

dr Piotr Zasępa

Akademia im. Jana Długosza w Częstochowie

IPOs trends and their impact on the level of venture capital divestments

Trendy IPO oraz ich wpływ na poziomie dezinwestycji funduszy *venture capital*

Abstract: This paper examines the nature of venture capital activity on IPO markets. It determines that between the main IPO markets we see differences in IPO trends and venture capital activity. The period between 2000-2012 shows how divestments of venture capital change accordingly to capital market behaviour. Changing shares of venture capital stakes in IPO transactions are quite important for their functioning. This paper shows the changes in the field of IPO transactions conducted on the US, UE and Polish markets.

Keywords: IPO, Venture capital

Streszczenie: Załamanie rynków finansowych i niskie wyceny spółek na rynkach giełdowych spowodowały spadek liczby transakcji pierwotnych ofert publicznych (IPO) zarówno w USA jak i rynkach europejskich. Jednym z głównych beneficjentów rozwoju transakcji IPO na giełdach papierów wartościowych są fundusze *venture capital*. Ich udział w realizacji tych transakcji jest dość znaczący i ma duży wpływ na poziom inwestycji funduszy w przyszłości. Ponadto spółki zasilane funduszami *venture capital* stanowią bardzo atrakcyjny cel inwestycyjny, który pozwala osiągnąć ponadprzeciętne stopy zwrotu po transakcji IPO ze względu na niedoszacowanie ich wartości w procesie dezinwestycji. Celem artykułu jest analiza wpływu zmieniających się trendów transakcji IPO na rynek dezinwestycji i inwestycji funduszy *venture capital* w USA, UE oraz w Polsce w latach 2000-2012.

Słowa kluczowe: IPO, Venture capital

Introduction

The initial public offering (IPO) is the introduction of the first values of the company on the stock exchange, which results in changes to the ownership structure. The transaction is extremely important in the development of enterprises and the evolution and development of the capital market. It offers an opportunity for entrepreneurs to raise capital for development, objective valuation and strengthening the company's image. Trends in various local capital markets for IPOs have their important points. The years 2000-2007 in the financial markets meant slowly rebuilding the position of IPO on the stock exchanges after the collapse of trading stock in dices associated with the so-called internet bubble. The first months of the crisis of the financial markets in 2008-2010 rebounded significantly in the valuation of companies listed on stock exchanges, which resulted in virtually no IPOs on major stock markets of the world. In parallel with the worsening economic situation and capacity to carry out IPOs, venture capital funds reduced their exit from the

investment to a minimum. They were forced to do very low liquidity on the stock markets which created an insufficient development of their portfolio companies. Analysis of the IPO market for funds is reflected in the level of divestment transactions of the IPO. Trends that can be observed in IPO transactions are closely linked to the ability of national economies and the levels of quotation indices and valuation of companies listed on stock exchanges. The goal of the article is to present the influence of the IPO markets on venture capital divestment in the period 2000-2012 in the USA, UE and Polish market.

Trends on the IPO global markets 2000-2012

Global equity markets can now be divided into two major poles between which there is a strong competition for capital investors. The first group consists of highly developed countries with stable market economies (the USA, Japan, UK, Germany), the second group is called emerging markets which include China, India, Brazil, Russia and the countries of Central and Eastern Europe. Most of the indices over the long term are strongly correlated with each other. The value of global IPOs in the world very well reflects trends in the stock market. It should also specify the different phases of the cycle on the stock exchange and the associated underpricing or overpricing of public offerings, which is associated with the achieved rate of return on investment.

Table 1. Value and number of global IPO 2000-2012 in bln USD

Year	Value	Number
2000	210	1883
2001	94	832
2002	66	839
2003	50	864
2004	124	1516
2005	167	1537
2006	246	1729
2007	287	1979
2008	95	762
2009	112,4	577
2010	284,6	1393
2011	169,9	1225
2012	145	904

Source: Own calculation based on E&Y Global IPO Trends 2006-2012

Analyzing further data on the number and value of IPOs, it can be concluded that in the period of 2000-2012 there had been a change in the geographical activity.

