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IPO[1]-SPO[2] problems of the Russian companies

In the second half of 2012, against the background of the next round of "quantitative mitigation" in the U.S. and Eurozone countries, an upsurge of Russian issuers interest to public offerings was noted. The history of the Russian companies involved in IPO and SPO in this short time is different.

In September 2012, in the framework of privatization process there was a relatively successful SPO of the Sberbank of Russia. The organizers managed to sell the government stock of the bank in the amount of 7.58% for Rb 160bn. The offering price was Rb 94.75 per share, the underpricing at the point of closing trading day was 1.88 p.p.

In October 2012 a successful IPO of private Cyprus company MD Medical Group Investment, the owner of "Mother and Child" Holding in Russia was arranged in the London stock exchange. The company has placed 35% of its shares and the amount of proceeds received by the founders of the holding amounted to $31m. However, at the offering price of $12.00 per depositary receipt, the closing price of the first trading day at the exchange made $11.94 per depositary receipt. The overpricing made 0.51%, which is in fact not typical to the IPO. In general, on the first offering day the value of the IPO shares of the companies are traded at a higher price than the offering value, which reflects the underwriters' fee for risky investments at this stage of offer.

Promsvyazbank shares IPO was a total failure. At the last moment it was postponed due to the lack of investors' demand for the shares of the bank.

The success of the IPO-SPO shares emitters in any country depends on the further investors' rate of return. There are two indicators used to measure the investment return on the shares of IPO companies: one of them is underpricing / overpricing margin between the first day closing market price at the stock market after the IPO-SPO placement and their offer price; the second indicator is the cumulative excess return, calculated on the basis of difference between the cumulative return on equity of IPO company and a similar indicator of the basic instrument (stock index, shares of comparable companies, etc.).

It is noteworthy, that during the IPO-SPO of the Russian companies, the underpricing level is very low as compared with other countries.

According to the data published by Jay Ritter[3], the U.S. researcher, the uderpricing of the IPO-SPO amounted to:

- *In emerging economies of Asia:* China in 1990-2010 - 137.4%, India in 1990-2011 - 88.5%, Malaysia in 1980-2009 - 62.6%, Korea in 1980-2010. - 61.6%, Singapore in

[1] IPO - Initial Public Offering of shares in the market, during which the company's shares become available to a wide range of investors and are freely traded at the stock exchange.
[2] SPO - Secondary Public Offering of shares.
[3] http://bear.warrington.ufl.edu/ritter/

1973-2011 - 28.3%, in the Philippines, 1987-2006. - 21.2%, Indonesia in 1990-2011 - 25.7%, Hong Kong in 1980-2010 - 15.4%;

- *in emerging economies of Latin America:* Brazil in 1979-2011 - 33.1%, Mexico in 1987-1994 - 15.9% , Chile in 1982-2006. - 8.4%, Argentina in 1991-1994 - 4.4%;
- *in emerging economies of Europe:* Bulgaria in 2004-2007 - 36.5%, Poland in 1991-2006 - 22.9%, Turkey in 1990-2011 - 10.3%;
- *in mature economies of:* Greece in 1976-2011 - 50.8%, and Japan in 1970-2010 - 40.4%, Switzerland in 1983-2008 - 28.0%, Germany 1978-2011 - 24.2%, Ireland in 1999-2006 - 23.7%, Australia in 1976-2011 - 21.8%, the United States in1960-2011 - 16.8%, UK in 1959-2011 - 16.1%, Spain in 1986-2006. - 10.9%, France in 1983-2010 - 10.5%, Denmark in 1984-2011 - 7.4%, Canada in 1971-2010 - 6.7%.

The data on IPOs in Russia cover 40 companies involved in transactions in 1999-2006. The average premium (underpricing) of shares of Russian companies is 4.2% of the offering price, which is the lowest indicator among all 45 countries in the sample[4]. The low level of underpricing was recorded in all “public IPOs” in Russia, including 0.25% of "Rosneft" shares in July 2006, 4.27% in Sberbank of Russia shares and 4.12% in VTB shares in February-May 2007. During the SPO sales of VTB shares (on 14.02.2011), the underpricing amount was 4.16%, and Sberbank of Russia shares (on 19.09.2012) - 1.88%.

Why is the level of underpricing of the Russian IPO-companies shares so low? Is it good or bad in terms of their investors? In our opinion, these facts suggest that the Russian companies shares prices during public offerings, as a rule, are much too high as compared to foreign companies offers in the global market. For this reason, the first-day offer price of the Russian IPO issuers grows less than that of their foreign counterparts, and in the long run it falls well below the shares of foreign IPO issuers.

