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## **Analysis of the Current Situation in the Area of IPO on the Czech Capital Market**

**Key words:** *Initial Public Offering (IPO), Financing, Czech Republic*

**Abstract:** Funding the development of the company through the ‘Initial Public Offering’ has a high representation globally, the Czech Republic unlike, and belongs to traditional methods of raising funds necessary for the development of business in the developed capital markets. Under the conditions of the Czech capital market it is possible to identify only few companies, who attempted to fund through the IPO way at present. The objective of this paper is to analyze the current situation in the area of IPO on the Czech capital market and identify the causes of the low number of IPOs in the Czech Republic. The paper was written with the financial support of the Czech Science Foundation (Grant Agency of the Czech Republic), grant project No. 402/09/P134 ‘Decision Model of Company Financing via IPO’.

### **INTRODUCTION**

Funding development of the company through the “Initial Public Offering” has a high representation globally, unlike the Czech Republic, and belongs to traditional methods of raising funds necessary for development of business in the developed capital markets. In the United States of America, Japan and in the Western Europe countries the method of company funding through IPO has been applying for several decades already. The first public stock offerings began to be applied in these markets in higher volumes from the beginning of the 60<sup>th</sup> of the last century. Since that period the importance of IPO has gone up globally and the initial public stock offerings are beginning to be applied more frequently in the Central and Eastern European countries. Under the current conditions of the Czech capital market it is possible to identify only few companies which have attempted to fund through the IPO way. The majority of the Czech companies are still undergoing the debit funding for financing their further development,

namely, in the form of bank loans. The objective of this paper is to analyze the current situation in the area of IPO on the Czech capital market and identify the causes of the low number of IPOs in the Czech Republic. The paper was written with the financial support of the Czech Science Foundation (Grant Agency of the Czech Republic), grant project No. 402/09/P134 ‘Decision Model of Company Financing via IPO’.

## DEFINITION OF THE TERM ‘INITIAL PUBLIC OFFERING’

When searching for relevant definitions of the term ‘Initial Public Offering’ for which the abbreviation ‘IPO’ is commonly used, we have relied on foreign sources, in particular from the United States of America and Western Europe.

– The U.S. SEC defines IPO as the initial public offering of shares by a company heretofore not publicly listed.

– NASDAQ defines IPO as initial offering of shares of a private company to the public.

– Similar definitions can be found in Welche’s works (2006, p. 824) who defines IPO as a mechanism through which shares in companies that are not traded publicly first get to common investors.

– Ritter (1998, pp. 5–30) states in his publication that IPO occurs when securities are first sold to the broad public. According to Ritter, these can be both equity securities (shares) and debt securities (bonds).

– In Rose (1996), IPO is defined as the initial public offering of shares related to the company’s decision to become a public company.

– According to Carter and Manaster (1990, p. 1045), IPO can be defined as the initial public offering of shares or bonds by an issuer previously not listed on the stock exchange or other similar organized public market.

– Giudici et al (2005, p. 34) believes that IPO is the initial placement of securities, in particular shares, on the stock exchange.

– Khurshed (2000) defines IPO as the initial offering of securities to the broad public or institutional investors by a company getting listed on the stock exchange at the same time.

– Ernst & Young (2008) defines IPO for the purpose of its analyses as initial offering of company shares to the public.

The above definitions show that when defining this term, most authors stress the fact that the *company is offering its securities, generally shares, to the public for the first time*, and at the same time *it is entering an organized public securities market*, most frequently represented by the stock exchange as a supreme organization. What is important is that an *IPO may only be effected by an issuer whose securities are not publicly traded on the market at the time*. Most authors believe that IPO includes a public offering of securities of a company

whose securities have been traded on the public market in the past, as long as the new issue meets the above requirements for an IPO. According to Jenkinson and Ljungqvist (2001, p. 254), Giudici, Vedove and Randone (2005), Huyghebaert and Hulle (2006, pp. 296-320), the following distinctions can be made according to the origin of the shares being offered in the IPO:

– ***IPO of primary shares*** in which new shares are issued and launched onto the public primary securities market,

– ***IPO of secondary shares*** consisting in the offering of previously issued shares until then only traded on the non-public secondary securities market,

– ***combined IPO*** in which newly issued shares are supplemented with a public offering of existing shares.

In the light of the nature of this article, the notion of ‘Initial Public Offering’ shall further be used in the more narrowly defined sense, and ‘IPO’ shall be deemed to be an abbreviation for the ***initial public offering of shares***.

