



## **Raising Funds at Western Capital Markets: Opportunities for Belarusian Companies**

### **Summary**

The challenges of higher energy prices and intensified competition at export markets set new tasks for the Belarusian companies. In order to stay competitive, they have to adopt energy-saving technologies and upgrade their technological base. These endeavors require substantial investment. With this in mind, the government officials suggested companies to seek finance on Western markets. In this paper, the pros and cons of the use of foreign equity capital is discussed. Originally, an initial public offering (IPO) has been proposed as a possible route of fundraising. Although it is very likely inspired by the stunning success of the Russian companies at London and New York markets, this experience is not readily replicable. There are other markets more suitable to the current needs of the Belarusian companies in finance for investment in energy-saving technologies and restructuring. However, the Belarusian companies have to be prepared to meet the requirements accepted by foreign financial markets.

### **Contents**

1. Introduction .....	2
2. Advantages and disadvantages of raising equity capital in Western markets.....	3
3. Experience of Russian and CIS companies at raising equity capital.....	4
4. Relevance of Russian experience with IPOs for Belarusian companies .....	6
5. Some alternative ways of raising equity capital for Belarusian companies .....	6
6. Conclusions .....	8

## 1. Introduction

Recently, the Belarusian economy has faced a number of serious challenges. The first and the most apparent one is the increase in energy prices initiated by the Russian suppliers at the beginning of the current year. Even the successfully performing companies have to cope with the cost increase. Indeed, there is a growing awareness of the need to decrease energy intensity. The Directive No.3 acknowledges that the energy intensity of the Belarusian economy is at least 1.5–2 times higher than in the developed countries (with similar climatic conditions and the structure of economy). Measured in kilograms of oil equivalent per USD 1, 000 of GDP (calculated by PPP), the Lithuanian economy consumes twice as little energy, while the Polish and German economies – 2.1 and 2.7 times less, respectively. Nevertheless, such a gap suggests that energy efficiency could be substantially upgraded. So the investment into energy saving technologies could be rewarding in the sense of cost-cutting and enhancing performance of the Belarusian companies.

Maintaining competitiveness at the external markets is the second major challenge. The recent report on the state of the Belarusian business describes the competitiveness problem in the following way: 'The growth of Russia's economy and subsequent increase of well-being of its population change the character of competition on the Russian market. Growing incomes determine demand shifts as Russian consumer prefer to buy more expensive and better-quality consumer goods, while Belarusian producers traditionally serve the needs of the poorer income groups. In order to maintain their positions at the Russian market, Belarusian companies are supposed to reposition their production' accordingly (Chubrik et al. [2007], p. 23). At the same time, imports of consumer goods both from the CIS and the non-CIS countries have been growing, thus reflecting some deterioration of competitive positions of Belarusian companies at home.

The adjustment to the increased energy prices and intensified competition require long-term and sustainable solutions, such as technological upgrade and modernization of Belarusian companies. For that purpose, substantial investment is required. There is a range of options for companies to finance investment and conduct restructuring. Some enterprises have opted for foreign borrowing (often, in the form of commercial credits). In particular, the National Bank of Belarus indicates that the volume of foreign debt<sup>1</sup> accumulated by 'other sectors of the economy' (that typically incorporates enterprises) went up by 35.2% between January and April of 2007 (in contrast to 0.7% in January–April of 2006).

However, there is another opportunity that has recently been announced by officials. In May 2007, the Deputy Prime Minister, Mr. Vladimir Semashko, said that Belarusian oil-processing and petrochemical companies would be encouraged to seek finance on international markets via initial public offering (IPO). According to him, it is only minor (10–15%) holding of stock to be offered for sale<sup>2</sup>. The Deputy Foreign Minister of Belarus, Mr. Andrej Evdochenko said that petrochemical companies are most prepared to utilize the IPO<sup>3</sup>, but in the future other leading export-oriented companies could follow the track.

