

# RSM Insight

Management Knowledge

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ROTTERDAM SCHOOL OF MANAGEMENT, ERASMUS UNIVERSITY

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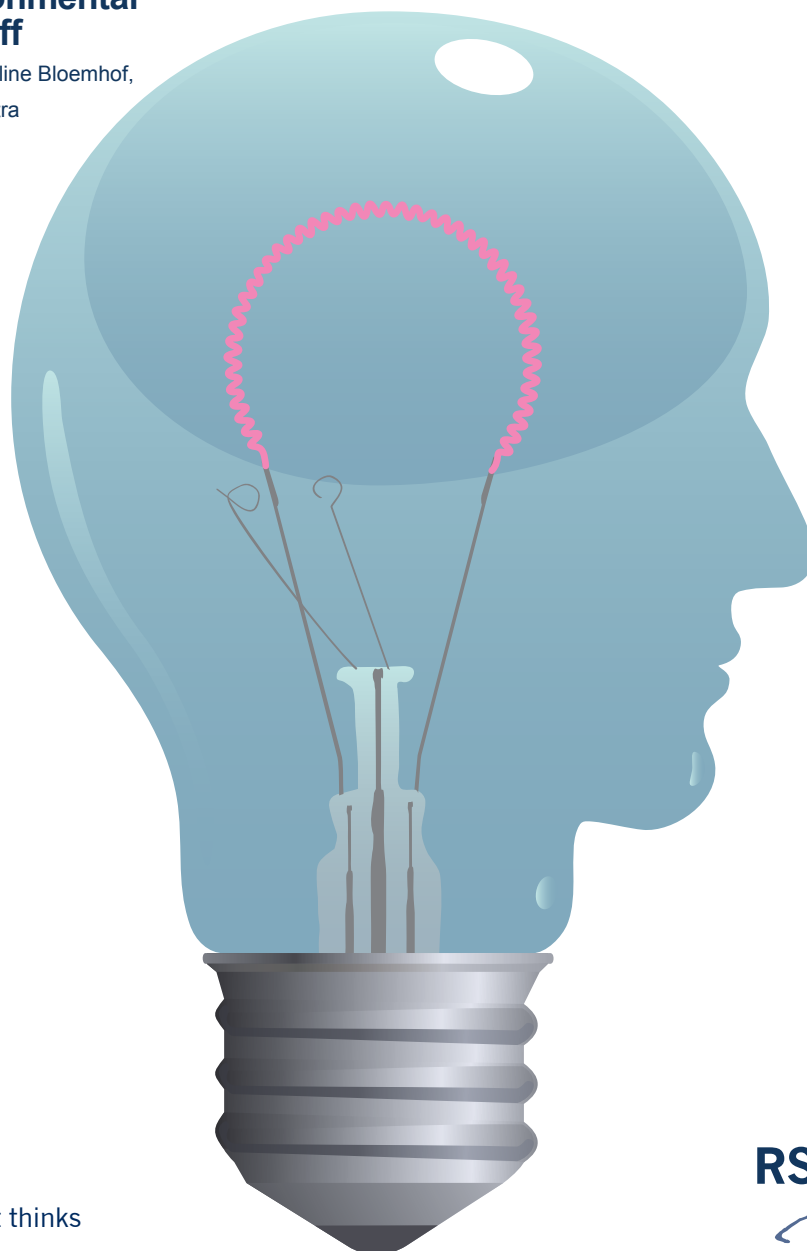
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The business school that thinks and lives in the future

# Why do firms go public?

by Abe de Jong, Carel Huijgen, Teye Marra & Peter Roosenboom

**Ambitious chief executives considering the possibility of floating their company on a major stock exchange should be careful what they wish for. They need to be sure that they are making the decision for the right reasons, at the right time, and that the initial public offering (IPO) is made in the right location.**

The reasons most often provided for going public will be familiar to most people with even a passing awareness of modern business. One, the most important benefit, is the access to public capital markets to raise finance to invest and drive further growth. Two, it offers a simple exit route to existing shareholders who want to monetise their investment. Three, the diversification of the shareholder base can enable the newly listed company to take a higher level of risk in its core activities, further driving growth. Four, it can help a company improve its name recognition and visibility. Five, a company that is listed can use its shares to pay for acquisitions; in effect, it creates a company's very own acquisition currency.

The downside is arguably less familiar, as it is brushed under the carpet in the heady excitement of the listing process. Nevertheless, the various trade-offs inherent in a public listing need to be fully taken

into account before the green light is finally given.

One, the newly listed company will need to comply with the rules and regulations issued by the stock exchange, or stock exchanges, on which it has chosen to list.

Two, it will need to become more transparent than in its private incarnation, and publish more information on its finances, strategies, tactics and plans for innovation, to satisfy the insatiable curiosity of stock exchanges, investors and the national and international media. Annual reports, press conferences and analyst visits are just some of the obligations imposed upon listed companies.

Three, the listing process is complex, and expensive. The investment banks, law firms, accountants and public relations firms that will need to be hired to ensure a successful IPO do not come cheap. These expenses typically consume seven to 10 per cent of a new issue's headline proceeds.

Four, an often overlooked consequence is that the inevitable loss of confidentiality enforced by the disclosure requirements of a public listing results in previously private information becoming available to existing or potential competitors.

Companies that make the private to public transition successfully, though, can transform their prospects, strengthen their market position by aggressively driving up market share and raising the barriers of entry to dissuade would-be competitors from entering the fray.

In the writing of our paper - *Why do firms go public? The role of the product market* - we put under the microscope the underlying reasons behind the decision to go public, one of the most important decisions a company might ever take.

The paper investigates the effect of product market characteristics on the decision to go public. Our results show that UK firms are more likely to go public when they operate in a more profitable industry and in an industry with lower barriers to entry. These firms are more likely to go public in order to improve their position in the product market and to deter new entrants into the industry. However, firms from more competitive industries and firms with smaller market share are less likely to go public. For these firms the loss



of confidential information to rivals outweighs the benefits of going public.

The decision to go public itself signals higher product quality to competitors. The decision to go public therefore depends on product market characteristics, and the position of the firm within the product market.

We further examine the product market related effects of going public in the years directly following the IPO. Firms that go public increase their market share and operational risk in the post-IPO period to the year before the IPO.

We also find that firms increase their scale of operations in the post-IPO years. IPO-firms significantly increase their capital expenditures, fixed assets, total assets, sales and profitability in comparison to the year before the IPO.

Overall, our results suggest that firms go public at a peak in their sales growth and continue to expand their

scale of operations directly following the IPO. After the IPO, firms show higher volatility in profitability, which is consistent with firms being able to pursue more aggressive product market strategies.

The increase in market share by the median IPO firm in the two years after the flotation suggests that the effect of having access to lower-cost equity financing for increasing the scale of operations at least initially dominates the effect of having to disclose sensitive information to product market competitors.

Going public involves a trade-off between competitive benefits and costs. Our results show that both confidential information theories and more recent theories that focus on product market benefits of obtaining a public listing are relevant for explaining the complex decision to go public. ■

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