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## **INITIAL PUBLIC OFFERINGS AND CORPORATE GOVERNANCE IN CROATIA**

### **Abstract:**

This paper empirically investigates the performance of Croatian initial public offerings (IPOs) throughout 20 years period. Besides financial benefit in the form of raising capital, IPOs also play a role in an increased public awareness of the company. By proving the comprehensive evaluation of reasons and consequences of IPO initiatives in Croatia we give analytic evidence on the influence of this corporate action on development of corporate governance. Furthermore, the paper discusses relation between internal and external corporate governance mechanisms in companies that initialize entering the financial markets for the first time, providing us with the analytical framework of understanding the impact on IPOs on corporate governance system in transition countries.

### **Keywords:**

Corporate governance, Initial Public Offering, Croatia, Transition Economies

**JEL Classification:** G10, G34, M10

## 1. Introduction

Procurement of funding has complex implications for the company. The task of a quality corporate governance system is to ensure that the company will maximize the effects of the obtained funds in developing their business model but also to steer efforts of capital accumulation. One of the ways to increase available capital is through public offering of shares.

An initial public offering, or the first issue of shares on the market, is a type of public offering in which company shares are issued on the market for the first time and usually sell the shares to the institutional investors, who then sell them to the public. The term going public is also used for the IPO process. The process of public offering is usually carried out with the help of investment banks or for larger issues with the help of financial syndicates, i.e. unions of banks that trade in securities. In the case when the investment banker assumes the full risk for the issue of securities, i.e. shares, it appears in the role of the signatory or underwriter of the issue of securities (underwriting). Assumption of issue risk implies that the investment banker buys the entire issue of securities from the issuer at a pre-agreed price, and undertakes the obligation to sell or distribute them, thus making the issuer's decision on the issue secure.

In this paper we analyse reasons and consequences of IPO initiatives in Croatia. The specificity of Croatian companies and the related development of the capital market is that joint stock companies, due to the legal obligation to list on the stock exchange, at the time when they conducted their real first public offering of shares, were already present on the stock exchange. Thus, in the classical sense of interpreting the process of the initial public offering of shares and the release of the company to the public, it was generally not at the same time the moment of the first presentation of the company's shares to the investment public.

## 2. The Pros and Cons of Companies Going Public

In considering the life cycle of a company and the problem of cash inflows, Adizes (2006) explains how some entrepreneurs underestimate the amount of money and working capital they need in the very beginnings of an entrepreneurial venture. He attributes this mistake to the enthusiasm typical of entrepreneurs in the early stages of a company's development, as entrepreneurs often make plans for the best-case scenario, instead of making the worst-case scenario and hoping for the best outcome. Due to the lack of capital, in efforts to raise money, companies also make basic mistakes: they take short-term loans for investments that give results in the long run, reduce prices to get funds and third, sell shares to those willing to invest capital in risky businesses, which do not necessarily share the visions and interests of the founders.

One of the ways to raise capital for the growth and development of a company is the initial public offering of shares. Draho (2004) provides a simplified definition according to which an IPO is essentially the sale of goods by sellers to a larger number of buyers. The seller is the company that issues the shares, the buyers are the investors, and the goods are the company's shares.

When the company goes public for the first time it can offer new shares or the existing owners can put their own ownership shares in the form of shares for sale. In the primary public offering, the company issues new shares, increasing the total number of shares in circulation. The funds thus collected go directly to the issuer, and increase the available capital of the company. Each subsequent possible offer of new shares is in fact a subsequent issue of shares to a previously conducted IPO process of the company. That process is called a secondary public offering. In the event that within the public offering of shares, the existing shareholders offer their own shares for sale, the collected funds do not go to the benefit of the issuing company but to the selling shareholder, and the total available number of shares does not increase. In the case of the sale of already listed shares of existing owners, this method of offering also has the characteristic of a secondary public offering.