In the past, some governments have also been keen to induce domestic companies 'to go public' to maintain their international competitive position. For instance, in the 1980s, the French government put pressure on firms and encouraged companies to seek finance on international markets. French policy-makers sold off the state's holdings in banking and industry, expanded the Paris stock exchange, welcomed foreign

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<sup>1</sup> <http://www.nbrb.by/statistics/ExternalDebt/>

<sup>2</sup> <http://news.tut.by/economics/88001.html>

<sup>3</sup> <http://telegraf.by/belarus/2007/05/20/bum/>

investors (that soon became the owners of about 40% of shares of French companies), and fostered a competitive market for corporate control. As a result, the performance of the French economy has improved (Hall [2007], p. 55).

In Belarus, coping with energy shocks and maintaining competitiveness requires long-term investments. One of the promising opportunities of financing investment and restructuring is via raising equity capital at Western markets. In this paper, the advantages and disadvantages of this option are thoroughly explored and the experience of the Russian companies with the IPO is discussed. On that basis, some other routes to fundraising are suggested.

The structure of the paper is as follows. The next section discusses the pros and cons of 'going public' by companies that plan to enter Western capital markets. The third section reviews the experience of Russian and some other CIS companies at raising equity capital abroad, while the fourth section examines the relevance of this experience for Belarusian enterprises. Accordingly, the fifth section suggests some alternative ways of raising equity capital for Belarusian companies. The sixth section concludes.

## **2. Advantages and disadvantages of raising equity capital in Western markets**

Why to use equity finance at all? The decision to take a company public should not be considered lightly despite some attractive advantages. The most obvious one is increased capital via access to a larger pool of international investors as well as different types of capital. It could also be stressed that selling of ownership stakes to investors is not an alternative, but an additional way of attracting capital. As a result, multiple financing opportunities are created for the company (bank loans, own funds, equity, etc.).

One of the major advantages is the access to a new international pool of investors possessing virtually unsurpassed liquidity. Capital can be raised for various purposes such technological upgrade, restructuring, expansion of plant and/or equipment, marketing purposes and so on. Public companies are more visible and this able to have access to larger pool of capital as well as different types of capital. Accordingly, the limitations of the domestic banking system can be overridden.

When compared to the other ways of raising capital, equity is not cheaper than debt or loans. Equity is typically the most expensive form of finance available to a business. This is because equity investment is one of the riskiest forms of investment open to an investor. Accordingly, investors demand higher returns to offset the greater risks that it might contain. However, the returns are performance-related so there is no need to pay the interest in case of economic troubles. But investors would not invest into an underperforming company. More importantly, investors themselves are capable of influencing the company's performance. They have a right to say about the direction the funds are used in order to sustain their belief in a company's future prospects. Naturally, they would demand the most efficient use of funds they put into the company. Otherwise they would unload their holding of shares. Also, companies have to establish effective and timely communication to investors. After the equity is issued, ongoing discussions with investors and analysts have to be held.

Often, going public allows a more objective valuation of the company in contrast to subjective estimates made by private valuers. This is among the reasons the government of Belarus had in mind while announcing the possibility of the IPO for Belarusian enterprises. In the words of the Deputy Prime Minister, Mr. Vladimir Semashko, the IPO 'would allow to find out the real market value [of these companies] necessary

when making deals with strategic investor<sup>4</sup>. In case state-owned companies would be fully privatized in the future, companies could be sold at higher price thus maximizing fiscal revenues.

The presence of external shareholders also implies that the responsibility of the company's management is increased. The failure of the managers to run the company properly could result in the loss of capital. This has certain costs since the company can not attract new funds immediately. Moreover, the reputation of the issuer could be undermined. Participation at Western capital markets contains such aspects as visibility and prestige. But public companies face significantly higher scrutiny than 'closed' companies. For the newcomers at the capital markets, it is of particular importance to gain reputation by presenting itself as a well-performing, open, and efficiently managed company which is capable to demonstrate sound and sustainable market performance over the medium to the long run.