#### **ANALYSIS OF THE DEVELOPMENT OF INITIAL PUBLIC OFFERING OF SHARES ON THE WORLD’S MARKETS**

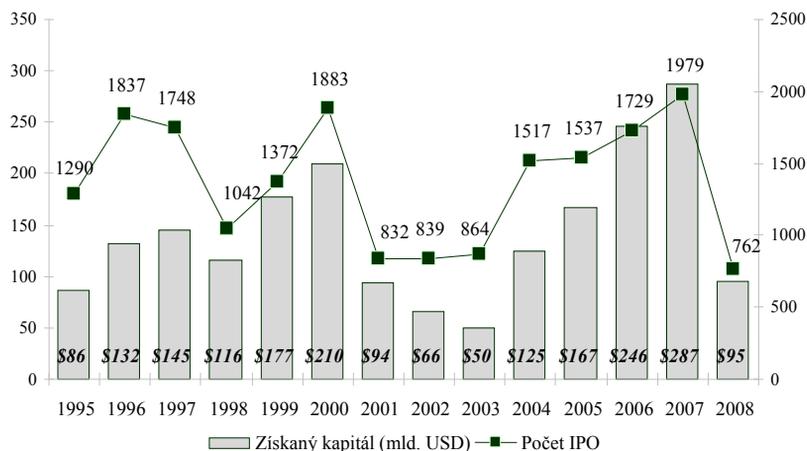
A basic overview of the world development of IPO is provided in Figure 1. It shows that activities in the IPO area take place in cycles corresponding to developments in economic cycles. The 12-year period pictured in Fig. 1 can be divided into four periods: following a period of economic stagnation in the early 1990s, in particular in the USA and UK, a growth in the number of initial public offerings of shares recurred in 1995–1997. The interest in IPO culminated in 2000 when 1,883 companies launched IPOs. On the U.S. market, these were mainly high-tech companies, and that is why this period of excessive optimism on the market is often referred to as ‘*internet bubble*’. After this period, in 2001–2003, the interest in initial public offerings declined, and their number thus did not exceed 900 per year. As shown in the graph, this trend changed in 2004, and the number of initial public offerings launched on the market was once again on the rise. The growth in the number of IPOs and the value of capital obtained by this way of financing was substantially due to the *emerging markets*, in particular Brazil, Russia, India and China. In 2007, 1,979 IPOs were launched on the world’s markets, with the aggregate proceeds of USD 287 billion. These figures can be viewed as a historical record, with China (259 offerings of USD 66 billion in total), USA (172 offerings of USD 34.2 billion in total) and Brazil (64 offerings of USD 27.3 billion in total) playing a significant role. However, in the first quarter of 2008, due to the credit crunch in the USA, a decline in further IPOs occurred on virtually all the global share markets. In the first quarter of 2008, a total of 236 IPOs of USD 40.9 billion took place which means a 38% drop in the number of IPOs and a 15% decline in the amount of capital obtained, as compared to the same period in 2007. Therefore, a world-wide decline both in

the number of IPOs and the amount of capital obtained could be expected to take place in 2008.

The second figure shows that, regionally, the EMEA area<sup>1</sup> which includes Europe, the Middle East and Africa accounts for the largest share in the total proceeds from IPOs. In 2007, EMEA accounted for nearly 40% of the total capital obtained through IPO on a global basis. Asia and Australia also enjoy prominent positions in the IPO sector, mainly thanks to the great economic growth in China. This region accounts for approx. 34% of the total capital obtained through IPO globally. In 2007, 919 initial public offerings of shares were launched there, i.e., more than 46% of the total number of IPOs worldwide. The share of America, i.e., USA, Canada and Brazil, in the total proceeds from IPO in 2007 was approx. 27%, and 18% of the total number of IPOs.

In 2008 however, due to the global economic crisis, a chill for any further interest in IPOs set in at all global stock markets. There were a total of 762 initial public offerings of shares worth USD 95 billion worldwide that year which, in comparison to 2007, represents a 61% drop in the number of IPOs and a 67% drop in the value of acquired capital. 51 IPOs were launched in the 1<sup>st</sup> quarter of 2009 with a return of only USD 1.4 billion. These figures indicate that 2009 will be a year with the lowest number of initial public offerings of shares in history and particularly in the value of capital obtained by this form of financing on the world stock market<sup>2</sup>.

