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Determinants of IPO readiness in emerging markets: the case for Ugandan firms

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The purpose of this study was to identify determinants of initial public offers readiness in large firms that have not yet sought to raise capital through a stock market. Following a series of focus group discussions, a conceptual framework is developed to determine micro determinants of initial public offers readiness. Since the firms face the same set of macro and market constraints, these are taken as a constant. The micro determinants are then regressed against a set of criterion indicators using logistic and multinomial logistic regression models and panel data collected from 35 firms for the financial years 2003–7. The fitted models show that age, level of disclosure, legitimacy of the board (inclusion of independent non-executive directors), and level of market activity (information asymmetry) are significant determinants of initial public offers readiness of the firm. Also, firms in Uganda do not meet most of the criteria for listing because they have not taken the requisite steps to improve governance by separating roles of the CEO and chairman, publishing accounts, and reducing single party control of their boards or making their shares transferable. This study provides empirical evidence of the direction policy formulation should take in order to grow and deepen financial markets in emerging or underdeveloped economies.

Keywords: black box syndrome; information asymmetry; legitimacy; IPO readiness; Uganda

1. Introduction

Stock exchanges are a modern focal point for raising cheap long term capital and for the mobilization of savings. They help increase transparency in the privatization process by encouraging wider share ownership and improve efficiency in resource allocation through a competitive mechanism. They increase liquidity and provide risk capital for trail blazing ventures (Wang and Ang 2004). They also help release idle funds for investment because they generally provide higher rates of return than alternative investments. When successful, activity in the market provides a strong impetus for economic growth (Wagacha 2000b). Despite these advantages, the growth of the stock exchange in Uganda has been relatively slow, and has especially received a poor response from private companies wishing to raise capital.

The Uganda Stock Exchange (USE) started operations in January 1998. Since its inception the USE has listed only 11 equities, five of which were cross border listings.
All the local listings were a result of government divestiture of all or part of its interest in formerly public enterprises. Despite the oversubscription of the initial public offers (IPOs) for the local listings, there have not been any flotations or IPOs involving private initiatives/local companies since the inception of the USE. This implies that businesses/entrepreneurs, other than public enterprises (PEs) which were listed mainly for structural adjustment reasons, are not taking advantage of the USE as a vehicle for raising capital. Trade volumes remain relatively low (April 2010 = US$ 2.577 million) and the total market capitalization is about US$ 4,800 million (www.use.org.ug May 2007). Furthermore, out of the total market capitalization, only about US$ 850 million is accounted for by local listings. This is in contrast to international emerging market trends (Blommestein 2003) which show rapidly increasing volumes and trends in stock market activity.

The advantages of well developed markets are legion. The development of a dynamic market automatically increases the level and sophistication of financial intermediation in an economy while offering to the investing public a myriad of financial products. This sophistication promotes economic growth through increased access to savings and risk diversification. A typical market comprises several institutions including banks, insurance companies, mutual funds, mortgage firms and finance companies which all contribute to resource mobilization. As a result, governments can also finance their deficits through the market and reduce fiscal pressure on the banking system. This can help bring down the cost of capital by reducing the public sector borrowing requirement (psbr) through the central bank.

Despite of all these apparent benefits stock exchanges, countries in sub-Saharan Africa (SSA) and have continued to perform dismally. Several reasons have been advanced for the poor performance of stock markets, including interest rate policy, taxation systems, legal and regulatory frameworks, lack of expertise and lack of technological progress (Wagacha 2001a). These reasons may not hold up to critical scrutiny because of the successful IPOs that have been carried out. Furthermore, it could be cheaper to raise capital on the stock exchange since IPO costs are tax deductible. Private firms are also privy to the benefits of stock exchanges, but seem to have avoided the stock market as means of raising capital. There also seems to be a concern that the risks associated with the required disclosure for IPOs are not adequately compensated by additional returns.

The objective of this paper is to examine the factors impeding the growth of the USE as a vehicle for raising capital by private firms. Why are local private firms and entrepreneurs not raising additional capital through the IPO route? The paper is divided into five sections. Section 1 is the introduction, while section 2 is the literature review. Section 3 is the methodology while section 4 and 5 cover the findings and discussion respectively. Section 6 is the conclusion.

2. Literature review

2.1. A theoretical framework

Most of the literature on theories of why firms go public hinges on the costs and benefits of public versus private ownership that confront private firms (Rosen et al. 2005). Various models have been developed to show the types of benefits and costs that influence the IPO decision. One of the earliest models by Zingales (1995) attempts to show how an original seller sells shares in a competitive market, thereby capturing the surplus associated with an increase in the value of cash flow rights.
associated with a future change in control. The owner retains enough shares to retain voting control so that he can subsequently extract some of the eventual buyers’ private benefits. The optimality of an initial IPO is conditional on a subsequent buyer’s ability to increase the firm’s cash flows. In this instance the IPO serves as a precursor to the firm being acquired. In an alternative model (Mello and Parsons 1998) it is argued that the firm’s owner receives valuable information from dispersed investors. This information is to the effect that the value that an owner can obtain from the sale of a controlling interest is much higher than that currently held. Going public reveals information as to whether a sale to new owners increases firm value thereby allowing the original owner to extract a larger fraction of the surplus.