Asian countries using their dynamic development focused on most global IPOs values and numbers. A major role in shaping this trend was the privatization process carried out by developing countries. In 2006, the value of public offers of privatization amounted to 105 billion dollars. These amounts related to 248 privatizations carried out in 48 developing economies such as China, India, Turkey, Egypt, Poland and Brazil¹. Of course, in the coming years the privatization trend with low quotations indices weakened, but still in 2008, 38 countries carried out 196 transactions amounting to \$ 38 billion. Compared to 2007, this was a 20 per cent drop in the number of transactions and as many as 19 countries had withdrawn their privatization plans. IPO transactions in 2007 accounted for 75% of all privatization transactions, while in 2008 only 40%. Countries that generated over 80% of all privatization transactions were China, Russia and Turkey². The years 2009 and 2010 were record-breaking in terms of government revenues from privatization, but the share of IPOs was low and stood at about 30%³. The most important trend changes in the character of the IPO was that in 2000, the capital was the main recipient of the EU and the U.S. markets. In 2011 and 2012, the main recipient of the IPO capital was the Asian market. It made the PRC market share of 42% in the values of IPOs and 31.7% of the total transaction. The second market in 2011 was the U.S. with 21.2% share. In 2012, the Asian region recorded a 76% share in the IPO, the U.S. 15% and the EU only 5%. There had been a significant change and shift the weight of individual regions in the period 2000-2012 in terms of value of IPOs. At the beginning of the decade the U.S. and Europe generated more than 75% of all IPOs, while in 2012 it was only 20%. Their place was taken by Asian countries, which together with South America covered 80% of the global flow of capital relating to the public offering. It should also be noted that in these regions IPOs continued to grow faster than their number. Unfortunately, this trend was reflected in the financial situation of the VC funds that lost a quick and reliable source of funds which is the capital market.

The share of venture capital and private equity transactions in IPOs in the U.S. and the EU markets

Fundraising, the development of a portfolio company and divestment of a standard investment process of venture capital funds. A very big beneficiary of the development of the capital markets are small and medium-sized enterprises which are supported by the equity of venture capital and private equity funds. It can be observed that a strong correlation between IPO and venture capital investments has an impact on the condition of the funds and the level of their rate of returns. The divestment process is very important for them because of the opportunity to sell their shares of equity. This is a necessary process to obtain liquidity to reinvest funds, giving the opportunity to achieve an above-average return when convenient until the sale of the shares. The achieved rate of return allows them to increase investor interest in this segment of the financial market and determine the possibility of its further development. Unfortunately, not only the intrinsic value of the

¹ S. Kikieri, Privatization trends, World Bank, January 2008.

² S. Kikieri, Privatization trends, World Bank, May 2010.

³ W. Meggison, Privatization trends and major deals 2010, The 2010 PB Report, p. 15.

company has an impact on the success of the IPO. This is influenced by the size of the company, liquidity and the condition of the capital market. The fund performance is also affected by the behaviour of the trading stock indices related to the valuation of listed companies, which may affect the overpricing or underpricing of the value of the IPO. It should be also noted that the valuation of the companies in the IPO process affects the issuer's position. If the tenderer is a VC or PE fund, the market underprices the value of the issue in relation to similar companies supplied by VC. In addition, the level of measurement affects the experience and reputation of the VC fund assessed by investors⁴. The rating fund and properly conducted IPOs may also affect the long operating history of the fund, its international experience, the level of interest it has, and marketing. The moment of divestment is therefore very important in shaping the VC fund returns. The role of venture capital funds in the development of IPOs in the capital markets has been considered by many researchers. Most of the works have involved under-valuation of the companies offered by the Funds.