Figure 1. Developments in the number of IPO's and the proceeds obtained from them on global markets in 1995–2008



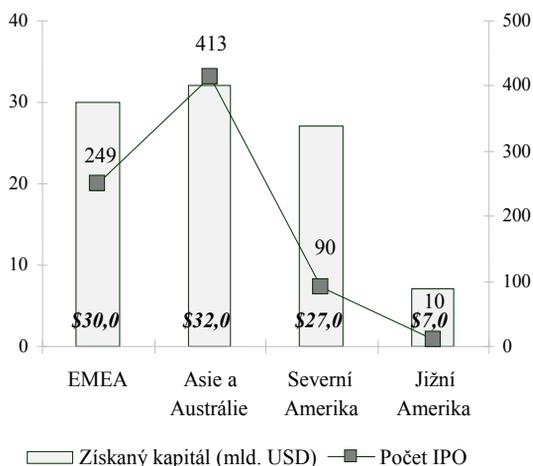
Source: Ernst & Young (2009).

<sup>1</sup> Europe, Middle East and Africa.

<sup>2</sup> And this is at least since 1995, from which data exists on the development of the number of IPOs and the value of acquired capital on world markets.

The following graph shows the number of IPOs and the value of acquired capital according to the geographical distribution in 2008. Regionally, the highest percentage of the total number of IPOs and the value of acquired capital are in the Asia-Pacific region, and this is primarily thanks to the steadily growing economy of China. In 2008 over 54 % of the total IPOs offered worldwide was in this region and it obtained more than 33 % of total world capital. The EMEA<sup>3</sup> region, which covers Europe, the Middle East and Africa, currently has a significant position in the area of IPOs as well. **In the year 2008 249 initial public offerings of stocks were launched from this region, which represented over 32 % of the total number of IPOs worldwide. This territory's portion of the total value of acquired capital is similar to the previous regions.** North America launched only 90 IPOs in 2008, which represented 12 % of the total number of IPOs worldwide. **Regardless, the returns from IPOs in this region were surprisingly high as they amounted to 27 % of the value of capital obtained worldwide.** But it is necessary to point out that this was thanks to the issuance of the Visa company, which amounted to an extreme figure of USD 19 billion (see table 1). The contribution of Latin America towards the number of IPOs and the value of acquired capital in 2008 was low, since only 10 IPOs were launched here with a total value of USD 7 billion.

Figure 2. Number of IPO and amount of proceeds according to the geographical distribution in 2008



Source: Ernst & Young (2009).

<sup>3</sup> EMEA is an acronym for Europe, Middle East and Africa.

## **ANALYSES OF THE CURRENT SITUATION IN THE AREA OF IPO ON THE CZECH CAPITAL MARKET**

Under the current conditions of the Czech capital market, funding of company development through an IPO is not very common as yet. No initial public offerings of shares (within the meaning of the above definition) have been launched in the Czech Republic until 2004. Only as of 2004, several companies can be identified on the Prague capital market, or rather the Prague Stock Exchange, that have undertaken this form of financing over time. An overview of IPOs launched at the Prague Stock Exchange is provided in the table below.

Table 1. IPOs launched at the Prague Stock Exchange

YEAR	COMPANIES
2004	Zentiva N.V.
2006	ECM Real Estate Investments A.G.; Pegas Nonwovens, S.A.
2007	AAA Auto Group N.V.; VGP N.V.
2008	NWR, N.V.

Source: own compilation.

Specialist literature sources identify various reasons of the low interest of Czech companies in funding their activities through the public issue of shares. Individual authors are unable to agree what cause is the crucial one. This fact leads to the formulation of an explanation that the core reasons of the current state cannot be found, because it is not a single problem, but several interactive problems which could be perceived differently in the past by individual companies considering IPO. All important reasons of the low IPO number in the Czech capital market can be divided into the following four groups:

- economic reasons,
- barriers of legislative character,
- barriers on the issuers' side,
- other reasons.

### **ECONOMIC REASONS**

Based on the carried out analysis of the economic reasons of the low IPO number we can state that the selected method of state property privatization, insufficient capital market regulation and protection of investors, preference of debt funding through bank credits, ownership structure of Czech companies and the overall state of the Czech economy in the early 90s of the previous century contributed materially to the fact that until the year 2004 not a single initial public share offering was realized on the Prague Stock Exchange.