Another model by Chemmanur and Fulghiere (1999) predicts that a firm goes public when information gathering costs are low or when enough information about the firm has been accumulated in the public domain. Subrahmanyam and Titman (1999) posit that outside investors acquire information about the firm that insiders lack and this information can be used to improve the firm’s investment decisions. When outsiders can discover this valuable information at low cost, the firm will go public, otherwise it remains private. A corollary to this argument is that as firms grow older, information gathering costs reduce because information about their activities becomes widely available in the public domain. This may be a result of their size, which imposes political costs, hence improved disclosure or dissipation of their ownership.

Pastor and Veronesi (2003) model the optimal IPO timing decisions of private firms. They show that firms decide when to exercise an option to go public and the value of this option rises when expected market returns fall, when aggregate profitability is high, and when uncertainty about future aggregate profitability rises. Their model predicts that IPO waves caused by declining expected market returns are preceded by high market returns. IPO waves driven by increased aggregate profitability follow periods of high market returns.

Boot et al. (2003) envision entrepreneurs trading off the benefits of greater ‘elbow room’ when running a private firm against the higher cost of capital associated with greater managerial autonomy. The empirical predictions of this model are tied to variations in restrictiveness of corporate governance regimes. Lack of data on private firms, however, creates a significant obstacle in attempting to test these models in an underdeveloped economy. Most unregulated private firms are closely held corporations with no legal obligation to make public disclosures regarding their financial performance. Their governance structures are also constrained by the level or extent to which management is separated from ownership. Usually, there is no distinction between the two, making it difficult to construe a classical principal–agent relationship.

2.2. Why do firms go public?

There are several explanations as to why firms go public. Conventional wisdom suggests that the public offering represents a stage in the growth of a firm (Jain and Kini 1999; Mikelson et al. 1997) at which it attempts to raise cheap additional funds through the IPO. In the post-IPO phase, the firm can evolve into one of three basic states. It can survive as an independent firm, fail outright or get acquired and lose its current identity. What is clear is that private firms with growth prospects eventually go public to finance investments, all other factors being constant. This however does
not explain the existence of several large successful private firms with further growth prospects.

Another school of thought in the literature suggests that firms go public not to finance growth but rather, to rebalance their accounts after a period of high investment and growth (Rydqvist and Hogholm 1995). This finding, which is based on empirical data for Italian, Swedish and Spanish companies, is rather surprising because it is counterintuitive. One would expect that firms would have no need to go public having raised capital from elsewhere for growth and expansion. Once growth opportunities have been extinguished, the need to go public so as to raise additional capital disappears.

A third explanation for going public is that an IPO represents the first stage in the sale of the firm (Zingales 1995). Firms make an IPO in order to obtain a market valuation for their assets, which facilitates the sale of the firm either gradually through reduction of ownership or immediately through an acquisition. A stock market listing enables companies to know the value of their investment at any time and thus provides a yardstick for evaluating management efficiency. Again the evidence in support of this explanation is mixed. Brennan and Franks (1997), using a sample of UK IPOs, find that almost two-thirds of shares of the IPO issuing firms were sold to outsiders within seven years of the IPO. Mikkelson et al. (1997), using a sample of US IPOs report a substantially lower (29%) turnover in control for established firms and a 13% turnover in control for start-ups. Many IPO issuers however include anti-takeover provisions to deter such acquisitions.

A fourth reason cited for public offering is that entrepreneurs see their growth prospects levelling off and seek to divest their holdings prior to failure. Firms in this category would experience a slowdown in activity in the post-IPO years before eventually failing. Typically one-third of IPOs fail. This provides support to the argument that entrepreneurs with superior information divest through an IPO in anticipation of subsequent failure (Jain and Kini 1999). This proposition is extremely tenuous because it makes several improbable assumptions. One, it assumes that entrepreneurs are exiting business and are not conscientious. Two, it ignores the fact that regulators have a continued stake in maintaining public trust in the market and engage in a drawn out process of due diligence to establish the business prospects/risks and profitability of the company. Three, it assumes that the investing public is easily gullible, and that the market is rather inefficient, i.e. that prices do not incorporate known information about future business prospects of IPO firms.