As for the Belarusian companies, access to capital and higher valuation are among the most likely reasons the government has in mind so far. At the beginning of this year, the Deputy Prime Minister, Mr. Vladimir Semashko, claimed that the Belarusian companies should conduct an IPO by the end of 2007. Recently, the officials confirmed their intention to encourage oil processing companies to use IPO in order to attract up to USD 200 m. The intention is to offer a fraction (10–15%) of holding of stock of the oil refineries and probably some other Belarusian companies to investors on the foreign stock exchanges. Nevertheless, the latter's names have not been disclosed.

### **3. Experience of Russian and CIS companies at raising equity capital**

Among the companies from the CIS, Russian corporations are the pioneers of the IPO at the Western markets. The preferable placement is often the London Stock Exchange (LSE), and specifically the Alternative Investment Market (AIM) utilized by new companies with little performance record. In general, Russian companies seem to utilize the IPO rather actively both at home and abroad, preferring such 'prestigious' grounds at London and New York.

The first Russian company to ever issue an IPO on a foreign exchange in 1996 was VypelCom (telecommunications). For that purpose, the New York Stock Exchange (NYSE) has been used. Since then, Russian companies listed on the NYSE have included Mechel (metallurgy), Tatneft (oil), Rostelecom (telecommunications), and Wimm Bill Dann (foodstuffs). The total market capitalization of these companies reached USD 26 bn in 2006. The US-based NASDAQ has two Russian telecommunications companies listed on its market: Golden Telecom (a market cap of USD 1.75 bn), and Moscow Cable Com (a market cap of nearly USD 90 m). However, from 2005 onwards, listing on either the NYSE or the NASDAQ has been curtailed. One of the reasons is the adoption of the burdensome Sarbanes-Oxley act along with the added distance across the Atlantic that have put the U.S. exchange at disadvantage. So the preference for Russian and some other CIS companies has turned to London as a venue for raising capital.

In 2005, the Russian IPO boom unleashed. In 2005 Russian companies collectively raised nearly USD 5 bn by listing their shares in London, New York, and Moscow. In 2006, Russia has occupied the 5<sup>th</sup> place in the world according to the volume of the IPO (USD 15.0 bn). In the current year, 85 companies from Russia would conduct the IPO, while 185 companies have declared their intention to complete it by 2011. The largest IPO has been conducted by the state oil company Rosneft by ABN Amro, Goldman Sachs, JP Morgan, and Morgan Stanley. The issue is USD 10.6 bn, and it is the largest emerging markets IPO ever.

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<sup>4</sup> <http://news.tut.by/economics/88001.html>

The LSE seems to be the most preferable foreign location for Russian companies. In 2006, about 80% of trading on the LSE international order book is now in Russian shares, while the Russian companies raised as much as USD 15 bn. It is expected that in 2007 the volume would reach USD 30 bn, while between 1991 and 2004, it is only USD 2 bn had been raised. Since 2005 the London markets has seen such Russian companies as Sistema, Severstal, Pyaterochika, Evraz Holding, Rambler Media, Novatek, Urals Energy, Amtel, Novolipetsk Iron Company, Comstar, Cherkizovo, and Rosneft. What is specific for the Russian IPOs is both the increase in the volume of raised capital and the widening range of sectors. It is not only commodity producers, but also banks, insurance companies, technology firms, telecom companies and media businesses that step into the market. The IPO is not related to a particular profile of the company.

The shift to London has been motivated by its proximity and also some 'tuning' to the emerging markets (and particularly the CIS ones). Also, the London market has been more proactive in encouraging AIM as alternative, easier-access ground and such instrument as the Global Depositary Receipts (GDR) (the latter is a negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on an exchange of another country). These alternative listings have less stringent requirements and provide a company with the opportunity to experience life as a public company before transitioning to a full listing at the LSE's Main Market.

As for the companies from other CIS countries, Kazakhstan's largest producer of copper, Kazakhmys, conducted the third largest listing of an international company on the LSE in 2005 by raising over USD 1 bn in October. Ukraine's food company, UKRproduct attracted nearly USD 9 m by listing its shares on the Alternative Investment Market (AIM) of the London Stock Exchange (used for smaller companies). However, Ukrainian and Kazakh companies have also penetrated the German markets to make listing.

