange. Case studies are of particular value when one is seeking help on a problem in which inter-relationships of a number of factors are involved, and in which it is difficult to understand the individual factors without considering their relationships with each other (Cooper and Schindler, 2000).

The focus in this study was the Nairobi Stock Exchange. The use of a case study allowed the researcher to effectively analyze several factors and how these factors relate to each other. A case study approach allowed the researcher to collect in-depth data on the population being studied and allow the researcher to be more focused and hence give recommendations that are specific and relevant to the research.

Population of the study consisted of the Chief Finance Officers (CFOs) of companies listed at the stock exchange with Head Offices in Nairobi. The CFOs were selected randomly from each sector of the Main Investment Market Segment of the Nairobi stock exchange: Agricultural, Commercial and Services, Finance and Investment, Industrial and Allied

The Sample frame was drawn from listed companies on the Nairobi Stock Exchange with offices in Nairobi consisting of all Chief Finance Officers. The structured sampling technique was used. This method calls for a division of the total population into appropriate strata that are mutually exclusive. Structured sampling technique gives the researcher advantages such as: increase in samples' statistical efficiency; provides adequate data for analyzing the various sub-populations and enables different research methods and procedures to be used in different strata (Cooper and Schindler, 2000).

A sample size of 28 respondents was selected within a total population of 45 listed companies. The respondents according to the sectors were as follows:

- 3 companies from Agricultural sector
- 6 companies from Commercial and Services sector
- 9 companies from the Finance and Investment sector
- 10 companies from the Industrial and Allied sector

Methods of data collection involved both primary and secondary data. Primary data was derived from questionnaires distributed to the CFOs. The questionnaires had closed ended questions and covered challenges faced by companies in the attempt to offer their shares to the public. Follow ups were done through the research assistant who assisted in the administering of the questionnaires. Secondary data was gathered from library materials, journals media publications and various internet search engines covering topics on Initial Public Offerings.

Data analysis included both qualitative and quantitative techniques. The qualitative data was summarized and categorized according to the common themes and represented using frequency distribution tables and graphs. The data was analyzed using the Statistical

Package for Social Scientists (SPSS) and the analysis was used to assist the researcher in answering the research questions. Descriptive statistics were used to analyze and present the data.

### Summary of Findings

#### Issues and motivations that influence the decision to undertake an IPO

**Table 1: Importance of various motivations for conducting the IPO**

	N	Min.	Max.	Mean	Std. Deviation
Motivation min cost of capital in IPO	28	1	1	1.00	.000
Motivation Company run out of private equity Vs IPO	28	1	3	1.18	.476
Motivation debt expensive Vs IPO	28	1	1	1.00	.000
Motivation to create shares for future acquisitions through IPO	28	1	2	1.04	.189
Motivation for principals to diversify holding through IPO	28	1	2	1.11	.315
Motivation to allow VCs to cash out through IPO	28	1	3	1.29	.535
Motivation to increase company reputation through IPO	28	1	3	1.32	.612
Motivation to establish company value/ price through IPO	28	1	3	1.11	.416
Motivation to broaden ownership base through IPO	28	1	2	1.04	.189
Motivation to attract analysts attention through IPO	28	1	3	1.82	.772
Valid N (listwise)	28				

**Table 2: Extent that various factors influence the timing of the possible IPO**

	N	Min.	Max.	Mean	Std. Deviation
Influence of stock market conditions on IPO timing	28	1	1	1.00	.000
Influence of first day stock performance on timing of IPO	28	1	1	1.00	.000
Influence of industry conditions on timing of IPO	28	1	1	1.00	.000
Influence of other firms going public on timing of IPO	28	1	3	1.43	.573
Influence of need for capital to grow on timing of IPO	28	1	2	1.04	.189
Valid N (listwise)	28				

**Table 3: Importance of various criteria in selecting the lead IPO underwriter**

	N	Min.	Max.	Mean	Std. Deviation
Underwriter overall reputation and status	28	1	2	1.04	.189
Underwriter quality & reputation of research department	28	1	3	1.50	.793
Underwriter non-equity related advise	28	1	2	1.29	.460
Underwriter fee structure	28	1	3	1.39	.786
Underwriter pricing and valuation promises	28	1	2	1.04	.189
Underwriters industry expertise and connections	28	1	1	1.00	.000
Underwriter market making, trading desk and liquidity provision services	28	1	1	1.00	.000
Underwriter institutional investor client base	28	1	1	1.00	.000
Underwriter retail client base	28	1	2	1.07	.262
Underwriter reputation on spinning	28	1	3	2.18	.548
Valid N (listwise)	28				