2.3. Advantages of going public

Theoretically, there are advantages that would accrue to firms that go public. First is the prestige and status gained by the firm as a result of the perception that business operations meet prudential requirements. This increased esteem is based on the fact that listing requirements are quite stringent and involve adherence to regulations issued by the capital markets’ authorities. Secondly, the stock market provides a cheap source of capital, compared to other known sources. Borrowed funds attract interest rates ranging from 30% to 16% annually. The costs of an IPO, which are a one-off cost, range between 12% to as little as 5% depending on the magnitude of the IPO. Thus for any firm wishing to raise additional capital, the stock market provides a clearly more attractive route, barring other externalities. Experience
shows that several entrepreneurs do not possess the requisite managerial skills necessary to run the business over the long haul. This is especially true as the business grows larger and larger. Entrepreneurs are ‘hunters’ rather than ‘skinners’. Hunters lose interest in the venture once the business is up and running, but skinners have an eye for detail and order. A company which is traded on the stock exchange therefore stands a better chance of attracting professional management.

Stock markets provide entrepreneurs with capacity to explore multiple investment ventures, by increasing their potential liquidity. Since shares of public companies are freely tradable, an entrepreneur who wishes to explore alternative investments obtains far greater latitude in raising cash from his/her financial asset portfolio. Quoted shares also offer the investing public an attractive and fairly safe avenue for earning a return on savings. A number of tax incentives can also be gained by a company being publicly quoted. In Uganda there is no capital gains tax and stamp duty. Dividends for listed companies are taxed at 10% at source compared to unlisted company dividends that are taxed at 15%.

2.4. **Contextual limitations of theory and literature**

Most of the explanations of how the IPO decision is arrived at are premised on two fundamental issues. One is that there are no macroeconomic bottlenecks and two that there is an efficient or well developed market for trade in financial assets. Another issue on which the IPO decision is premised, although this is not so critical, is the assumption of a degree of sophistication in the firm’s disclosure and governance regimes. These assumptions cannot be taken for granted when examining the case of underdeveloped markets. Firms in developed markets have only one choice set, that is the decision to go public or not and the costs associated therewith. On the contrary, firms in underdeveloped markets have an array of choice sets to consider when making the decision to go public. For instance, what are the tax implications of undertaking a full disclosure and what is the effect on the economic rent currently enjoyed by the firm?

The origin of markets in developed economies is clearly linked to the industrial revolution and the growth of mass production. Such sophistication in production required more specialized management, hence the separation of ownership and management which led to the evolution of financial markets. In underdeveloped countries this is not the case. Stock markets in underdeveloped economies are generally creations of policy rather than natural organic growth. Markets have been legislated into place without any relation to the level of economic sophistication. Underdeveloped economies are still faced with a host of structural and political bottlenecks that constrain market development. Market development has thus been detached from the nature and size of the economy. Poor fiscal policy management, an elementary monetary policy (no yield curve) and restricted demand because of poor equity supply all conspire to curtail market development. There are also low levels of public trust, due to political instability and continual erosion of purchasing power resulting from public expenditure deficits in developing countries. As an example of the lack of competitiveness in financial markets, in most underdeveloped countries of sub-Saharan Africa the pension sector is usually dominated by one statutory monopoly. Such monopolies hold up savings while paying returns far below market rates. In Uganda, the National Social Security Fund (NSSF) dominates the market and holds in excess of US$ 750 million on which it pays a
real return of about 3% (2009), compared to a prime rate of 7.5% offered by the central bank.

It is often argued that people in underdeveloped countries have poor savings habits. This ethnocentric view of savings habits in underdeveloped countries is untrue. Rather, savings habits are constricted due to the lack of savings opportunities in the formal market. Formal markets are dominated by the banking sector which dismally fails to offer the variety of financial instruments that would encourage savings in underdeveloped markets. Savers are therefore more adjusted to investment in non-financial assets such as land, farm animals and housing. All these factors have a restrictive effect on the growth of capital markets.

3. Methodology

The first part this study involved exploratory interviews of key experts and an extensive literature review. The objective was (a) assess and content analyse the issues that could be used in a focus discussion groups (FDGs) (b) for the purposes of identifying variables for an empirical survey of firms’ readiness for going IPO. Several key stakeholders/experts were purposively interviewed in an unstructured manner to develop a conceptual framework. The expert interviews resulted in the development of a conceptual framework. The factors hindering growth of capital markets can be divided into three areas, based on the key informant responses to the interviews. First, are macro constraints relating to the underdeveloped nature of the economy. Second are market specific constraints and third are firm specific constraints. These factors are summarized in the following conceptual model (Figure 1). The factors are discussed in greater detail thereafter.

![Conceptual Framework](image)

Figure 1. Conceptual framework of global constraints to private sector IPOs in underdeveloped economies.

