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# EXECUTIVE SUMMARY

# SMALL FIRMS AND THE INITIAL PUBLIC OFFERING – THE ISRAELI CASE

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The Koret-Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental issues. The program focuses on connecting government, philanthropic, and business resources that are vital to national growth and development.

Directed by the Milken Institute Israel Center, the Koret-Milken Institute Fellows Program awards annual fellowships to outstanding graduates of Israeli and international institutes of higher education. Fellows serve yearlong internships at the center of the nation's decision-making—the Knesset, government ministries, and other Israeli agencies—and aid policymakers by researching and developing solutions for various economic and social challenges.

In addition, fellows craft their own policy studies aimed at identifying barriers to economic and employment growth in Israel. The fellows' studies, carried out under the guidance of an experienced academic and professional staff, support legislators and regulators who shape the economic reality in Israel. The program offers the ultimate educational exercise, combining real-life work experience with applied research five days a week.

Throughout the year, fellows receive intensive training in economic policy, government processes, and research methods. They acquire tools for writing memorandums, presentations, and policy papers, and they develop management, marketing, and communication skills. The fellows participate in a weekly workshop, where they meet senior economic and government professionals, business leaders, and top academics from Israel and abroad. They also participate in an accredited MBA course that awards three graduate-level academic credits that are transferable to other universities in Israel. The course, which focuses on financial and economic innovations, is taught at the Hebrew University of Jerusalem's School of Business Administration by Professor Glenn Yago, Director of the Milken Institute Israel Center and Director of Capital Studies at the Milken Institute in California.

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve as advisers to government ministries while others work at private-sector companies or go on to advanced studies at leading universities in Israel, the United States, and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, bringing about economic growth, and improving the quality of life for Israeli citizens.

The Koret-Milken Institute Fellows Program is nonpolitical and nonpartisan. It is funded by the Koret Foundation, the Milken Institute, and other leading philanthropic organizations and individuals in the United States and Israel.

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# Executive Summary

The initial public offering, or IPO, is a popular and significant capital-raising vehicle for companies. Although receiving wide coverage in academic literature and practice because of its importance, academics have paid little attention to the size of companies that issue shares in IPOs, particularly those with small market capitalizations. This is surprising given empirical evidence that suggests small-cap companies constitute the majority of companies traded on stock exchanges.

Small-cap companies are usually characterized by a concentrated ownership structure, unsatisfactory liquidity and a significant lack of information. This study analyzes data unique to the Israeli market to evaluate the success of IPOs for these companies and make recommendations with regard to small-cap IPOs and financing alternatives.

The Israeli stock market experienced abnormally high IPO activity from 1992 to 1994 with 356 companies listing, compared with 313 companies that conducted IPOs from 1985 to 2010, excluding that "bubble period." Of the companies that raised less than NIS 50 million each during the "bubble" period, about 55% had stopped trading by mid-2011. Tel Aviv Stock Exchange-listing rules were relatively loose during that time of high market activity, enabling firms to list that otherwise would not have qualified. At least one-third of the companies that issued shares to the public during that period could not have done so under current rules.

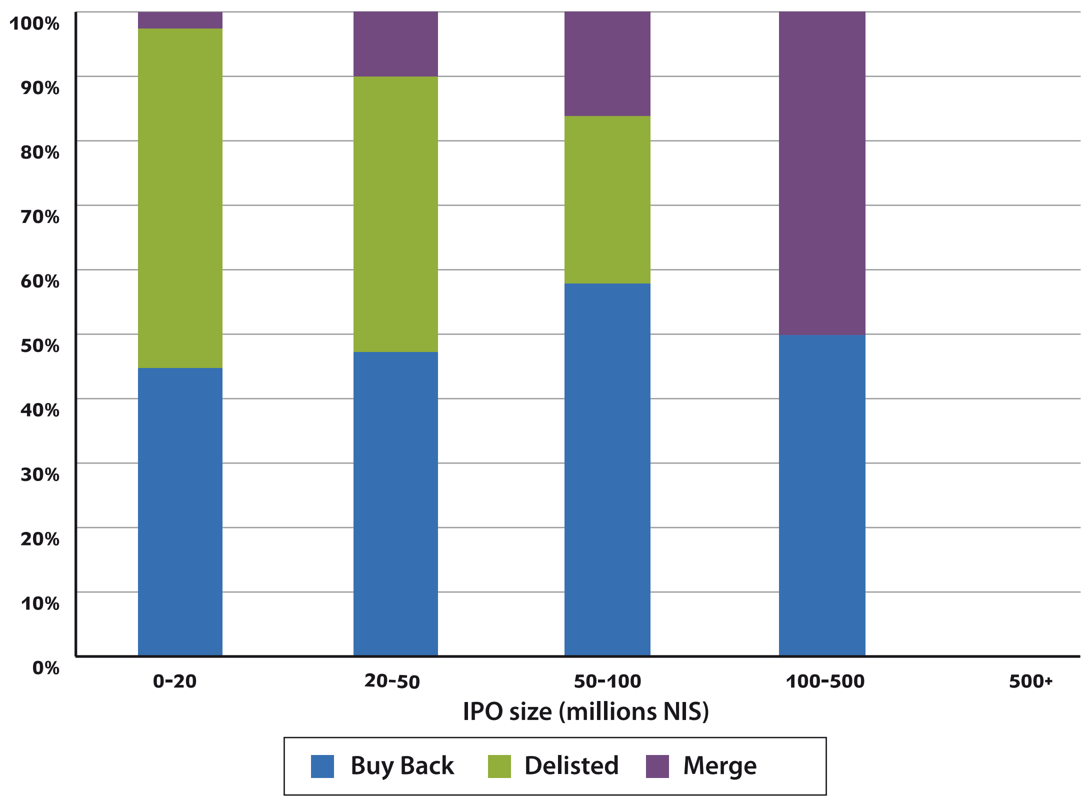
This event produces a sort of "natural experiment" that allows the evaluation of the effect of regulation and listing rules on IPOs and the trading of small-cap companies. An analysis of a sample of IPOs was performed on two complementary groups -- companies that issued shares to the public in the "bubble" period and have since stopped trading and those that sold shares to the public during the period and are still trading on the TASE.

