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WHY FIRMS GO PUBLIC: THE CASE OF TADAWUL

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ABSTRACT

If a company chooses debt financing or equity financing may be related to its structure, i.e., a public or a private company. This study will focus on the reason why any private company would want to choose equity financing and transform into a public one and all the fallouts of such decision. The study critically analyses the characteristics of both public and private companies. Moreover, the process of transforming from private to public one is analyzed. Using data from 2006 to 2016 from the World Bank the characteristics of publicly held versus privately held companies are analyzed and discussed. It is concluded that if a company is financially strong and operates internationally it is better to go public as international operations can be difficult to manage with a limited set of boards and a huge reliance on debt financing. Moreover, by going to public, stocks will provide additional capital, keeps the directors away from illegal issues as it is a limited liability company where constant auditing ensures safe operations and accounting, and easy to franchise as the name of company as statements are available to the public. On the other hand, if the company is small and promising, it is feasible to stay private to hide strength from strong competitors until this strength is established.

INTRODUCTION

When firms want to finance their businesses, or make any financial decision, they must consider their available resources, current capital structure, and future goals in order to raise capital. It is usually done either through debt or equity issues, which is when a company chooses to issue bonds or go public through selling shares in the stock exchange. However, not all firms go straight to IPOs due to many factors will be discussed later in this research paper. But sometimes, they choose another alternative to IPOs which is to sell shares to outsiders using private placement.

To clarify more, IPOs and private placements are the same by being characterized as equity issues, give ownership to outsiders, and make the company public. The only difference is that IPO is for the general public, and private placement is for a selected public. In other words, private placement deals only with a small set of investors, and costs less to raise the required funds [1]. It is important to keep in mind that equity issues regardless of their type, will result in ownership dilution. Ownership dilution is the decrease in the ownership percentage of shares due to an increase in the number of shares outstanding. There is another way for a private firm to go public which is through mergers and acquisitions with a publicly listed company. This method has many critiques that will be discussed later in the literature review.
Now coming to debt issues, they vary in terms like bonds, notes, leases, etc. due to minor elements such as risk levels and returns promised. However, they all meet on a single characteristic that makes them debt issues. They are all obligations to the issuer (companies and governments) since he has borrowed money from a lender (individuals and companies). Thus, the issuer promises the lender a certain return to be paid periodically until the issue matures, and the principal has to be repaid at that date.

Therefore, each company must consider a lot of financial and human factors when it comes to raising capital. Each method can have advantages and disadvantages ranging from ownership dilution to bankruptcy due to high debts and large loans. As a result, this paper will look closely at the characteristics of public companies and private companies, advantages and disadvantages of IPOs, and how IPOs are done. In order to understand why most developed countries and few developing countries- with powerful corporations have experienced a decline in number of listed firms over the last 10 years. While on the other hand, developing countries that have many infrastructure projects and small companies are increasing the number of listed firms.

Saudi Arabia had a high percentage change in number of publicly listed companies over the last 10 years. As a result, this research paper will focus on the reasons why any private company would want to choose equity financing and transform into a public one and all the fallouts of such decision. Moreover, in the 2030 vision, Saudi Arabia is looking to privatize most organizations and facilities that are owned by the government like hospitals, which is a trend seen in most developed countries like the US. Thus, this paper will open more future research opportunities to see whether having fewer public companies can better help the economy, and ultimately the country to developed and thrive.
This paper will critically analyze the characteristics of both public and private companies, then the process of transforming from a private to a public one. Lastly, leave few suggestions for a future research to see the relationship between having fewer public firms and country development.

LITERATURE REVIEW

IPO vs Private Placement

In 1995, Zingales advocated for the use of an IPO saying that it can extract more value because the shares will be offered to a greater public in a competitive market, which has mixed views on the value of the company [2]. However, in a private placement, the competition will be significantly less. Thus, the value extracted will be less as well compared to an IPO. Later, in 1999, Chemmanur and Fulghieri [3] looked at the dilemma of whether going public through an IPO or a private placement, and came up with a model that considers four aspects which are: a) The level of information asymmetry, which tries to see to what extent one party knows more about the company than the other, to ensure as much fair power distribution as possible. b) How outsiders evaluate the company, in order to know which type of underwriting this company deserves, and make sure that the price will not be over nor undervalued. c) Involvement of Venture Capitalists. d) Investors' strategy in the new market, to see whether this company is on the right track.

Based on the previous four factors, a company can know which option suits it better, due to the varying differences between private placement and IPO. Private placement has lower costs when raising funds than IPO and only a selected public will be dealt with rather than many. On the other hand, IPO is more frequently chosen because the public are more diverse, and the value of the company will be decided based on stocks' prices rather than a negotiated number with buyers and lawyers that might decrease the proceeds.