Source: Key informant interviews.
3.1. Macroeconomic Constraints

One of the most widely acknowledged macro constraints to capital market development is what is known as 'insider dealing' in public affairs. The conduct of public affairs is characterized by 'cronyism' which creates economic rent-seeking opportunities that negate benefits of proper business conduct. The entrenched culture of 'cronyism' is reflected in the large potential for direct self dealing; abuse of privilege to enrich relatives and friends. Such an approach to managing public resources restricts opportunities for investment by raising the cost of doing business. Furthermore, due to resource scarcity, most firms in underdeveloped countries are micro businesses whose raison d'être is limited to subsistence of the owners. These businesses operate on the fringes of the formal sector. And their morphology creates a wide resource dispersion which cannot lead to any meaningful growth, because consolidation is not even possible.

Interest rate policy was also cited as one of the reasons that resources for IPO issues are scarce. Because governments are major borrowers who provide financial institutions with risk free positions through bond issuance, potential stock market investors are not interested in investing in unknown firms in the stock exchange. This argument may only be valid for smaller firms because in cases of denationalized firms, where all significant performance fundamentals have been properly balanced, the IPOs have been oversubscribed. There is also no evidence as yet pointing to successful firms failing to raise capital on the stock exchange. In other SSA countries such as Kenya, private firms have listed successfully.

Structural problems relating to the historical context of markets in underdeveloped economies are another oft cited reason for lack of private sector response in terms of listing. The origin of capital market IPOs was privatization. However, there was minimal capital market involvement in the privatization until late in the process. In the case of Uganda, the first IPO based on privatization did not take place until 2001, yet the restructuring and divestiture programme started as far back as 1993. Thus privatization preceded market development rather than vice versa, and this has significantly affected the availability of tradable securities (stocks) on the market.

3.2. Market Specific Constraints

While privatization has occurred as a result of the divestiture of public assets, for some of the privatized assets, the level of risk has remained high, where large investors have retained a controlling interest. One oft quoted example in Uganda is the New Vision Publishing and Printing Company which is 51% government controlled. A chief executive officer (CEO) of this company was forced out of office after the president expressed dissatisfaction with the company’s 'anti-' government stance. The New Vision is the widest circulation newspaper in the country and is quoted on the USE. In a more efficient market, such action would have impacted the price of the company’s shares negatively.

During the interviews it was noted that one of the main benefits of flotation on the stock exchange was the liquidity that market players would be able to derive from investing in financial assets. Participants should be able to value their portfolio and to adequately manage their risk exposure. However, one of the realities of underdeveloped markets is low volume of activity. At the Uganda Stock Exchange,
many counters are inactive because investors seem to have a ‘buy and hold’ mentality. There were also few institutional investors active in the capital market. There are no venture or equity funds on the USE, a factor pointing to lack of financial depth in the market.

Market efficiency was also identified as a constraint to market growth. The trading floor operated an open cry system in which settlement was on a T + 5 day basis. There was no central depository system and trading was manual. As a result the level of market efficiency was lower than that of markets in developed economies. The enabling law for constitution of a central depository system and electronic trading had not been in place by parliament. While the USE had acquired all the necessary tools for computerized trading there were still structural problems associated with implementation. Market completeness was also cited as a constraint to market growth. Investors did not have at their disposal the wide range of instruments for investment and hedging, for example futures and derivatives. All these affected the level/volume of activity on the market.

3.3. Firm specific constraints

Most of the businesses operating in underdeveloped economies are family owned. The owners are reluctant to lose control, and abhor being in the public domain. This is complicated by the short term orientation of investors based on the historical/political past of the country. Most investors keep a lot of funds tied up in physical assets rather than direct business ventures because of the potential for instability that characterizes third world countries. Many believe that in case of instability, physical assets are more enduring and would not need excessive rehabilitation to put them back into use or to liquidate them for that matter.

Several firm owners who were interviewed acknowledged that they had foreign sources of financing as opposed to local mobilization. Uganda’s foreign direct investment (FDI) currently stands at about US$ 280 million as opposed to Kenya’s US$ 100 million (2009), showing that several investment opportunities were being externally financed, compared to the larger Kenyan economy. There appears to exist a network of firms lending to related parties, which eliminates need to source capital through stock markets. This is especially critical in view of the exchange rate differentials between world financial markets and the local financial market. Funds borrowed internationally can be acquired at a cost as low as 8% (LIBOR + 3), while funds borrowed in local currency were at a cost as high as 26% in several instances. Several investors thus did not appear to have the incentive to raise finance locally.

There may also be poor understanding of the dynamics of finance capital and cost of money as most entrepreneurs do not seek professional advice. The cost of borrowed capital ranges between 16% and 26%, while the cost of equity, as a one-off, may be about 5%–12% depending on the amount being raised. In subsequent periods the cost of capital raised through share offers is a function of profitability. IPO costs are also tax deductible.