The analysis of firms that stopped trading showed three main reasons for the halt.

- **Buyback.** The controlling shareholder repurchases the shares and takes the company private.
- **Delisting.** The company does not comply with TASE liquidity, market capitalization, and/or regulation rules and is delisted.
- **Merger or Acquisition.** The company is purchased by another firm and its shares stop trading.

As opposed to large-cap companies where mergers were the more prevalent reason for a trading halt, in the case of the small-caps analyzed, the most significant reasons were buyback and delisting. The chart below shows that the relative share of delisting decreases with IPO size, while the relative share of mergers increases with IPO size. A merger can be considered a good signal of the firm's quality whereas delisting indicates bad quality since the firm doesn't comply with listing requirements.

Figure 1. Causes of trading halts of IPO's of 1992-1994




The analysis of stock purchases by controlling shareholders revealed a negative correlation between the TA-100 index and the shareholders' ownership. This means the shareholders issued shares to the public during the market peak (sold high) and repurchased the shares during the market slump (bought low). While this evidence alone cannot be used to claim causality, it is consistent with the asymmetric information problem where the controlling shareholder uses his superior information to his benefit as he takes the profitable side of the deal and the public takes the other. Because the controlling shareholder is involved in the firm's operations and strategic planning, he possesses superior information about the true value of the company's assets.

Minority shareholders, meanwhile, must rely on share price as their primary source of information. In the case of small-cap companies, however, these prices aren't a reliable source given the illiquidity those shares. The average number of small-cap shares traded is only 38% of the average number for larger companies. This illiquidity results in a lack of information for the minority shareholders, providing the controlling shareholder with an informational advantage.

Meanwhile, the prevalence of delisting among small caps suggests that the companies that issued shares were of low quality because they could not comply with stock-exchange standards and provide good-quality trading.

The supplementary analysis of companies still trading following their "bubble-period" IPOs focused on several indicators of their trading quality, as well as measures of their ability to exploit growth opportunities and increase market capitalization. The indicators of trading quality examined were trading frequency and trading volume. Market capitalization increase and inclusion in one of the TASE indexes were used to measure company growth. TASE-index inclusion is a good measure of a company's success because it implies the firm is up to the exchange's standards, signaling the company's strength and quality.

The analysis shows that even those small firms still traded are characterized by low-trading activity, thus suggesting that the share price reveals little information. With respect to inclusion in indexes, fewer than 3 percent of the companies have a market capitalization that qualified for listing in the TA-100 index (other requirements of the TA-100 were not examined), indicating their inability to grow and improve.

Internationally, stock exchanges in Europe have made several attempts to solve, or at least alleviate, the problem of small companies by offering designated platforms to trade small-cap shares. In this scenario, the listing of the small companies on the stock exchange can be implemented in two stages. In the first stage, the company introduces trading in the designated platform with less stringent regulation and reduced fees, providing the company with an adjustment period. Once trading is stabilized and the company is ready to comply with the regulation standards, it can graduate to the established trading platform and list its shares on the main floor of the exchange. The result of these efforts was an initial burst of IPO activity for small-cap companies listing their shares on the designated exchanges, but the final result was low liquidity, high delisting rates and few firms transferring to the main exchange.

While a direct comparison with Israel is inaccurate because of different market structure and company characteristics, the European and Israeli experience seems to suggest that the issue of low-trading quality for small companies cannot be resolved by less stringent regulation and reduced fees. Rather, the problems associated with the trading quality of small-cap companies emphasize the need for appropriate listing rules, and the asymmetry of information problem suggests that alternatives to the IPO should be considered to fund the operations of small companies. Alternatives that allow monitoring and thus alleviate asymmetry of information are banking finance, venture capital and private placements.

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