Intermediaries and Investment Banks

When it comes to intermediaries and third parties such as investment banks, they try to balance between the firm's objective of maximizing the proceeds, and the bank's objective to fairly discount the value for information asymmetry. As a result, when a well-qualified unbiased investment banker joins forces with an industry expert, they can reduce the information asymmetry, fairly discount the value, and maximize the proceeds [4]. However, there are documented scenarios where a lot of new issues underperformed after a long period of time in 1991 by Ritter [5] and in 1995 by Loughran and Ritter [6]. As a result, in 1998, Carter et al. [7] proved that if all the right elements were perfectly combined and executed (qualified banker and industry expert) they will reduce the underperformance of the new issue in the long run.

Mergers and Acquisitions

Now coming to mergers and acquisitions, there are a lot of aspects to look at such as the pre- and post-acquisition financial status of both the acquired and acquiring firm. In addition, the post-acquisition is the performance of the acquiring firm. Based on a study conducted in 2005 by Camerlynck et al. [8] found that bankruptcy is not the only motivation for choosing acquisition. On the contrary, the study also found that the acquired companies had higher than industry liquidity and solvency. Meaning that, the acquired companies were able to meet both their short and long-term obligations, while the acquiring companies had higher growth rates in total assets and sales. Thus, the option to go for acquisition can be also motivated to achieve a better performance through finding a good financial fit and join forces.

Regardless of the motives, the dominant hypothesis for acquisition is to only escape bankruptcy. That is why most models give weight to profitability and leverage ratios [9]. However, Higson and Elliott [10] didn't find that strong relation between poor profitability and the likelihood to be acquired by other company. However, Higson and Elliot found that a firm's size is an important distinguisher between getting acquired and acquiring others. Afterwards, in 1994, Clark and Ofek [11] found that liquidity is not acutely a great predictor as it didn't differ much between acquired and non-acquired companies. Instead, the study found that solvency better predicted which company will be a take-over target. Later in 1996, Theodossiou et al. [12] added that the targets must also have a moderate leverage ratio.

Now coming back to Camerlynck et al. [8] study of 2005, they further found that acquiring firms are significantly bigger that the targets even in total assets, sales, and employees. Moreover, acquiring firms had better growth percentages and prospects, in addition to being more dynamic. To sum up, this study about acquisition and the reasons.

I. Acquired companies are relatively more profitable than their industry
II. Acquired companies don't have as much growth prospect as the acquiring ones, but they do have more liquidity and less leverage.
III. Acquiring companies are relatively similar to their industry in terms of profitability
IV. Acquiring companies take over other companies in order to complement their operations and financial needs, by choosing a smaller company that is performing better than the industry.

DATA

The following data in Table 1 was taken from World Bank website, and then plugged into excel to see the percentage change using this formula = Current – Previous / Previous.

Table 1: Percentage change data

Region	Country	2006	2016	% change
GCC	Saudi Arabia	86	176	105%
	Oman	215	113	-47%
	Bahrain	43	43	0%
	UAE	55	125	127%
Middle East	Turkey	259	380	47%
	Israel	601	427	-29%
	Lebanon	11	10	-9%
United States	USA	5,133	4331	-16%
Europe	European Union	10,213	6,402	-37%
	France	730	485	-34%
	Germany	656	531	-19%

Region	Country	2006	2016	% change
	Spain	3,339	3,480	4%
	New Zealand	151	173	15%
Asia	Philippines	238	262	10%
	Russian Federation	539	242	-55%
	Singapore	461	479	4%
	Sri Lanka	237	295	24%
	Thailand	518	656	27%
	China	1,421	3,052	115%
	Bangladesh	199	557	180%
	India	4,796	5820	21%
	Japan	2391	3535	48%
	Malaysia	1021	893	-13%
	Indonesia	344	537	56%

DISCUSSION

Characteristics of Publicly Held and Privately Held Companies

The following is the characteristics of publicly held companies. First, market value of the company is tracked and calculated on a daily basis through the exchange, which enables the investor to know his position in real-time manner and act wisely upon it. Second, stock prices are indicators of the performance of the company, and investors' belief in the company as well. Third, all the information is public and audited for investors through SEC (Securities and Exchange Commission) that ensures fair public disclosure. As a result, each public company is forced to act legally and report fairly throughout its life. Fourth, a public company can raise capital through ways other than private funding like selling stocks and bonds. Not to forget, stocks are the equity form of financing, and bonds are the debt form of financing. Fifth, part of the public company is owned by the public due to the Initial Public Offering. Which in return, gives the public the right to influence decision making, and the board is obliged to answer to the shareholders/public. Therefore, the board is not 100% in control of the firm. Sixth, the shareholders/public has the right to claim their portion of the company's assets and profits [13].