Most private firms are black boxes (type I) in which there is no separation of ownership and management (see Figure 2). The governance structures are weak and there is a paucity of independent board direction. There is also a high level of non-disclosure and poor financial record keeping. Most of these firms’ financial statements would not pass the USE’s listing requirements. Furthermore, a large
number of firms (type II) are not the specific source of income; rather they are a legitimating front for illegal activity. In this case, the risks associated with additional disclosure are not adequately compensated by additional returns, and the urge to undergo due diligence is lacking.

Another factor hindering capital market development at the firm level was identified as poor growth prospects for firms in underdeveloped economies. This had further led to a reduced willingness to make IPOs because the low levels of business activity lead to firms taking up rent-seeking positions which would be unfavourable to openly governed businesses. Thus several firms have remained closed up to the public.

In the second part of the study key stakeholders were brought together to form FDGs which critically reviewed the variables identified at the first stage. The discussions in the focus discussion groups involved an analysis of three key issues. These were (1) whether there was an adequate understanding of stock market operations and how firms could leverage financing from such markets, (2) whether the firms’ business was capable of meeting the listing requirements and (3) whether firms could bridge the expectations gap between the market and potential investor vis-à-vis any potential IPOs they were likely to make. The FDGs also led to the identification of measurable attributes that could be used in a model for the prediction of IPO readiness.

It was agreed that measurement of IPO readiness was specific to firms since there had been successful IPOs, thereby rendering macro and market constraints surmountable. Firms in a given macroeconomic jurisdiction face the same set of macro and market constraints. Such constraints can only become a significant determinant under varying economic environments or in cross country studies. On the basis of the foregoing discussions, a conceptual schema outlining the nature of firm specific dimensions was derived as in Figure 3 after the FDGs.

On the basis of the foregoing conceptual model and review of literature (see for example Chen and Jaggi 2000; Yang-Pin and Wei 2006) on firm specific attributes, the following criterion and predictor variables were identified and are used in the logistic and multinomial logistic regression models. The column for hypothesized sign shows the direction of the proposed relationship between the criterion and predictor variables.
4. Model specification

The hypothesized relationship is shown in the two stage mathematical model below.

\[ I_{pordy_{it}} = \sum (Ceochra_{it}, Acpublis_{it}, Sharetra_{it} \text{ and } BodCtrl_{it}) \]  

\[ I_{pordy_{it}} = \beta_0 + \beta_1 \text{Age}_{it} - \beta_2 \text{Timintra}_{it} + \beta_3 \text{Bigfour}_{it} + \beta_4 \text{Dscore}_{it} \]
\[ + \beta_5 \text{Logsales}_{it} - \beta_6 \text{ROA}_{it} - \beta_7 \text{Finstruc}_{it} + \beta_8 \text{Legit}_{it} - \beta_9 \text{Infoasym}_{it} + \mu_{it} \]  

The above model was used to derive an unordered multinomial and ordered logistic regressions.

4.1. Research design and sampling criteria

This study used a cross sectional time series design, whereby panel data regarding a specific historical event (preparation of financial statements) was collected covering a five year period (2003–7) (Table 1). Since a firm making an IPO must meet certain listing criteria, it was necessary to focus on firms with a potential to go IPO. These firms were to be found in the category of large taxpayers for which a population of 353 large taxpayer organizations was established. A review of the population however showed that several of these organizations were either already traded firms, branches of foreign firms or public sector organizations. The list was therefore recast to 227 (64%) eligible firms. Again due to the absence of legal compliance requirements for public filing of financial statements (see Yang-Pin and Wei 2006) it was not possible to use a random sample because of the risk of rejection, hence a purposive sample was adopted.
A sample of 115 firms was identified on the basis of judgement. These firms had to have been in existence before 1997 based on their tax identification number (TIN), must have been profitable for at least three years and have audited accounts. The identified firms were individually approached by the lead researcher with a letter and a copy of the questionnaire, requesting them to participate in the study. Several firms rejected the request to provide information citing confidentiality and distrust. Thirty-six firms responded positively, implying a 31.3% response rate. However, the data provided by one firm was rejected on the basis of incompleteness and was eliminated from the analysis. The data from the accepted 35 firms yielded 175 cases of panel data, which formed the basis of analysis of the study hypotheses.

### 4.2. Data analysis and reporting

The data was analysed using SPSS™ and STATA™. Descriptive statistics (Table 2) were computed to obtain a feel of the data. Correlations of the model variables were also computed (Table 3) and two logistic regression models were fitted to examine
the relationships between the variables and the extent to which the independent variables were good predictors of the criterion variable. In the first model an unordered multinomial logistic model (Table 4) is computed while in the second model, an ordered logistic regression is computed (Table 5).