In a study of IPO cases in the US market, Ritter and Welch (2002) state that the theoretical reasons why companies would like to commence with a public offering of shares are numerous. However, data on the large variance in the number of IPOs over time indicate that market conditions are the most significant factor in a company's decision to go public. The degree of development of a company in its life cycle is likely to be another important factor. The same authors also state that USA based companies primarily emphasize financial reasons, i.e. the desire to increase share capital and create a market position in which founders and other shareholders can replace the value they hold in shares for money in the future, while non-financial reasons such as increased publicity or etc. play a small role for most businesses.

A comparative overview of the IPO motives of EU and US managers included in the research conducted by Levis and Vismara (2013) is shown in Table 1. Motives in order of importance are presented in descending order of importance as managers rated them in the survey.

Table 1 Comparative overview of the IPO motives for EU and US managers

	IPO motives			
	EU managers view	US managers view	UK managers view	Italian managers view
1	Improve the prestige, image and visibility of the company	Create public shares for use in future acquisitions	Sell the company to external shareholders	Finance the company's internal race Support the external growth of the company Improve the image and prestige of the company Increase the visibility of the company
2	Enable an increase in available capital	Establish a market price, i.e. the value of the company	Increase stock liquidity and company value	
3	Implement the organic enterprise growth	Improve the company's reputation	To be recognized by the financial public as a major player	
4	Increase the shareholder base	Expand the ownership base	An IPO is a natural stage in a company's development	
5	Increase the liquidity of corporate securities	Allow one or more founders to diversify their shares		

6	Attract institutional investors	Minimize the cost of capital		
7	To be recognized by the relevant investment community as a key players			
8	Support mergers and acquisitions			
9	Support business operations			
10	Facilitate the implementation of the Employee Shareholder (ESOP)			

Source: Levis and Vismara, 2013, p. 65

Besides accumulation of funds, the EU managers as significant motives for IPOs identify the increase of visibility and prestige, increase of funds for growth and financial flexibility, and especially significant for UK based companies, the possibility of leaving the ownership structure of previous investors.

### 3. Mechanism of Share Public Offering in Croatian Business Practice

Vajdić (2007) emphasizes the influence of the following factors on the creation of favorable conditions for public offers in Croatia and the decisions of companies to raise fresh capital through the sale of shares: (1) strengthening the investment potential of institutional investors such as pension and investment funds; (2) measures of Croatian National Bank to reduce the growth of external debt, as well the introduction of limits on the growth of bank credit activity, which discouraged the growth of bank placements and resulted in higher credit indebtedness to domestic companies; (3) smaller companies, with relatively smaller credit capacity compared to large companies, are focused on issuing shares or bonds to raise funds necessary for business expansion; (3) the sale of shares, i.e. ownership shares in companies, appears as the most favorable option for acquiring the necessary capital, since bond issuance is actually a form of long-term financing whose volume of issuance partly depends on the size of the company; (4) the entry of new co-owners into the ownership structure is becoming an increasingly acceptable option for existing business owners in Croatia, and at the same time the awareness of the difference between management and business owners is maturing; (5) finally, the increase in the popularity of the public offering in the general public is significantly contributed by the positive publicity and success of previous public offerings (INA, HT) in which all parties recognize the value for themselves. Banks agents get their fee, the issuer raises capital relatively cheaply, while small investors see the possibility of earning on rising prices in secondary trading on the stock market.

#### 3.1. Overview of the Most Significant Processes of Public Offerings in Croatia

Tipurić et al (2008) state that according to the publicly available data, during the observed ten-year period from 1996 to 2006, altogether 39 successful public offerings of shares had been conducted, which would make total of 3.9 public offerings per year.

We observe time period after 2006. During that time numerous significant IPO-s took place. Table 2 shows in chronological order the most significant IPO issues in the period from 2006 to 2017. The "no" mark in the "Funds for the company" column indicates that the money was not collected for the company, but the total value of the IPO was paid to the existing owners who put their shares up for sale. Also, if the stated amount is less than the total value of the issue, it means that the IPO was not used exclusively to increase the share capital of the company itself, but partly for the sale of ownership shares of existing shareholders.