The first of the works, however, pointed to an overstatement of the company (was presented in 1991 by W. Megginson and K. Weiss⁵) associated with the so-called certification of the fund, being explained better with reputation and experience. Subsequent studies have pointed to an understatement of funding bids. The first such study presented in 2004 by P. Lee and S. Wahl was examining the period 1980-2000⁶. Further studies indicate that other factors than overpricing and underpricing determine the impact of a VC fund to further development process of companies. Differences in overpricing and underpricing of VC and power companies without external capital disappear in the years after the IPO⁷. It should be noted that in 2000, during the so called boom of the Internet companies, underpricing the value of companies in the U.S. market in the IPO process was as high as 65%⁸. Moreover, it remained opinion that the undeveloped company with poor quality bubbles during an IPO, which significantly reduced the level of confidence in the company's technology offering venture capital funds. The consequence of this was the introduction of more stringent rules on companies carrying out the IPO process, which significantly changed the approach to VC funds and this way of disinvestment. Analyzing the data obtained and the investments made by VC funds and PE capital should be noted that the period of rapid growth was present in the years 2002-2008. The year 2009 was a momentary break down of VC investment due to the financial crisis. Between 2010-2012 a slow increase in investments in global markets could be observed. The selected EU markets investments developed in correlation with global investments with a possible delay of one year.

⁴ G. Jeffrey, *Venture capital exits in Canada and the United States*, University of Toronto Law Journal, p. 185.

⁵ W. Megginson, K. Weiss, *Venture capital certification in Initial Public Offering*, The Journal Of Finance, Vol. XLVI, No. 3, July 1991, p. 879-892.

⁶ P. Lee, S. Wahl, *Grandstanding, Certification and the underpricing of venture capital backed IPO*, Journal of Financial Economics 73, 2004, p. 375-407.

⁷ T. Chemmanur, E. Lotskina, *The role of venture capital backing in initial public offering*, Boston Colage, February 2005, p. 38.

⁸ Jay R. Ritter & Ivo Welch, *A review of IPO Activity, pricing, and Allocation* Journal of Finance, American Finance Association 2002, vol. 57(4), p. 1795-1828.

The Polish market had a high rate of investment by venture capital funds after the collapse of a small investment in 2002.

Ways to fund divestment may take different forms. The two most important methods of completion are selling shares to a strategic investor (trade sales) and the IPO⁹. As has already been pointed out, trends in the capital markets for IPOs significantly affect the exit by funds from their investments through the stock exchange. The collapse of the IPO market in the U.S. and European markets changed the trend of disinvestment methods carried out by the VC funds. Trade sale to strategic investors began to dominate in the means of completion of the investment, and funds were looking for their customers among large corporations. The crisis of IPOs may be associated with the new regulations requirements, conflicts and the collapse of some investment banks and the growing interest in less concentrated and demanding Asian markets. It should be noted that even for the period 1975-2010 up to 79.9% of companies in the U.S. fed VC made the IPO in the first 10 years of operation and the percentage of companies supplied by means of VC were only 37.2%. For a period of five years this was respectively 52.2% and 17.4%¹⁰.

Table 2. The share of venture capital divestments in IPO transactions in the U.S. market

Year	IPO VC Number	Number of total IPO	Share	Value IPO VC (bln USD)	Value of total IPO (bln USD)	Share
2000	242	446	54,26%	25,4	108,2	23,48
2001	37	85	43,53%	3,4	41,3	8,23
2002	22	81	27,16%	2,4	25,4	9,45
2003	29	60	48,33%	2,1	15,2	13,82
2004	94	286	32,87%	11,1	39	28,46
2005	57	285	20,00%	4,4	31,4	14,01
2006	57	187	30,48%	5,3	40,4	13,12
2007	86	172	50,00%	10,32	46,4	22,24
2008	6	31	19,35%	0,47	24,1	1,92
2009	8	12	66,67%	1,642	19,2	8,55
2010	9	52	17,31%	7,6	36,3	20,93
2011	51	67	76,12%	9,8	26,4	37,12
2012	49	60	81,67%	21,4	42,6	50,02

Source: NVCA Yearbooks 2010-2012 and PWC IPO Trends 2012

Analyzing the data in Table 2, it should be noted that the share of VC funds in IPO transactions in the United States in both: quantity and value is very high. The capital market in the U.S. is the main source of raising capital for companies growth.