5. Findings and discussion

5.1. Descriptive statistics

Table 2 below shows the descriptive statistics for the total sample.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
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<tbody>
<tr>
<td>Age</td>
<td>6</td>
<td>43</td>
<td>17.97</td>
<td>11.451</td>
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<tr>
<td>Timintra</td>
<td>-5.851</td>
<td>192.000</td>
<td>3.93769</td>
<td>17.440119</td>
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<tr>
<td>Bigfour</td>
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<td>.501</td>
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<tr>
<td>Dscore</td>
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<td>1.00</td>
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<td>.15133</td>
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<tr>
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<td>1.0257</td>
<td>.49399</td>
</tr>
<tr>
<td>ROA</td>
<td>-47</td>
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<td>1.1093</td>
<td>.25420</td>
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<tr>
<td>Finstruc</td>
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<tr>
<td>Legit</td>
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<tr>
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<td>-.689607</td>
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<tr>
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<td>.500</td>
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<td>.31</td>
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<td>Ipordy</td>
<td>0</td>
<td>4</td>
<td>1.0204</td>
<td>1.08204</td>
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The results show that the average age of the firms included in the sample was 17.97 years (SD = 11.451), with the least mature firm being six years while the oldest was 43 years. About 31% of the firms in the study had published accounts but only 3% had transferable shares. The average firms’ debt was about two times the total assets, suggesting that firms were using various sources of financing to raise capital. However there was very huge variation in the reported debt of firms (from 0.1 times to 73 times the total assets). This implied that either the firms’ sources of financing were not formal (black box firms) because the payments of interest were also modest or profits were booked as debt infusions to avoid tax payments.

The average level of disclosure by the firms in the study sample was about 68% (SD = 15%), implying an inability to meet all listing requirements by a large number of firms. Furthermore, the level of stock market activity for firms in the study as a proxy for information asymmetry is also negative (X = −0.69). This implies that the firms in the study sample had minimal stock market involvement, a strong indicator of lack of knowledge or distrust.

Another variable of interest was legitimacy proxied by the percentage of independent directors on the board. The statistics show that on average only 32% of the directors for all firms were independent directors, implying that firms were closely held and the majority shareholder had the largest say in determining business strategy. The variable for IPO readiness also had a very low mean (1.024), implying that most of the firms in the sample met only one of the criteria for listing which are used as proxies for IPO readiness. The data was also tested for skewness and kurtosis in line with central limit theorem. The data was found to be normally distributed.
Table 3. Correlations of predictor and criterion variables.

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Notes: **Correlation is significant at the 0.01 level (2-tailed). *Correlation is significant at the 0.05 level (2-tailed). Figures in parenthesis denote significance.
with skewness measures for all variables approaching zero. However because of the distinct characteristics of individual firms, there was a high kurtosis (for some variables) as observed in the measures of central tendency. The data met the requirements of normal distribution and this reinforced its usability despite the limited number of observations.

5.2. Correlations

Table 3 presents the Pearson correlations for the study variables. The results show that there is a significant positive correlation between *ipordy* (IPO readiness) and *age*, *auditor type (bigfour)*, *disclosure level*, *legitimacy* and *information asymmetry* at \( p < 0.01 \). These results are as expected because as age and legitimacy increase, the level of disclosure is also expected to increase, IPO readiness improves (Chen and Jaggi 2000; Sejjaaka 2005). Sales are related to size and indeed large firms tend to...
disclose more (see Watts and Zimmerman, 1990). However, size does not imply increased IPO readiness as there is no correlation between the two. This observation is especially interesting because, as stated earlier, there are several large firms that had avoided making IPOs despite their profitable business and public prominence. Another important finding is the positive relationship between IPO readiness and information asymmetry ($r = 0.228, p < 0.01$) which shows that firms that exhibit a high level of market activity are more likely to exhibit a higher level of IPO readiness. This is in conformity with Jin and Philip (2003). However, there is no correlation between IPO readiness and profitability and financial structure.

A positive relationship between age and CEO duality, share transferability, and board control was observed. As the influence of a single shareholder decreases, all the other dependent variables improve, underlining the importance of overcoming recency if a firm is to go IPO. Indeed, as age improves, share transferability also improves. As firms mature, it is likely that their control also passes to many more people, who eventually are more likely to take the firm through the IPO route as a means of exiting their shareholding. This means that firms in Uganda are not yet mature for IPO activity.

Firms audited by ‘big four’ auditors had a higher level of disclosure, more non-executive directors (NEDs), and a significant separation between ownership and management. There was also a significant correlation between legitimacy and separation of the roles of CEO and chairman ($r = 0.546, p < 0.01$). Profitability ($ROA$) and financial structure ($finstruc$) appear to be poor indicators of IPO readiness. Firms that had intangible assets, including stock market investments ($infoasym$), were more likely to also publish their accounts ($r = 0.271, p < 0.01$).

5.3. Regression results

Regression results for the sample firms are presented (Tables 4 and 5) using two models. The first model is an unordered multinomial logistic regression in which the summated dimensions of IPO readiness (CEO duality, account publication, share transferability, and board control) are regressed against the predictor variables. The model’s fourth level does not provide a fit because none of the firms achieves a full score of four for all the years for which panel data was collected, implying varying degrees of readiness for firms in the study.