Various methods of regression analysis are used to substantiate this hypothesis. We will illustrate it on the example of two methods for analyzing the long-term cumulative excess return of 30 Russian issuers shares, participated in IPOs, carried out within 2002-2007.

In summary, the results of the Russian companies IPOs, including "public" ones, are shown in Fig. 1, where the long-term analysis of the cumulative excess return on shares of two Russian companies portfolios for the period of 1070 business days, or about 4.5 years after public offering of these companies’ shares. Fig. 1 shows the cumulative excess return on Rosneft, Sberbank of Russia and VTB shares. Herewith, for comparison, the curve of the cumulative excess return on 27 IPOs of private Russian companies, which took place in 2002-2007 is demonstrated[5].

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[4] We have obtained a similar underpricing value of Russian companies’ IPO-SPO in the amount of 4.4% in the course of the study conducted in 2011 on the data on 150 issues of Russian companies that have passed through the IPO-SPO in the period of 2000-2007.

[5] Pharmacies 36.6 (APTK), Irkutsk (IRKT), RosBusinessConsulting (RBCI), Kalina Group (KLNA), The Seventh Continent (SCON), Lebedyansky (LBDO), Pava-Bread Altai (AKHA), Sollers (SVAV), Razgulay (GRAZ), Magnet (MGNT), OGK-5 (OGKE), Sistema-Hals (HALS), Raspadskaya (RASP), Polymetal CMI (MAGN), Nutriinvetholding,

For a curve of cumulative excess return plotting on 27 issues of IPO private companies shares, the following calculations are to be made. A series of the curve points of cumulative returns on 27 IPO-companies shares is formed. Herewith, the value of the shares issues in each company portfolio is assumed equal to:

$$P_t = \frac{\sum_{i=1}^{27} \frac{P_t^i}{P_0^i}}{27},$$

where P_t^i – IPO-issuer share value *i* at the point of time *t;* P_0^i – IPO-company share offer price *i*.

The curve of MICEX index cumulative return is formed in a similar way:

$$I_t = \frac{\sum_{i=1}^{27} \frac{I_t^i}{I_0^i}}{27},$$

Where I_t^i – MICEX index value for the company *i* (the companies made placements in different time periods, and respectively, the index value will be specific for each company) at the point of time *t;* I_0^i – MICEX index at the point of time when the company *i* made the offer.

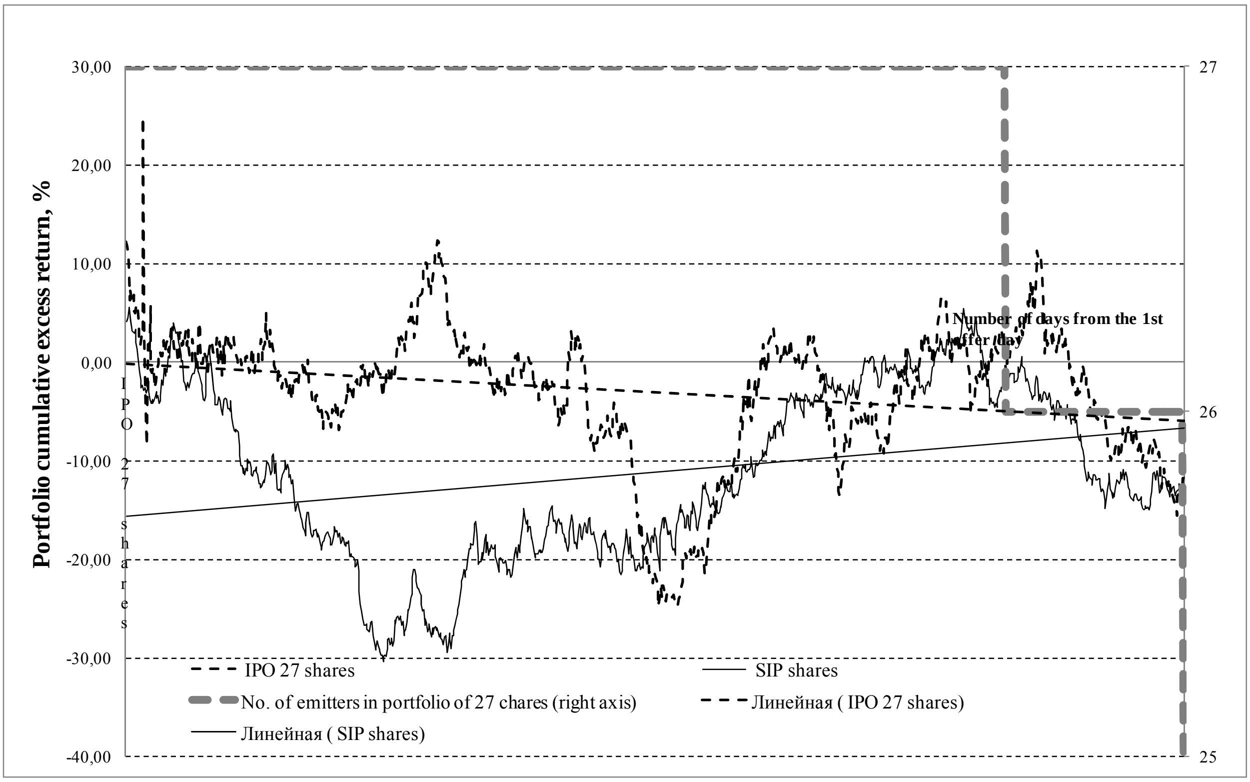
Finally, a series of cumulative excess return of 27 IPO-companies portfolio of shares is formed as compared with the index portfolio:

$$Dif_t = I_t - P_t = \frac{\sum_{i=1}^{27} \frac{I_t^i}{I_0^i}}{27} - \frac{\sum_{i=1}^{27} \frac{P_t^i}{P_0^i}}{27}$$

The cumulative excess return on shares of three companies' portfolios (Rosneft, Sberbank of Russia and VTB) involved in public IPOs is formed in a similar way:

$$Dif_t = I_t - P_t = \frac{\sum_{i=1}^{3} \frac{I_t^i}{I_0^i}}{3} - \frac{\sum_{i=1}^{3} \frac{P_t^i}{P_0^i}}{3}$$

Pharmstandard (PHST), Renaissance (VZRZ), Dixie (DIXY) , PIC (PIKK), Armada (ARMD), OGK-2 (OGKB), M-Video (MVID), St. Petersburg Bank (BSPB), NCSP (NMTP), LSR (LSRG), Synergy (SYNG).



Source: estimates based on Moscow Stock Exchange data

Fig. 1. **Cumulative excess return of two groups of shares of Russian issuers**

As can be seen from the graph in Fig. 1, that over 4.5 years cumulative excess return of private IPO portfolio was usually higher than that of the stock portfolio of three government companies (SIP shares portfolio). However, after 4.5 years, the difference between the excess return of shares of private and government companies has practically disappeared. The trend lines in the chart of both indicators were aligned at one point. This roughly corresponds to the behavior of the cumulative excess return on shares of IPO-companies in the majority of emerging economies.

The more favorable results of excess returns on IPO of private Russian companies shares in comparison with "public" IPOs may be due to excessive excitement generated when placing the shares of government companies, when together with the investment banks - underwriters and issuers, government media and officials of the highest level get involved in marketing. Officials responsible for the IPO of government companies, as a rule, are motivated to maximize revenue from the sale of shares and may ignore other social and economic privatization objectives. As a result, individuals and domestic institutional investors are forced to buy overpriced shares of privatized companies[6]. An example of an alternative approach to the privatization of shares of national companies is IPO-SPO of Brazilian state company Petrobras,

[6] Commenting on the Sberbank of Russia shares SPO at its very beginning, the then Head of the bank A. Kazmin explained that the objective is "to sell more and at a higher price." According to him, in order that the application is granted, "we should take the market price plus some premium", "the will be no discount…", "we are not abnormal." Quoted from: Interview A. Kazmin. The task is: to sell more shares at a higher price. Kommersant, 31 January 2007.

when shares were sold to domestic investors at a discount of 2% of the oil company stock market value.

Eventually, both, individual market participants, as well as issuers of "public” IPOs are often dissatisfied with the results of sales. Herewith, individual market participants are disappointed with the fact that offering price of shares is deliberately overpriced, which does not bring them the expected high short-term and medium-term investment returns. Issuers are dissatisfied that the contribution of the population and other domestic investors in the total amount of IPO proceeds is minimized, while the propective high dispersion of shareholders increases the risk of a conflict with the minority investors.

This experience raises questions about the additional risks of "public” IPO. As demonstrated by the experience of Rosneft, Sberbank of Russia and VTB, individuals and domestic institutional investors are participating in the acquisition of shares of governmental companies on equal terms without any benefits in privatization along with the largest foreign investors. For all categories of investors the same mechanism for determining the offering price with the order book is applied, which in itself adds to the offering price maximizing. In addition, the high cost of offers in progress of "public” IPO is the result of active participation of foreign investors in privatization.