## **BARRIERS OF LEGISLATIVE CHARACTER**

The unsatisfactory legislation was considered by many specialists as a material barrier for successful IPO realization in the Czech capital market in the past. The Czech legislation, in particular the Commercial Code<sup>4</sup> and the Securities Act<sup>5</sup>, contained a number of provisions which made the whole procedure of increase of the registered capital through the public issue of shares very difficult and extended the whole process materially, thus creating the legal uncertainty for IPO realization. This is why I have investigated individual legislative barriers that complicated the process of public issuance of shares in the Czech capital market in the past (mainly prior to 2001). These barriers were compared with the current legal status in order to determine whether (or not) suitable legislative conditions for the realization of the public issue of shares already exist.

From the carried out analysis of the legislative barriers it follows that nowadays the major legislative barriers, which were designated to be the main reason of the low number of the initial public offerings on the Czech capital market in the past, have been eliminated fully. The existing legal regulations concerning IPOs can be considered as corresponding to the regulations applied in the developed capital markets. Strengthening of trust in the Czech capital market and protection of public interests and investors is the objective of the existing regulatory measures. The main reason of a still low number of the initial public share offerings on the Czech capital market, therefore, had to be searched in another group of obstacles and barriers, i.e. on the side of prospective issuers.

## **BARRIERS ON PROSPECTIVE ISSUERS' SIDE**

Further obstacles to increasing the low number of the initial public share offerings in the Czech capital market could be ascribed to prospective issuers alone. This is why I realized the *primary research in Czech companies*, focused on the reasons of low interest on the part of companies in funding their activities through the Czech capital market.

Based on the results of the primary research we can state that the majority of surveyed companies still do not consider the Czech capital market as a prospective source for funding their development. Despite the fact that the majority of the investigated companies are convinced that their management is informed very well about the possibilities of raising the necessary funds through the capital market, only a few companies initiated in their history some advanced negotiations about their realization of the initial public share offering. All of these negotiations ended up with the rejection of this form of funding.

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<sup>4</sup> Act No. 513/1991 Sb., Commercial Code, as amended.

<sup>5</sup> Act No. 591/1992 Sb., Securities Act, as amended.

The carried out research has proved that the low interest of Czech companies in funding their development through an IPO is connected in particular with *good availability of bank credits*. Their granting is perceived generally as a simpler and more advantageous method than raising the funds through the initial public share offering. We have established surprisingly that the majority of the surveyed companies were of the opinion that the costs connected with acquiring the bank credit or bond issue are lower, even in the long-time horizon, than the costs connected with stock issue. The fact that the size of needed funds does not lead to an adequate volume of issue of new shares at which the IPO would be cost-acceptable can be considered as a possible clarification of this approach. It has to be acknowledged that with the rising volumes of the issue, costs of IPO realization - in the relative reflection, i.e., as a percentage of issue volume - actually go down.

On the basis of personal interviewing some of the representatives of the investigated companies, I came to the conclusion that the IPO realization costs, expressed as a percentage of the volume of the stock issue, are sometimes compared erroneously only with the annual interest rate of the bank credit. Such thinking can be a further reason, why the majority of respondents consider the initial public share offering a more expensive source of funding even in the long-time horizon, compared with the bank credit. The carried out calculations show that IPO seems to be a more advantageous form of funding than the bank credit, namely both from the point of cash flow and from the point of its impact on economic results. This is valid even if the percentage reflection of the IPO realization costs of the issue volume reaches twice the level of the annual interest rate from the bank credit.<sup>6</sup> This is because in the long-time horizon the one-time costs for IPO exceeded the accumulated level of paid interest for the whole term of the granted credit.

*The fear of possibly lost or restricted control over the company* due to the issue of new shares can be considered another significant factor, when deciding about an IPO on the Czech market. Such a situation occurs when a foreign partner starts co-operating with a Czech company and it must be added that this is quite a frequent phenomenon in the Czech Republic. Within the scope of the initial public share offering this fear can be eliminated, but to a certain degree only, by subscribing limited quantity of shares that would represent only a certain part of the registered capital to be traded in public after the IPO realization. Moreover, mainly institutional investors, which as usually do not intervene into company management, are interested in the initial public share offering.

In my opinion the above argument against IPO is partially related to the fact that a company's business activity, in particular of its management, will be much

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<sup>6</sup> If all prerequisites, determined for the illustrative example contained in my dissertation, are valid.

more thoroughly and critically monitored by the public, i.e. investors, analysts, journalists, etc., after IPO realization. The negative approach to the public offer of the stock can thus be connected with the fear of the '**public control**' of management activities, which must be absolutely transparent after the company enters the capital market. My assumption was confirmed indirectly by my personal meetings and interviews with certain representatives of the investigated companies.