In the first model (unordered multinomial logistic regression), age, disclosure and information asymmetry (knowledge of stock market activity) are found to be significant predictors for IPO readiness at the first level ($p < 0.01$). At the second level disclosure and financial structure and information asymmetry are the only significant predictors ($p < 0.05$). The finding of age is consistent with the observations of Pagano et al. (1998) that Italian firms that went for an IPO were likely to be eight times older than their American counterparts. Age is an important determinant of the decision to go public because with the passage of time the shareholding of the firm is more likely to be widely dispersed, reducing the fear of loss of control (Roell 1996). Disclosure, which is the most significant predictor, is also consistent with the findings of Mehran and Peristiani (2010) and Aggarwal and Rivoli (1991). The cost of disclosure is significantly increased in case of an IPO. Thus firms that already have a high degree of disclosure are more likely to have a higher degree of readiness to make an IPO. The finding of information asymmetry is also consistent with Chemmanur et al.’s (2010) findings that private firms facing less
information asymmetry and those with projects that are cheaper for outsiders to evaluate are more likely to go public. Firms which already appreciate the operations of the stock market are more likely to have more faith in the operations of the market and therefore would have no problems in deciding whether to make an IPO.

On the contrary, our findings do not support the significance of size which is well documented in the literature (see Aggarwal and Rivoli 1991; Pagano et al. 1996; Mehran and Peristiani 2010; Chemmanur et al. 2010). This is probably so because of the wide variation in the size of the firms used in this study. It is difficult to control for this variable because all the firms used had already met the inclusion criteria, for which size has a small threshold. Nevertheless, size is found to strongly correlate with disclosure and auditor type. Big firms are more likely to have big four auditors given the cost of services associated with big four audits.

In the second model, (ordered logistic regression), age, auditor type (big four), disclosure, legitimacy and information asymmetry are found to be significant predictors of IPO readiness, as shown in Table 5.

Firms which are older, have a higher level of disclosure and exhibit less information asymmetry are more likely to meet the IPO readiness criteria and these are potential candidates for listing. Within the two models, age, disclosure and information asymmetry are found to be significant predictors (Pagano et al. 1998; Mehran and Peristiani 2010) of IPO readiness. In model two, legitimacy is also found to be significant in addition to the other predictors already mentioned. Filatotchev and Bishop (2002) have noted the importance of legitimacy, arguing that board composition is an important factor in reducing the extent of under pricing. Thus firms which have improved governance are in this respect more likely to have an improved IPO readiness. However, Bodnaruk et al. (2008) present a different view, arguing that firms held by less diversified controlling shareholders are more likely to go public.

Generally, most of the firms in the study did not exhibit strong separation between ownership and management and few published accounts. They were also closely held and had onerous provisions on share transferability, a critical requirement for public holding/trading. In this sense then, most private firms in Uganda exhibit a poor state of IPO readiness because most do not meet more than two of the criteria set for flotation.

6. Conclusion

Capital markets are essential to financial sector development because they promote economic growth through increased savings mobilization and spreading of risks in enterprises. Capital markets also help finance the public sector borrowing requirement while reducing fiscal pressure of debt redemption if maturities of securities are lengthened. Governments can raise long-term funds through the capital market and enhance the creation of a robust yield curve. In the case of privately held firms, capital markets provide a low cost source of financing for risky ventures. Furthermore, if owners wish to opt out of the business, capital markets provide the most logical way of shedding their interest in the business. However, their development in SSA continues to be slow with the private sector failing to use them as vehicles for raising capital.

Market development is a process and will take time. There are several impediments to rapid growth but these are unavoidable. First, listing requirements
are onerous but need to be so because capital market integrity is a necessary condition for market growth. Secondly, the private sector needs to make a ‘buy in’ and understand the relevance of capital markets in dissipating business risk and providing latitude in the magnitude of investment that can be achieved through savings mobilization. Thirdly is the need for professionalism in business management and the need for sophistication in disclosure. There are a number of policy implications from this study that if considered can be the basis of growing capital markets in underdeveloped economies.

6.1. Policy implications

The firms that were sampled in this study all failed to meet the four listing criteria that were used, viz. CEO duality, publication of accounts, board control and share transferability. This failure implies that there is, across the board, a poor governance regime for firms. Even for large firms that meet all the listing requirements such as disclosure adequacy, three year profitability and inclusion of NEDs on their boards, the general performance on the criterion variables remains abysmal. Despite the firms’ claims in their vision and mission statements, their activities/attitude remain(s) opaque and inconsistent in governance terms. Firms must thus be sensitized and convinced on the benefits of professional management and tradability of their shares. This, however, is not an easy task in an emerging market where immense rent-seeking opportunities abound. The implication is that firms in effect remain closely controlled because the gains from their current status outweigh any listing benefits we may envisage.