Table 2 Overview of the most significant IPO issues in the Republic of Croatia during the period 2006-2017

Company	Ownership in the public offering	Industry	Date of IPO listing	Funds for company (mil HRK)	Total value of the IPO (mil HRK)
INA d.d.	State owned	oil and gas	1 <sup>st</sup> Dec 2006.	No	2.740,00
Viro tvornica šećera d.d.	Private	food production (sugar)	20 <sup>th</sup> April 2006.	126,53	126,53
Atlantic Grupa d.d.	Private	production of food, beverages, cosmetics, and distribution of consumer goods	19 <sup>th</sup> Nov 2007.	358,08	716,15
Magma d.d.	Private	sale of clothing, toys and sports equipment	6 <sup>th</sup> Aug 2007.	85,68	290,36
Optima telekom d.d.	Private	telecommunications	7 Jan 2008	29,15	241,15
HT d.d.	State owned	telecommunications	5 Oct 2007	No	7.050,00
Veterina d.d.	Private	production of food and medicine for animals	23 <sup>rd</sup> Oct 2007	No	184,48
Jadransko osiguranje d.d.	Private	insurance	18 <sup>th</sup> April 2007	No	125,00
Euroherc osiguranje d.d.	Private	insurance	8 June, 2007	No	27,00
Luka Rijeka d.d.	Mostly state owned	maritime transport, port services, warehousing and freight forwarding	11 <sup>th</sup> Aug 2015	300,00	300,00
Tankerska Next Generation d.d.	Private	maritime transport	12 <sup>th</sup> Feb 2015	208,00	208,00
Granolio d.d.	Private	agricultural production, trade and services	23 <sup>rd</sup> Mar 2015	94,02	94,02
Arena Hospitality Group d.d.	Private	tourism	6 <sup>th</sup> June 2017	788,36	788,36

Source: Agram Brokerei d.d. 2008; Grubišić 2008; Viro tvornica šećera d.d. 2016, Granolio d.d. 2015, Luka Rijeka d.d. 2015, Tankerska Next Generation d.d. (2015), Arena Hospitality Group d.d. (2017)

### 3.2. Motives for initial public offerings in Croatian companies

In accordance with the available data from the prospectus of the most significant IPO issue in Table 3 we provide an overview of the basic reasons that Croatian companies point out as key to using the public offering mechanism to raise capital.

Table 3 Reasons for implementation of initial public offering in Croatian companies

Company	Reasons for initial public offering
Arena Hospitality Group d.d.	Financing of a specific investment project, inorganic business expansion, debt refinancing
	<ul style="list-style-type: none"> <li>Accelerating the implementation of the Group's capital investment plan aimed at renovating a number of accommodation facilities in Croatia and financing the Group's expansion in the Central and Eastern Europe Region</li> <li>Financing the acquisition of the remaining 12% stake in the hotel company Sugarhill Group, which consists of seven hotels in Germany and one hotel in Hungary</li> <li>Repayment of existing debts in the amount of up to 25% of net funds collected in the public offering of shares (Arena Hospitality Group, 2017)</li> </ul>
Atlantic Grupa d.d.	Inorganic business expansion
	The primary stated goal of the company is to direct the funds raised from the public offering to the inorganic expansion of business in existing and new markets in the region, through acquisitions in the pharmaceutical business with the aim of creating a strong pharmacy chain with a leading position in the market. (Atlantic Grupa d.d., (2008)