Other reasons for the low interest of the Czech companies in funding their activities through IPO are connected with their scarce experience of this form of funding and also with their **unwillingness to accept the duty of regular public reporting of its activities**. This approach also proves partially the fear of the management of the 'public control' of its activities. The increased risk of revealing business plans to the competition and/or regularly repeating costs connected with fulfillment of the reporting duty can be considered the rational reason for their unwillingness to participate in the reporting duty.

The duty to report is a very significant factor affecting the investors' trust in the initial public share offerings and in the capital market in general. It has to be acknowledged that for the issuing companies such trust is crucial, because they must be sure they are really able to raise the necessary funds through the capital market. Moreover, as proved by foreign research, companies from the countries with more complex requirements for revealing information and strict regulations on the securities sector have, given other conditions remain similar, lower costs for obtaining the necessary capital.

The interviewed companies have identified the following barriers to the IPO realization: **time and organization complexity of the whole process, dissatisfaction with high costs of employing the lead underwriter and high consultancy fees paid to consultancy agencies**, and, last but not least, the **fear of possible public failure**, which might affect the company negatively. The concurrence of these factors with the aforementioned factors leads to the conclusion that the majority of respondents considers a possibility of the IPO realization under strict terms only, or totally rejects it.

## **OTHER REASONS**

Besides the above reasons of the low interest of the Czech companies in funding their activities through IPO, there can be identified certain other reasons for such a state of affairs. The lack of tax privileges and/or state subsidies for the issuing company and non-use of IPO for further privatization of the state property are considered the most important ones.

## DISCUSSION

Initial Public Offerings in the developed capital markets represent one way of obtaining the capital required for the expansion of a company. Funding in this manner is not only significant for individual stock companies, for which an IPO is an alternative to long-term funding, but also for additional development of the capital market as a whole. The use of initial public offerings of stocks fulfils one of the functions of the capital market, specifically its allocation function. Getting funding through IPOs has been in use for several decades in the USA, Japan and Western Europe. Initial public offerings of shares started to be applied on a large scale in the early 1960s. **Since that time the importance of IPOs has been growing** in the world standard. In the recent years Central and Eastern Europe has also begun to utilize public offerings, and we can identify several companies in the Czech Republic that have joined this type of funding since 2004.

Regarding the prospects of financing corporations externally through the public issue of shares, it is necessary to be aware of the fact that the activity in the IPO field closely corresponds to developments in the economic cycle. **Considering** that the financial and economic systems are tightly connected, developments in the financial market are strongly affected by both instant and expected future developments in national and world economies. **For this reason it is necessary** to keep the workings of the economic cycle in mind when issuing shares and other commercial instruments. From a macroeconomic point of view, the expansionary phase of the economical cycle (i.e. the period of economic prosperity) is considered to be the favourable time to issue IPOs. Stock capital becomes available in a growing economy because there are high expectations for profit on both the issuer's and investor's sides. With respect to the current financial crisis, it can be assumed that in next few years there will be a significant drop in IPOs in all world stock markets. We can expect that the Czech Republic will not see any further issuing of IPOs until the economy recovers and there is a subsequent upswing in the economic cycle. This unfavourable prognosis in future IPO development is confirmed by the fact that the initial public offerings of shares that should have been realized by now in the Czech capital market since the second half of 2008 have been put off till there are more favourable economic conditions to enable issuing companies to further grow and develop. There is nothing to do but hope that after the financial crisis subsides and a subsequent economic recovery arrives that other companies will enter the Czech capital market with IPOs and that there will be an expansion in the number of successful issuers in the Czech Republic. **Moreover, it is appropriate to note that just as companies diversify their assets, they should also take advantage of other forms of financing.** This would allow companies to balance the disadvantages of long-term financing together with the limited creation of internal sources against the advantages that an IPO offers.

## **CONCLUSIONS**

It follows from the research on the situation in IPOs in the Czech Republic that financing company development through IPOs, which are linked with entrance into the capital market, has not become a common practice in the Czech capital market. Comparing the present situation with the situation in international markets, it must be stated that the Czech capital market shows anomalies not only with regard to advanced capital markets such as those in the USA or Japan but also in reference to markets in Central and Eastern Europe.