Indeed, the Russian IPOs reflect the maturity and transparency of many Russian companies. The businesses are profitable so the IPO is utilized as an additional opportunity for the owners to cash in. However, for a number of companies listing is also about the status. The London market is a prestigious ground. Also, some political aspects could be mentioned. The IPO boom is taking place before the 2008 elections in Russia with some uncertainties related to them. It is likely that the Russian companies try to capitalize on the current 'appetite' of investors that in the future could start to consider political risks more closely. Some experts argue that the current strong performance is determined by the 'cheapness' of the Russian equity market in terms of a price/earnings basis<sup>5</sup>. This is relevant to the Russian oil and gas companies in terms of their asset-based evaluation. Accordingly, investors are keen to get a share of the company now until it becomes dear.

The recent survey of 63 Russian companies made by consultants Heidrick & Struggles<sup>6</sup> says that at least of 40% of them consider an international listing. Also, now more than 100 Russian companies are preparing for an initial public offering. However, the authors admit that often companies are controlled by small groups of shareholders, while the minority ones have to be sufficiently protected. The survey discloses that only a half of the Russian companies considering an IPO abroad have independent directors. But this is often essential for an international listing. For instance, the UK code of corporate governance stipulates that independent directors should make up not less than a half of a company's board. The New York Stock exchange requires the number of independent directors to be the majority.

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<sup>5</sup> <http://www.czech-transport.com/fne-portal/index.php?aid=125>

<sup>6</sup> <http://www.reuters.com/article/newIssuesNews/idUSL0923474420070329>

#### **4. Relevance of Russian experience with IPOs for Belarusian companies**

There are no clear reasons to refute such opportunity since the very outset, but one of the key problems is timing. Given the gas and oil conflict between Belarus and Russia, and a painful, albeit gradual, energy price increase, Belarusian companies might require funds in the shorter term to invest into restructuring and financing important investments.

In fact, a successful IPO can take up to three years to complete, and the underwriter's fees can range from 3% to 10% of the offering's value. But it is not about paying money and then having the company listed abroad. Listing does not automatically guarantee the interest of international investors. The very process of the IPO demands from the company, among other requirements, to implement international accounting standards and disclose the volume of profits earned. In essence, the IPO can only be utilized in case the company is ready to accept a high level of transparency. The provision of information should also be done on a regular basis so the investors would monitor the company's performance.

In a way, the analogy with the consumer's decisions can be used here. Investors are like consumers making choices over buying a particular commodity in accordance with its usefulness. As for investors, they are interested in returns to their invested funds. Some products like food or clothes are purchased continuously. So if a company seeks consumers to be loyal to the brand it offers, a good should meet the preferences of consumers. But people should know the quality of the goods they buy. Consumers collect their information about the goods they want to buy from advertising. The latter has to be convincing for buyers. Investors sacrifice their money only in case of assurance to get their money plus the expected returns back. For that purpose, they have to be able to monitor the company's performance in order to be confident about its ability to generate profits in the future. That is why the transparency rules are applied to. The transparency requirements can be compared to the laws that protect consumers by protecting unfair, consumer-deceiving advertising. In both cases, the reason is to make sure that people are provided with correct information. But in the case of equity investment, the requirements are served to protect megabuck investments.

As for the IPO, one of the basic requirements is to provide accounting reports made according to the international standards (this is to make the company's performance accessible and comprehensible to foreign investors) over the period of three years (backward reporting is not allowed). It appears that in case the decision to conduct the IPO is made at the end of 2007, it would be realized not earlier than in 2011. Fundamentally, the observation of listing requirements is not about mechanical fulfillment of certain predefined obligations, it goes deeper to touch upon such aspects as protection of minority shareholders' rights and corporate governance. But it is more proper to start launch investment programs earlier in order to meet the challenge of higher energy prices and the task of enhancing competitiveness. In this situation, a real perspective for the Belarusian companies is to use less strict, but still viable and important ways of raising funds.