The following is the characteristics of privately held companies. First, a private company has complete control over the firm and the decision making, because it is totally owned by the founders or a specific group. Second, a private company is not obliged to disclose its information to anyone. As a result, it avoids a lot of costs of hiring an auditing firm that will waste their time and delay some of the operations. Third, the only way to get capital is going to private funding, since private companies cannot use the capital market. However, private funding will raise the cost of capital. Fourth, private companies range from small businesses to mega large influencer businesses such as PwC. Therefore, being a private company gives the firm more freedom to operate in a way that best suits its goals [14].

The Differences between Publicly Held and Privately Held

According to Junyan and Pei [15] there are few differences between publicly held and privately held companies. For public it has more obligations due to the rules and standards of the IPO whereas for private has less rules, regulations, and formalities. The public company has more options when it comes to raising capital and is less expensive in the long run than privately held. As for the private, less options of financing and can cost more each time to raise new capital. In addition, the public company has greater appeal and actual evidence of its outstanding performance, which can intimidate the competitors. As for private company, it is more vague and unreliable evidence of its performance that can work as a competitive advantage if it is doing very well.

What Makes a Private Company Wants to Go Public?

There are few factors which makes a private company to go public. They are greater financial flexibility in raising capital using debt, since it is a limited liability corporation. Frequent auditing that ensures safe operations, honesty, loyalty, and better governance. Better image and reputation if merged with one of the big public companies. Competitors can see the strength of the company when it is doing very well, due to the existence of programs such as Bloomberg, serves as cash out strategy from bankruptcy.

Types of Equity Financing

When companies want to raise capital, they have three options: either debt financing, equity financing, or a combination of both. The optimal decision depends on the size of the firm; it's since current stage in the business cycle, and its growth prospect. Moreover, in equity financing, the company has three choices, either to sell some of its ownership using private placement, rights offering, or through an IPO. Private placement is when securities get sold to a small number of investors typically less than 35. In addition, those investors are usually large banks, insurance companies, and funds such as pension and mutual funds. Therefore, private placement does not happen in an open market. As a result, the private placement does not need to be registered with the Securities and Exchange Commission. Rights offering give the existing shareholders 'for a limited period of time' the right and option to buy additional shares. This method preserves the shareholders' current proportion of the total company's stock. Moreover, the additional shares are sold at a discounted price and are transferable, which means they can be resold by the holder to the open market. Initial Public Offering happens only once for each company. It is the process of selling stocks for the first time to the public. As a result, the company will change from being privately held to publicly hold. However, it is a very complicated process that requires the help of a third party. This help is called underwriting, which goes through many processes and extensive valuation to reach a decision regarding the type of security to be issued (common or preferred), the offering price, and the best timing to start.

Advantages of IPO

First, raise capital. This is the most distinctive benefit of IPOs. As a result, capital can be utilized to invest more, expand the business, or even pay off existing obligations. Second, increased public awareness. Public awareness of the company will increase due to the IPO, as it often generates publicity through marketing the securities to potential investors. In addition, this may lead to an increase in the market share for the company. Therefore, many venture capitalists have used IPOs to increase the awareness among investors to raise capital. Third, less cost of capital. By going public, the company will improve its financial condition by obtaining money that does not have to be repaid or considered as debt. As a result, the cost of capital will be very small compared to private companies that rely on loans. Fourth, diverse options using stocks. Stocks in the organization can be utilized as a part of acquisition plan. In addition, organization stocks can be offered to workers as investment opportunities and as a type of incentive or compensation. Moreover, shareholders of the company benefit from holding shares ‘that are subject to certain restrictions’ to use them as collaterals for loans. Fifth, daily evaluations on the company’s performance. The stock exchange provides an irrefutable valuation of the company on a daily basis. As a result, the company is always aware of its position, potential future, investors’ beliefs, and develop plans based on real accurate data that change every day.

Disadvantages of IPO

First, loss of management control. The IPO transfers a portion of the company to outsiders with the right to influence the decision making, which depends on the percentage that they hold. As a result, the management control will decrease and have less power to influence. In some cases, such loss in power results in stockholder lawsuits, loss of confidence in management, and possible hostile takeovers. Second, complex and takes time. IPO is a very time consuming and expensive process. Therefore, if a business is interested in going public, first it must apply to the Securities and Exchange Commission (SEC) to ask for permission to sell stocks to the public. The SEC registration process itself is complex and requires the company to expose a variety of sensitive information to potential investors. As a result, endure the risk of someone using this private information for some personal gain. Third, expensive to start. The IPO process can take from 6 months to 2 years, and it can also cost a company between \$50,000 and \$250,000 in underwriting fees, legal and accounting expenses, and printing costs. However, it might exceed this amount depending on the company’s goal, the underwriting firm, and methods used to plan and execute the IPO. In addition, smaller companies face more difficulties with complying with some regulations due to the high cost such as the auditing firms’ fees, accounting oversight committees, and the generation of the required financial documents. Fourth, pressure to constantly generate income regardless After going public, the value of the company can be reflected in its stock prices, which puts pressure on the company to generate income in short time horizon, rather than focusing on long-term growth. Fifth, loss of confidentiality. Loss of confidentiality is inevitable due to the mandatory task of disclosure that happens at least once a year. This disclosure has all the information investors need in order to make a decision and it is regulated by SEC. As a result, companies must be transparent in their operations, expenses, employees' background, etc., including the bad stuff. Therefore, the company will communicate with the market using these statements, which give all the information needed to the interested users.