However, the traditional method of calculating the cumulative excess return for IPO and SIP, used by D. Ritter, W. Magginson and others, not fully reflects the investors’ incentives in such investments. Method of cumulative excess return assessment is based on a retrospective analysis of the issuers portfolio proceeds as a result of IPO. Usually it is used in the following manner. Among all IPOs, there selected those issues that are in circulation at the time of the evaluation. Cumulative return of each issue is compared with the cumulative return of the basic financial instrument for the same period of time. Herewith, the stock index, shares of comparable companies or shares of the same company whose return is measured with CAPM model are selected as the basic instruments. Then the arithmetic average excess return is calculated on the pooled analysis of IPO-companies shares, whose issues of securities in the portfolio have the same value.

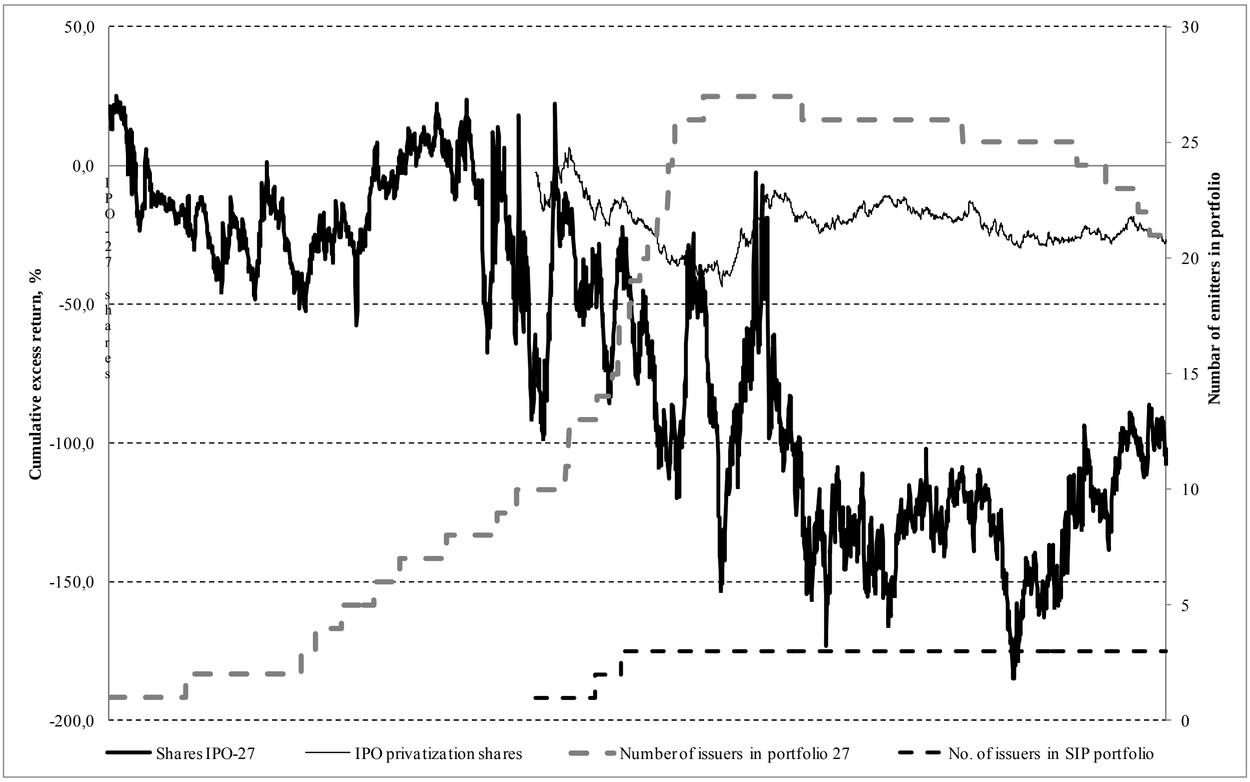
However, there are significant disadvantages in this method of the cumulative excess return assessment. The major failure is the unpredictable character of IPO shares portfolio. A potential investor in the IPO market cannot know in advance which of the purchased shares issue of IPO-companies will serve as a long-term investment. In a few years after the IPO placement, some companies suspend public sales of the shares, because the control stake of the issuer is acquired by a strategic investor (for example, shares of "Lebedyansky", "Kalina", "The Seventh Continent"), and the company is restructured within the holding (Polyus Gold, Polymetal) or gets into a difficult financial situation (RosBusinessConsulting IS). In addition, the IPO transactions of many issuers are usually rather time-consuming. Under such circumstances, the investor forms a portfolio gradually, so far as the IPO are arranged by the companies.