**Table 4: Extent that various factors led to the level of under pricing**

	N	Min.	Max.	Mean	Std. Deviation
Underpricing as a reason to mitigate future litigation by investors	28	1	3	2.21	.787
Underpricing as reason to compensate investors for taking risk in IPO	28	1	3	1.46	.637
Underpricing to ensure wide-base of owners	28	1	1	1.00	.000
Underpricing to compensate investors for truthfully revealing price they can pay	28	1	3	2.14	.651
Underpricing because IPOs creates wealth for insiders	28	1	3	1.36	.621
Underpricing so as to increase stock price through a cascade effect	28	1	3	1.79	.738
Underpricing to increase publicity on opening day	28	1	2	1.07	.262
Valid N (listwise)	28				

**Table 5: Importance that various signals convey to investors regarding the value of going public**

	N	Min.	Max.	Mean	Std. Deviation
Selling insider shares as a signal regarding value of going public	28	1	3	1.07	.378
Selling large part of firm in IPO as signal on value of going public	28	1	3	1.07	.378
Large first day price jump as signal of value of going public	28	1	3	1.07	.378

Using top investment banker as signal of value of going public	28	1	2	1.18	.390
Using a big-four accounting firm as a signal of value of going public	28	1	3	1.50	.745
Having strong historical earnings as a signal for value of going public	28	1	1	1.00	.000
Valid N (listwise)	28				

Table 1 – 5 all give an analysis of research question 1 (one): Issues and motivations that influence the decision to undertake an IPO. Most CFOs indicated that most of the issues and motivations were either important or very important in the decision to undertake an IPO. This is reflected by mean values ranging from 1 to 2.5.; the standard deviations on the other hand indicate that most variables measured are statistically significant despite there being a measure of mixed responses to the factors.

### Company/ industry characteristics that influence the decision to undertake an IPO

	N	Min.	Max.	Mean	Std. Deviation
Concerns over SEC reporting requirements in IPO decision	28	1	2	1.29	.460
Concerns over costs/ fees of an IPO in IPO decision	28	1	1	1.00	.000
Concerns on maintaining decision making control in IPO decision	28	1	1	1.00	.000
Concern over already existing capital in IPO decision	28	1	3	1.07	.378
Concern over low price of firm stock in IPO decision	28	1	1	1.00	.000
Concern over dilution of EPS in IPO decision	28	1	2	1.04	.189
Concern over ownership dilution in IPO decision	28	1	2	1.04	.189
Concern on preference of acquisition to IPO decision	28	1	3	1.14	.448
Concern over bad market/ industry conditions in IPO decision	28	1	1	1.00	.000
Concern on officer liability in IPO decision	28	1	3	1.93	.604
Concern over information disclosure to competitors during IPO decision	28	1	1	1.00	.000
Valid N (listwise)	28				

The analysis reveals that company/ industry characteristics do influence the decision to undertake an IPO. The mean lies within 1 to 1.5 (very important), with the standard deviations being statistically significant and below 0.5. This is with the exception of; Concern on officer liability in IPO decision making that registered a mean of 1.93 (important) and a high standard deviation of 0.604.

### How a company can enhance success of the IPO

	N	Min.	Max.	Mean	Std. Deviation
Extent to which overall business potential ensures successful IPO	28	1	1	1.00	.000
Extent to which quality of TMT ensures successful IPO	28	1	2	1.04	.189
Extent to which superior market knowledge ensures successful IPO	28	1	1	1.00	.000
Extent to which entrepreneurial information advantages ensures successful IPO	28	1	1	1.00	.000
Extent to which level of industry competition influences success of an IPO	28	1	2	1.04	.189
Extent to which market disequilibrium influences success of an IPO	28	1	1	1.00	.000
Extent to which underexploited market opportunity influences success of an IPO	28	1	1	1.00	.000
Extent to which contractual alliances influences success of an IPO	28	1	1	1.00	.000
Valid N (listwise)	28				

All the factors identified as affecting the success of an IPO are statistically significant with a standard deviation ranging between 0 (zero) and 0.189. The means confirm this with the most data lying between 1.00 and 1.04.

### Conclusions

Despite the mixed responses to some of the factors, the study findings indicated that: Issues and motivations that influence the decision to undertake an IPO; Company/ industry characteristics that influence the decision to undertake an IPO and how a company can enhance success of the IPO were either very important or important.

### Recommendations

The study recommends that companies should list their shares in the NSE to raise capital instead of using debt. In addition, the study recommends that before making/ considering the decision to undertake an IPO, the company should understand its internal characteristics as well as industry factors that are likely to affect the IPO. Further to this, to enhance success of an IPO, factors such as; company's top management team, overall

business potential, possession of superior knowledge and contractual alliances, are key to success of the IPO.

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