The Underwriting Process (role of the bank)

Underwriting is the process of raising investment capital on behalf of the entity that is issuing the security. Moreover, the people responsible for the underwriting are called underwriters, and they provide three services for corporate issuers. These services are: Formulating the method used to issue the securities, pricing the new securities, and selling the new securities. As a result, this process is carried out by investment banks that work as mediators and they aid corporations and governments to raise funds through selling the securities to the public such as stocks and bonds. When banks issue securities of stocks for a company for the first time, they call it an IPO (Initial Public Offering). Initially, underwriters buy the securities for a price less than the offering price (to the public), in order to get compensated for the risk and increase their chances in earning profit. Then, they sell these securities to the potential investors or the public. After selling and raising the capital needed, the company will receive the capital after paying the underwriters [16].

However, investment banks can issue these securities by using their own money. Then, they earn a profit through the spread between bid and ask prices. Finance defines this process as 'making a market' in a security as explained in Wall Street Prep. In addition, they do not finance or fund companies easily. They inspect the companies first to know if they are able to survive the competition, set foot in the market, and grow. Therefore, if a company performed well and had great evaluation, the greater the extent of the help the investment bank will undertake and provide. On the other hand, if a company underperformed, there is no chance that the bank will continue or increase the help provided.
Not to forget, all investment banks and underwriters search for companies with potential that assures them a guaranteed profit (premium). As a result, small and medium sized enterprises (SME) face more problems, due to the banks' fear of bearing a lot of risk and not enough return.

Since this process is a complex one, it might require a lot of experts to participate in the underwriting, thus forming a syndicate. In the syndicate, there are several managers, a different person for dealing with the issuer and the pricing, and a different person for distributing and producing reports. Each of the members gets his respective profits. Therefore, banks play a major role in raising capital for firms and governments, thereby supporting the economy and helping in the development of the country [17].

Types of Underwriting

There are few types of underwriting which are: First, firm commitment underwriting. This is the most common type in some countries, where the issuer sells the entire issue to the underwriters. Then, the underwriters will sell it to the public, and the profit will be the difference between the price bought by the underwriters and the offering price. This difference is called gross spread. Second, Best Efforts Underwriting. The underwriters will try their best to sell the shares. However, if there are any unsold shares in the agreed upon price, they will be returned to the issuer without financial responsibility on the underwriters. Third, Dutch Auction Underwriting. This type does not set an offering price in advance through negotiation with the issuer. It uses an auction where actual future investors can bid and decide how much they are willing to pay. Therefore, based on the bids, the underwriters will determine which price suits most of the bidders while selling as much as they can in the process [18].

In the end, IPOs are good for raising capital safely without having lots of debt and increased risk. However, ownership will be reduced and the influence in decision making will be distributed to a larger crowd. Therefore, companies must make a trade-off and choose what best suits their long-term goals. In addition, if the firm chose to go public through an IPO, it must choose the right time to issue, right price to sell the shares, and the right underwriter to do the job. This way, the IPO will be done in the best way it can be to achieve the maximum. However, each company must keep in mind that sometimes staying privately held is the best solution, where it is not obliged to file financial data to the SEC. Therefore, it has more freedom and less restriction on its operation. In addition, private firms do have shares that are traded. However, they are traded amongst very limited selected rich individuals that have professional knowledge and opinions that actually help the company to grow [19].

CONCLUSION

Every company all around the world has both debt and equity financing, but the difference is between whether it is a public or private company. As seen in the discussion, each has different way of operating and priorities due to the legal obligations that come with each status (public and private). Thus, if a company is strong enough financially and operationally, and operates internationally, then I believe it is better to go public as international operations can be difficult to manage with a limited set of boards and a huge reliance on debt financing. Moreover, by going public, stocks will provide additional capital, keeps the directors away from legal issues as it is a Limited Liability Company, constant auditing ensures safe operations and accounting, and easier to franchise as the name of the company along with its statements are available to the public. If the company is small and promising, then it is better to stay private to hide strength from strong competitors until this strength is established and enhanced further, in order to reach a good competitive advantage. Moreover, keeping the company's decision power within a limited set of board will provide focus and reduce wastage of time. More importantly, it is important to keep in mind that each scenario has its drawbacks. Thus, a good analysis and understanding of the tradeoffs is crucial.

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