⁹ P. Zasepa, *Venture Capital – sposoby deinvestycji*, CEDEWU, Warszawa 2010, p. 150.

¹⁰ A. Gill, U. Waltz, *Going public-going private, a case of VC-backed firms*, Goethe University 2012, p. 2.

For VC funds, it is also a very important source of capital and the state of the capital market has a decisive impact on the level of IPOVC funds. The fact that it is an important source of capital is shown in generated VC funds during periods of the downturn in stock markets, which reached levels of shares 76% and 81% for the number of IPOs, and 37% and 50% for IPOs participation in 2011 and 2012. These are unprecedented levels since 2000, reflecting the high level of dependency on the use of VC funds, IPO as a way of disinvestment despite a significant decrease compared to the years 2004-2007. The number 60 of IPOs in 2012 is lower than that recorded in the Indian market (63) and much lower than the number of IPOs in China (295).

The European market is different than the VC market in the USA. This is due to the nature of the economy and support the development of companies with foreign capital financing, and lower risk aversion. This affects the nature of the investment funds and market dominance of the market of PEVC.

Tab. 3. The share of venture capital divestments IPO transactions in the European market

Year	IPO VC Number	Number of total IPO	Share	Value IPO VC (bln USD)	Value of total IPO (bln USD)	Share
2000	120	480	25,00%	1,28	50,5	2,53%
2001	26	380	6,84%	1,39	25,5	5,45%
2002	30	141	21,28%	1,26	16,3	7,73%
2003	37	103	35,92%	1,6	6,7	23,88%
2004	59	420	14,05%	2,3	19,7	11,68%
2005	184	598	30,77%	2,65	51,4	5,16%
2006	108	806	13,40%	3	65,2	4,60%
2007	199	771	25,81%	2,69	64,3	4,18%
2008	72	295	24,41%	0,71	9,9	7,17%
2009	109	126	86,51%	1,24	6,2	20,00%
2010	155	380	40,79%	2,09	26	8,04%
2011	118	430	27,44%	3,5	26	13,46%

Source: EVCA Yearbooks 2000-2012, IPO watch Europe 2003-2012

The share of funds in the IPO transactions in the European market was not as significant as in the case of the U.S., but remained stable and at a high level. The European market is not uniform, it is a fragmented market where there are many different stock exchanges. No one major market makes it possible, as divestment through the IPO are limited, and not all stock markets have sufficient liquidity. The exchange bringing together many IPOs carried out by the VC funds is the exchange in London, which, depending on the period noted down about 40%-50% share. Among European exchanges the Warsaw Stock Exchange is also distinguished, which in 2007-2011 reported a large increase in the number and value of

IPOs. This was due to the opening of the New Connect market, which has a large number of emissions compared to the main floors of the Warsaw Stock Exchange.

Tab. 4. The share of venture capital divestments and IPO transactions on the Polish market

Year	IPO VC Number	Number of total IPO	Share	Value IPO VC (bln PLN)	Value of total IPO (bln PLN)	Share
2000	1	14	7,14%	0,02226	9,1	0,24%
2001	7	9	77,78%	0,126	1,1	11,45%
2002	3	6	50,00%	0,254	0,6	42,33%
2003	9	36	25,00%	0,992	2,9	34,21%
2004	9	36	25,00%	1,0038	3,7	27,13%
2005	15	35	42,86%	0,9198	5,2	17,69%
2006	21	38	55,26%	3,1416	4,1	76,62%
2007	6	105	5,71%	0,231	18,2	1,27%
2008	1	94	1,06%	0,0084	12,3	0,07%
2009	4	39	10,26%	0,5964	6,9	8,64%
2010	2	60	3,33%	0,21	15,5	1,35%
2011	5	210	2,38%	1,512	9,2	16,43%