#### **5. Some alternative ways of raising equity capital for Belarusian companies**

Typically, issuing equity requires consumption of time and expenditure. Among various options, the IPO is the most time consuming and expensive process. For the Belarusian companies in particular, the key challenge is disclosure rules. Their extensiveness varies depending on the market, but often includes information regarding compensation of senior management, transactions with parties related to the company, conflict of interest, competitive positions, how the company intends to maintain its market position and expand it in the future, material contracts and lawsuits. These requirements are rather new for the Belarusian companies.

As the experience show, the information about the performance of major companies in Belarus is still scarce. What could be collected from the public sources, for instance, is only occasional information that leaks into the media, like the profitability of some major companies, the amount of taxes they paid into the budget, and the average wage of employees in a particular sector. In contrast, the IPO requires broader publicity (including compensation to senior management, profits earned by the company, etc., while information has to be updated regularly) as a requirement to be fulfilled against the selling of a small share of the company.

Fundamentally, there are different routes to raising funds abroad and therefore gaining one or several of the above-mentioned advantages. The fully-fledged IPO is not the single way: there are other, less demanding ways to reach the international markets. While entering equity markets, the Belarusian companies should be aware of the increased competition among the issuing companies. It might well be the case that the demand for the equity issued by the CIS companies is not inexhaustible and future issuers are unlikely to achieve the 'aggressive pricing' that many of their predecessors did.

When making the decision about the issuing equity, companies have to detect the costs. Fees charged in the underwriting process vary across the stock exchanges. A consulting company 'Oxera'<sup>7</sup> emphasizes that 'underwriting fees generally constitute at least a half of all direct IPO costs'. The report made by the company maintains Europe/US differences in terms of underwriting fees are likely to have a more significant impact on the comparative cost of raising equity in different markets than differences in the other direct costs' (July 2006, p.2). The analysis of various IPOs from January 2003 to June 2005 reveals that the gross spreads of IPO on the US exchanges appear to be the highest, averaging from 6.5% of issue proceeds for IPOs on the NYSE and 7% for NASDAQ IPOs. In comparison, spreads on the LSE's Main Market are 3.25% and those on the AIM are 4%. At the same time, fees charged in the underwriting process in the European markets are lower. In the US, these fees amount to 6.5–7% of the issue, while in Europe this figure reaches 3–4% (according to the calculations are jointly made by Bloomberg and Oxera). In the USA, the higher legal and auditing costs are largely attributed to the costs of complying with the requirements of the Sarbanes-Oxley Act 2002.

There are other cost components, such as listing fees charged by the exchanges. But these constitute a negligible amount of the total cost of raising new equity (often less than 0.1% of the amount issued regardless of the exchanges on which the securities are listed). Other direct IPO costs include legal, accounting, and advisory fees, as well as marketing and PR costs. Taken together, these costs tend to add from 3 to 6% for most issuers. Nevertheless, data on these costs are typically not available in the public domain.

The choice of market is not only determined by the costs of raising equity. Stock exchanges have different standards that signal differences in the commitment of companies to better governance and disclosure. In a range of source, the UK is ranked as the leading country in terms of corporate governance. A listing on London's Main Market should deliver the greatest benefits in this respect, closely followed by the USA and Germany.

Given the experience of the CIS companies (Russian, Kazakh, and Ukrainian), the IPO can be a second step (if the need arises), while the proper starting point is the use of less demanding markets. In contrast to the Russian companies, their Ukrainian counterparts reach the European (and particularly German) markets via the Frankfurt Stock Exchange. In particular, the Ukrainian companies have been using the markets

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<sup>7</sup> <http://www.oxera.com/>

in Germany for dual listing. The European platforms are not only 'cheaper' in terms of underwriting fees, but also characterized by less stringent regulations. Also, there are opportunities to use issuing schemes other than the IPO.