<b>HT d.d.</b>	Increasing liquidity on the Croatian capital market and greater recognition of companies in the international investment public
	The prospectus states that the public offering of HT shares will be carried out in accordance with the HT Privatization Act and with the aim of enabling the Government of the Republic of Croatia as a Seller of shares to dispose of part of its shares while ensuring liquidity of stock trading and raising the company's profile. to the international investment community (HT-Hrvatske telekomunikacije dd, 2007)
<b>Luka Rijeka d.d.</b>	Financing a specific investment project
	The intention of the company is to increase the turnover and profit capacity of the company's business system by implementing the investment project for the expansion of the Škrlevo rear terminal, (Luka Rijeka d.d. 2015)
<b>INA d.d.</b>	Increasing liquidity on the Croatian capital market and greater recognition of companies in the international investment public
	The Government of the Republic of Croatia, as a shareholder, wants to exercise its right to freely dispose of shares through an IPO offer, with the intention of ensuring greater liquidity in stock trading on the Croatian capital market and increasing INA's presence in the international investment community (INA-Industrija nafte d.d. 2006)
<b>Podravka d.d.</b>	Inorganic and organic business expansion
	The purpose of the share capital increase is the need to finance the production and market expansion of the Group through investments in organic growth, ie investment in production capacities, and inorganic growth, i.e. acquisitions: <ul style="list-style-type: none"> <li>• purchase, i.e. financing the acquisition of shares in Žito d.d., Ljubljana</li> <li>• financing the construction of a new factory of Belupo d.d. expansion of business in new markets (Podravka d.d. 2015)</li> </ul>
<b>Viro tvornica šećera d.d.</b>	Financing a specific investment project
	The company lists several upcoming investments in the prospectus: <ul style="list-style-type: none"> <li>• investments in a new packer and palletizer, reconstruction of the packing house and warehouse building in order to increase the daily load of sugar, which has now become a bottleneck</li> <li>• investment in equipment for pasteurized sugar solutions for the soft drink industry, which is significantly imported</li> <li>• introduction of HACCP standards (Viro sugar factory d.d. 2016)</li> </ul>
<b>Tankerska Next Generation d.d.</b>	Financing a specific investment project
	The company states that the net receipts collected by the Offer will be used to finance the acquisition of additional modern MR Produkt tankers as well as for general corporate purposes.

The data points out to the fact that HT and INA conducted the public offering procedure of the government owned shares. That resulted in the ownership transformation of the company, whereby the share capital of the company was not increased, and funds were not collected for the company. The Government of the Republic of Croatia, as a seller, emphasizes the increase in the liquidity of shares of the Croatian capital market and greater recognition of the companies in question in the international investment public as the basic goals of the sale of its ownership share. In the case of the Atlantic Group, existing shares and newly issued shares were offered for sale. Of the total value of the public offer, the corresponding amounts were paid to the former owner and the company for the needs of financing business development. In other mentioned examples, new shares were also offered in the public offer, which increased the share capital of the company, and in this way funds were raised to finance the business.

#### 4. Conclusion

In this paper we offer a review of the most important IPOs in Croatia as well as main reasons for that sort of corporate actions. The results of the conducted research at the population of Croatian companies suggest that the decision to go public was guided by the financial and strategic thinking of the company. The decisions to go public cannot be explained by using only one of the offered IPO theories since each focuses on one of the motives, while companies are motivated to achieve multiple benefits or goals at once, which is again specific to each company and industry in which it operates.

The initial public offering of INA was conducted at the end of 2006, in the shadow of which the public offering of shares in the company Viro sugar factory, also important for the relatively small Croatian capital market, was carried out. During the summer of 2007, the company Magma successfully sold its shares, and in the same year, public offers of shares of Veterina, Optima telekom, Atlantic Group and HT followed. After a full seven years without public offers, public offers of shares in Granolio, Luka Rijeka and Tankerska Next Generation took place on the Croatian Stock Exchange in 2015. The last significant initial issue of shares was offered by Arena Hospitality Group in mid-2017.

Concerning the influence of initial public offerings to the development of corporate governance mechanisms the research results show how only INA and HT shares managed to significantly launch the Croatian capital market in the long run, thanks to the size of companies, their revenues, financial results, and share in stock trading, and contributions to market capitalization. In the Croatian capital market, a similar success to that of 2007 has not been repeated until today.

This comprehensive evaluation of reasons for IPO initiatives enables us to better understand triggers that cause development of corporate governance system in Croatia but also more general in other transition economies in central and east Europe.

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