Second, the results show that IPO readiness is partly a maturation process. As a firm’s age increases, its critical ‘IPO-relevant’ variables also seem to improve. This is probably due to the fact that older firms are better managed and therefore have a much better performance. Older firms are also less likely to be controlled by the founder and therefore for the disparate stakeholders to continue co-owning the business, a higher level of transparency is inevitable.

Third is the need to improve the disclosure regime of firms as part of the process of increasing IPO readiness. The empirical results show that adequate disclosure is a very significant determinant of a firm’s preparedness for an IPO. Firms need to be assisted to improve disclosure if they are interested in going for an IPO. There are other benefits associated with increased disclosure such as lower cost of capital (see Botosan 1997). This is necessary to make firms more competitive in a global environment. However, the incentives to remain closely controlled may override the benefits of going public hence the inadequate disclosure. Given the existence of huge economic rents in underdeveloped economies, firms or entrepreneurs with proprietary information have a tendency to extract those economic rents as fast as possible, hence they have a short term business perspective. To a large extent therefore, many firms are type I firms: the actual source of their business prosperity is unclear and there is no separation of ownership and management. They are not ready to ‘undress’ for the market and be courted by the investing public. In such circumstances, longevity of the business is rare.

The fourth policy implication of the findings in this study is that firms that wish to be IPO ready must increase their legitimacy. Legitimacy in this study has been proxied by the extent to which the board includes independent non-executive directors (see Chen and Jaggi 2000). Firms have an immediate and far reaching
impact on the communities in which they operate. As a result, including on their boards eminent members of their communities would be a positive indicator of their continuous commitment to those communities, the extent of responsible business practice and environmental aptitude. However, the level of independent non-executive directors’ involvement is about 30%, meaning that the communities in which the firms operate do not have a say in the businesses which daily impact their lives. In fact the largest firms in the country are on record as having refused to provide data for this study.

Policy change can result in significant improvements in market development. An increase in incentives to direct local savings away from real assets to financial assets would result in availing more funds for investment. An increase in liquidity by developing secondary market capacity would also further increase the synergies for growth. There is thus a need for a concerted effort to grow capital markets by shaping attitudes to going IPO. It was expected that information asymmetry would be a key predictor of the lack of IPO readiness of Ugandan firms. In this study it was proxied by the level of intangible investment in the balance sheets of firms in the study sample. On average firms’ investment in intangibles was very low and this was consistent across the board ($\sigma = 0.48$). If this proxy is an indicator of the extent to which firms are involved in the markets, then it is evident that their belief in markets is quite limited and they are not viewed as a practical source of capital.

For firms to go for an IPO or to operate to a higher global business standard there is a need for legislation obligating firms of a given size to file financial statements with a designated public body. This requirement is now standard in several emerging market jurisdictions such as Taiwan (see Yang-Pin and Wei 2006). This filing requirement should not be confused with the tax authority reporting that firms are required to undertake annually but must be seen as part of a market confidence building process. Such a policy requirement would make information regarding firm performance more readily available as a basis for macroeconomic planning. Secondly, large firms, even though privately held are ‘public interest’ companies which enjoy common property resources. They should be enjoined to show their corporate responsibility through disclosure of their performance.

6.2. Limitations and areas for future research

The main limitation of this research has been the paucity of data. Private firms are not obliged to disclose to the public their operating results and financial positions, unless they are regulated. Thus in this study it was not possible to use a larger sample. To overcome this problem panel data was used to provide a longitudinal view of the firms and increase the number of observations to five for each study case/variable. In addition, the independent study variables used are derived from historical data, free of respondent perceptions. The results of this study could be improved through a cross country comparison that would factor in varying emerging macro and market conditions.

With regard to empirical testing, it is evident that the current theoretical models are not very useful in examining the case of underdeveloped economies. This is because these models, which are principally cost/benefit aligned, assume that all universal conditions are optimal, that is the economy and market are optimally regulated and efficient. Thus the key decision faced by owners of the firm is whether to go public or not. However, in the case of underdeveloped economies, we have to
develop a model that contends with economic and political issues, market sophistication issues, and firm (governance) specific issues. We may develop macro models for in between country analyses, or micro models for specific market condition analyses, but the key focus remains constraints rather than the opportunity set faced by firms in underdeveloped markets. Specifically, the decision set faced by the owners of the firm must address utility of the decision to go public at the three levels identified in the conceptual framework.

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Notes on contributor
An Associate Professor of accounting and finance at Makerere University Business School, Dr Samuel Sejjaka holds a PhD in accounting, is a Fellow of the Association of Chartered Certified Accountants (ACCA) and a member of the ACCA’s Research Committee. He has extensive experience working as a consultant in both the public and private sector in the areas of financial management, assurance and business process reengineering.

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