The Frankfurt Stock Exchange, the major German market, has three levels the companies can choose among depending on their willingness to accept disclosure rules. The first step is the Open Market used by most of the largest foreign companies (like Nokia, Microsoft, Gazprom, etc.). This segment is regulated by German laws, and the cost and time efficient way to enter capital markets in Europe. In order to enter this market, it is enough for the company to submit the Exposé requiring one year of operations and financial reporting (that can be done according to the national standards) audited by a certified auditing company (that can also be local).

The next level is a sub-segment of the Open Market called 'Entry Standard'. It has slightly stricter selection rules, but equity can be issued within three months. Formally, the company can still submit the Exposé, but in practice the Prospectus is demanded. The Prospectus requires the three-year report done in accordance with the International Financial Reporting Standards (IFRS) (although US, CA, J-GAAP standards are also possible to use for that purpose). The company has also to launch the regularly updated web-site to describe its profile. Importantly, any facts occurring in the company's field of operation have to be published due to their effect on the company's assets or financial situation, or on the general development of the issuer's business. It is, neutral assessment of the events has to be published, and not the advertising.

The third level is the market regulated by the EU laws. It is called the Main Market that has two standards. The primary standard has the strictest rules and regulations, and typically suitable only for the largest companies. The General Standard includes the rest of the large and mid-caps. Both standards require meeting transparency standards defined by the EU law. The EU requirements include, among other aspects, provision of annual and interim reports based on the IFRS standards and disclosure of management's dealings. Also, ad-hoc publicity s required (all company's events have to be made public).

Among these three levels, Belarusian companies can seriously consider targeting of the Open Market. The experience of the Ukrainian companies shows that only one Ukrainian company from that country has been able so far to issue shares according to the rules of the Entry Standards. Its market cap is almost USD 1.1 bn, while the company submitted the 2.5 years of financial report (done according to the IFRS standards). As for the Open Market, only one year of financial reporting (done by national standards) is required. This segment is also suitable for strategic investors. Further, the upgrade to the Entry Standard is possible that requires the reporting according the preparation of the IFRS financial statements. In fact, this is a very close step to the fully-fledged IPO. Although the majority of the Ukrainian companies is listed via dual-listing process (i.e. their shares are traded at Frankfurt and Kyiv markets), it is possible for the company from Belarus to enter the trading in Frankfurt without its shares being listed in Minsk (so the activation of the domestic stock exchange is not the essential requirement).

## **6. Conclusions**

New terms of energy supply to Belarus have forced domestic companies with increasing costs. Also, the intensification of competition at one of the major export markets has made the issue of international competitiveness more acute for the Belarusian exporters. In order to meet these challenges, Belarusian companies have to conduct substantial volumes of investment into energy-saving technologies and modernization.

In its turn, the Belarusian government is aware of the needs for increasing energy efficiency and restructuring. Recently, the intention to encourage some state-owned companies 'to go public' by offering a minority share at the stock exchanges abroad, has been announced. There is a range of advantages that the equity issue offers, including the access to capital, less pressure on liquidity, and positive influence of investors about the direction in which the funds are used. But these advantages would only materialize as soon as transparency requirements are respected. These requirements are established in order to provide investors with comprehensible information about the company's performance and thus give them the chance to estimate the risks their investments contain.

Originally, the officials have mentioned the IPO as a way to raise capital. But the requirements of this process result in substantial time and money costs. Given the intention of the government to launch this process already in the short-term, other ways of raising capital can be suggested.

Ukraine's experience shows that the Belarusian companies might seriously consider the use of the German markets and particularly their segments uncovered by the stringent EU transparency laws. The process could be realistically started with the technical listing by accessing the Open Market, with the further upgrade to the IPO in three years or even more. At the same time, it should be recalled that the market for the equity from the CIS is not inexhaustible. The Belarusian companies are likely to face the increased competition with large companies from other CIS countries, and Russia in particular. Russian and Ukrainian companies are more experienced in the equity issue, while the Belarusian ones would be the beginners. Nevertheless, some positive influence from the equity investors and toughening competition for capital would likely produce a positive impact on the efficiency of the Belarusian companies.

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