The findings of the research into low numbers of IPOs in the Czech Republic show that the selected method of privatising the state-owned property had an adverse effect on the development of the Czech capital market as a place where companies can obtain necessary funds through issues of property securities or debt securities. Czech companies have not yet started perceiving the capital market as a source of financing their further development and small investors have not started seeing the capital market as an alternative to enhance the value of their temporarily free funds.

In the past, unfavourable conditions resulting from legislation and the institutional environment were considered the major cause of the long-term low numbers of initial public offerings in the Czech Republic. It follows from the results of the analysis of legislative barriers to carrying out IPOs that in recent years, a number of steps were taken to draw the Czech capital market nearer to the European standard, at least formally. Laws were passed that determine the scope and regulations for entrepreneurial activities of individual subjects, and an independent authority was set up that kept an eye on the transparency of the market and compliance with the given regulations; there are institutional and technical prerequisites available that facilitate trade in securities.

It is manifested in the research that all major legislative as well as economic barriers that in the past were considered the causes of the low numbers of initial public offerings in the Czech capital market have been removed. It is therefore necessary to look for other causes of the low number of IPOs elsewhere, that is, with prospective issuers. In view of this, primary research in Czech companies was conducted. It focused on discovering the causes of the companies' low interest in financing their activities through IPOs.

The primary research results show that even today, the majority of surveyed companies do not consider the Czech capital market a potential source for financing their development. Although the majority of the investigated companies are convinced that their management is well informed of the possibilities of raising necessary funds through the capital market, only a few companies started advanced negotiations regarding conducting an IPO. All the negotiations have finally resulted in rejecting this form of financing.

The conducted research has shown that the low interest of Czech companies in financing their development through IPOs is linked with giving preference to

debt financing, in particular through bank loans. To obtain bank loans is generally accepted as being easier and more profitable than raising funds through IPOs. Another significant element that plays its role when deciding about an IPO in the Czech setting is the fear of possible loss or restriction of control of the company resulting from the issuance of new shares. Research findings suggest that the argument against an IPO is partly related to the fact that company activities, activities of its management in particular, are to be monitored by the public in more detail and more critically after an IPO is conducted. The unfavourable attitude to IPOs may be linked to the management's **fear of 'public inspection' of their activities** that have to be completely transparent when companies enter the capital market.

Further reasons of the low interest of Czech companies in financing their activities through IPOs are connected with their little experience with this type of financing and also the unwillingness to accept the duty to disclose information about their activities. This attitude supports the above hypothesis regarding the management's fear of public inspection. Further obstacles listed by the surveyed companies as those discouraging them from an IPO include the following: an IPO is labour-intensive and time-consuming, the payments for the lead underwriter and consulting agencies are too high, and, last but not least, there are fears of failure that could have an adverse effect on the company.

For the reasons given above, IPOs are considered to be more hazardous than utilisation of alternative sources of company financing, which is closely related to the low popularity of IPOs in the Czech capital market.

Nowadays there are no more legislative and general economic barriers that used to be considered as significant obstacles for IPO realization on the Czech market in the past. Decisions to go public depend now mainly on individual companies' attitude to this form of funding and on the assessment of not only all drawbacks, but also of all the advantages connected with IPO. I think that distrust in the Czech capital market will disappear gradually and that the leading Czech companies will soon switch from their dependence on the credit funding and will be entering the Czech capital market through IPOs. It has to be acknowledged that companies diversifying their assets should utilize the multi-source funding in the same way, because it enables them to compensate the disadvantages of the debt funding, together with the limited creation of internal sources, by the advantages resulting from IPOs.

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**ANALIZA OBECNEJ SYTUACJI W OBSZARZE IPO  
NA CZESKIM RYNKU KAPITAŁOWYM**

**Słowa kluczowe:** Pierwsza Oferta Publiczna (IPO), finansowanie, Republika Czech

**Abstrakt:** Finansowanie rozwoju firmy w ramach "Pierwszej Oferty Publicznej" jest coraz bardziej powszechne na całym świecie i należy do tradycyjnych metod gromadzenia funduszy niezbędnych dla rozwoju przedsiębiorczości w krajach o rozwiniętych rynkach kapitałowych. Nie odnosi się to jednak do Republiki Czeskiej. Biorąc pod uwagę obecne warunki panujące na czeskim rynku kapitałowym, możliwe jest zidentyfikowanie tylko kilku firm, które wypróbowały finansowania w ramach IPO. Celem niniejszej pracy jest analiza obecnej sytuacji w zakresie IPO na czeskim rynku kapitałowym oraz identyfikacji przyczyn niskiej liczby IPO w Republice Czeskiej.