There is a need for the method of assessment of the cumulative excess return on IPO shares, that would provide comparable return on investments in issuing companies with regard to the fact that their portfolio is formed gradually and is either replenished with the assets of the regular IPO issuers, or reduced, when some shares IPO-companies withdraw from the public market trading. This can be achieved by comparing the estimated cumulative return on the shares of two Unit Investment Funds (UIF) formed in compliance with a certain framework. One of the Funds is a public UIF, formed of the companies' shares in the progress of IPO placement. The other one is the index UIF, where the share prices of the respective issues are replaced with index values.

Rules for the model of UIF formation are as follows. Each time of the shares public offer it is expected that investments in the amount of Rb 100,000 is credited to UIF. The number of shares equal to the quotient of the amount contribution by the estimated price of share (ESP). The ESP is assessed by dividing the value of the UIF portfolio by the number of shares in circulation at the beginning of the day when contribution is made. If the shares of an IPO issuer are withdrawn from public trading, on the last day of those shares offer they are sold from the UIF model portfolio. Proceeds from the stock sales are withdrawn from UIF model portfolio, and the corresponding number of shares is redeemed.

Based on ESP, the cumulative return of IPO-companies shares and relevant effective UIF index are calculated according to the UIF model portfolio shares. The difference between a daily excess return of UIF shares and the excess return of the index UIF provides a cumulative excess return of IPO and ESP issuers by the new method.

Fig. 2 shows the results of calculation of the cumulative excess return of 27 IPO private companies stock portfolio (shares IPO-27) and the portfolio of 3 government EIP-companies (shares of privatization IPO). Herewith, In the portfolio of IPO-27 shares of the same companies are analyzed in the above calculation of the cumulative excess return. An alternative method of the excess return assessment gives the results different from the traditional method of its calculation. Cumulative excess return of IPO-27 private companies' UIFs over a decade was expressly negative, exceeding 100 p.p. The cumulative excess return of privatization IPO shares (of Rosneft, Sberbank of Russia and VTB), despite a 5-year period of its existence, is preferable against the stock returns of 27 private companies. However, the cumulative excess return of ESP-companies shares is also negative.



Source: estimates based on Moscow Stock Exchange data.

Fig. 2. Cumulative excess return of two portfolios

The reason for negative results of the cumulative excess return over a decade is a negative impact on the return of IPO-27 portfolio, provided by the IPO-companies shares, withdrawn from circulation. During this time the shares of 6 companies – RosBusinessConsulting IS, Kalina Group, Seventh Continent, Lebedyansky, Polymetal and Nutriinvestholding were withdrawn from circulation. There are two conditional reasons for withdrawal of those issuers: restructuring (especially acquisition by a global foreign company) and insolvency. As a rule, cumulative excess return of IPO-companies shares, for which public offering was only a step in the preparation for sale to a strategic investor is higher than cumulative return of companies, which became insolvent after the IPO underpricing. Withdrawal of the top successful companies from the market significantly reduces the market value of the portfolio and the estimated value of the model UIF shares. An unlucky company, remaining in the model UIF portfolio, also brings down the cost of its shares. As a result, the IPO-27 portfolio profitability is rapidly declining as well. UIF portfolio of privatization IPOs is still free from the impact of these factors due to the limited number of its member companies, which temporarily helps to achieve a higher cumulative excess returns.

Based on the analysis of long-term return of privatization and private IPOs of Russian companies, the following conclusions can be made. Unfortunately, placement of any privatization or private IPO-SPO does not ensure successful performance. Long-term cumulative excess return of the companies' portfolios in both cases is negative. Herewith, different methods of assessment allow to estimate the long-term return on shares from different viewpoints. Traditional methods of assessment show that the cumulative excess return on shares of private companies, as a rule, exceeds the cumulative excess return of privatization IPO-companies.

However, after 4.5-5 years those indicators are getting leveled. Meanwhile, for the 5-year period, it remains negative for the Russian companies.

Another method of assessment, based on the model UIF shares of IPO-companies allows to find out that in a decade, the fund formed of the shares of 27 IPO private companies, is facing serious difficulties. Withdrawal of the most profitable shares of IPO-companies in the process of their acquisition by a strategic investor, the depreciation of investments in the unsuccessful companies results in the expressly negative cumulative excess return of the IPO company portfolio indicators after 5 years. This problem can be expected in portfolios consisting of shares of privatized companies with the expansion of the range of such issuers and the accumulation of a longer history of their excess return.