Source: GPW, EVCA Yearbook 2000-2012

Analyzing data of IPOVC funds and PE capital in Poland, it should be noted that their share in the number of transactions for the period 2000-2006 was high, at over 25%. Value shares recorded a slightly lower level, which in some cases may mean that the Polish funds quickly decide the value of the IPO and companies were not rated high at the time of the IPO. Perhaps there was some funds lock (lock-up) related to the sale of shares and hope to increase their value after the IPO. Years 2007-2011 are characterized by the decline of IPOs made by the funds in the total number of transactions on the Stock Exchange. In the case of the Polish market, the launch of the New Connect reduced the number of IPOs undertaken by funds, as companies treated the new segment of the market as an alternative to obtaining funding from VC funds and PE.

Moreover, as in the case of global trends, sale to a strategic investor and management buyouts become one of the main forms of divestment. In addition, based on data from Polish divestment funds in the last five years, it cannot be considered a stable development trend of the shares in each category, because various methods dominate in different time periods. The Polish fund market in this area is quite unstable, which is associated with the changing tax laws.

Tab. 5. Share of divestment made by funds in Poland in the years 2007-2011 in %

The process of divestment	2007	2008	2009	2010	2011
Trade sales	17,6	24,0	19,9	9,5	69,2
IPO	3,5	0,4	45,4	0,8	20,3
Write off	0,0	3,0	0,0	47,0	0,0
Repayment of interest	0,0	20,9	0,0	0,0	0,0
Repayment of loans	14,0	0,0	0,0	0,0	0,2
Sale to another fund	49,8	39,0	1,9	17,1	2,3
Sale of financial institution	1,6	0,0	31,7	0,2	5,8
Buy out	2,4	5,2	0,0	25,4	2,0
Other	11,2	7,4	1,1	0,0	0,2
Together	100,0	100,0	100,0	100,0	100,0

Source: EVCA Yearbook 2012.

Summary

IPO market is an important determinant for investments by venture capital funds. Ability to output via the stock exchange seems to be the best and most effective way to completion. Therefore, it becomes important to analyze the trends in the market of IPOs and the change in their character. In addition, empirical data indicate positive behaviour of listed companies offered venture capital funds in the first year after the IPO. In addition, it was found that over the next two years, they still generated positive returns. They are attractive and trends shaping in the individual markets which will significantly affect the ability to make this type of divestment by the VC and PE funds. It also seems important for companies to search for European and American capitals in Asia and vice versa, because the IPO market is now a global area, with the liberalization of capital flows geographical boundaries become less important.

Literature

- Chemmanur T., Lotskina E., *The role of venture capital backing in initial public offering*, Boston Colage, February 2005.
- Gill A., Waltz U., *Going public-going private, a case of VC-backed firms*, Goethe University 2012.
- Jeffrey G., *Venture capital exits in Canada and the United States*, University of Toronto Law Journal.
- Kikieri S., *Privatization trends*, World Bank, January 2008.
- Kikieri S., *Privatization trends*, World Bank, May 2010.
- Lee P., Wahl S., *Grandstanding, Certification and the underpricing of venture capital backed IPO*, Journal of Financial Economics 73, 2004.
- Megginson W., Weiss K., *Venture capital certification in Initial Public Offering*, The Journal Of Finance, Vol. XLVI, No. 3, July 1991.

- Meggison W., *Privatization trends and majour deals 2010*, The 2010 PB Report.
- Ritter J.R., Welch I., *A review of IPO Activity, pricing, and Allocation Journal of Finance*, American Finance Association 2002, vol. 57(4).
- Trojanowski T., *Zarządzanie działalnością marketingową w skali krajowej, międzynarodowej i globalnej*, pod red. A. Pabiana, Wydawnictwo Politechniki Częstochowskiej, Częstochowa 2011.
- Zasepa P., *Venture Capital – sposoby deinwestycji*, CEDEWU, Warszawa 2010.