IPOs AND CORPORATE GOVERNANCE IN THAI EQITY CAPITAL MARKET: AN OVERVIEW

The purpose of this paper is to outline the main features concerning IPO proceedings and corporate governance of listed corporations in the Kingdom of Thailand. After describing advantages and disadvantages of going public, the Author narrows down the focus on the relationship between IPOs and corporate governance. In particular, it should be noticed that the relevance of reliable corporate governance is an essential element for the success of the equity capital market. The Kingdom of Thailand, from this perspective, represents a leading case among the legal systems of the ASEAN region. Finally, the paper focuses on the history and the characteristics of the Stock Exchange of Thailand and the innovative Market for Alternative Investments.

by

PIETRO BORSANO[i]

1. What an IPO Is

1.1. The Initial Public Offer ("IPO") is the first sale of stock made by a private company to the public of investors.

It is commonly known as "going public" process, because a major change in ownership happens. After the listing, the company is no more privately held and new owners enter the scene, the stockholders.

IPOs represent the main way of collecting equity capital for financing the company; it should be pointed out that funds raised via an IPO are free from repayment obligations, therefore providing financial flexibility to the corporation, once listed.

Until the technology boom, the going public process was mainly reserved to big and old private companies. It meant that only structured and solid corporations were able to approach financial markets.

Nowadays, IPOs can be issued by: *i*) small and young companies, in order to raise capital to finance projects and expand their business, and *ii*) large, privately owned companies, in order to become publicly traded.

Hence, companies do not offer any more strong financials and a solid basis for going public. From this perspective, IPOs are mostly done by start-ups seeking to expand their businesses.

Two main subjects participate to the IPO: the issuer (i.e. the company) and the underwriting firm, which is usually an investment bank.

The latter is responsible for making the offer and sales of stocks. The proceeding is the following: the investment bank usually buys stocks from the company at a discounted price than the one offered to the market. The difference is called "underwriting discount" and is around 7%. After the IPO, the underwriting firm will sell the shares (previously acquired from the issuer) in the stock exchange market, and it will gain from the difference between the market price and the discounted price, which it bought the shares at. The role of the underwriting firm is essential, since it guarantees that at least a minimum amount of stocks has already been sold, before going public. In other words, it supports the demand of stocks when they will be publicly traded.

1.2. The IPO is a long and expensive journey. It generally takes about one year to conclude all the procedures and an average of US$1.5ml in fees and other expenses.

In fact, for the success of the IPO, the company needs a team of experienced and well-known advisors. This team can be formed by: investment bankers, corporate lawyers, accountants, and experts of the specific stock market.

This team is supposed to fulfil several goals.

Once the team has been formed, the next step is to start collecting all the financial information required about assets, cash flows and liabilities of the firm, in order to build the prospectus. This mission includes identifying, selling or writing off unprofitable assets, and finding areas where cash flow can be beefed up.

In the meantime, some companies also look for new management and a new board of directors to run the newly-listed corporation.

Around eight-ten months before the IPO is scheduled, companies put together the prospectus and circulate it for comments. The prospectus includes a three-year history of financial statements and takes into account the securities being offered and the terms of the offering. In general, all the most important information for investors can be found in this document.

In addition to the prospectus, all the documents asked by the Securities and Exchange Commission of Thailand (i.e. registration statement, amendments, preliminary prospectus etc.) are available in order to let investors do the right choice.

Around six months before the scheduled date, transition contracts for vendors are finally provided. Next, the financial statements are completed and submitted for auditing.

Three months before the IPO date, the board of directors meets and the last review of the audit takes place. The company joins the stock exchange it will issue the IPO with.

It should be finally noticed that usually initial shares are available just for few investors (i.e. investment banks and professional investors). In fact, the rapid growth in value, since shares have been sold for the first time on the stock market, allows huge possible returns on the investment, when these subjects will resell the stocks to non-professional investors.

However, usually a restriction clause is in force, according to which it is not allowed to resell the shares for at least thirty days after the listing.

2. Advantages and Disadvantages of IPOs

2.1. The number of IPOs issued is highly connected with the health of the stock market and the overall economy of the nation.

Thus, during a recession, the number of IPOs is lower as stock prices are depressed; when this number increases, it is also a sign of economic recovery.

IPOs help the business to generate the capital needed to expand their businesses towards several directions.

For example, the increased scrutiny allows public companies to have better rates, when they issue debt.

Moreover, newly-listed companies can at any time issue more stocks for raising more equity capital. Thanks to this opportunity, M&A are easier to implement, because stocks can be issued as part of the deal.

IPOs is worthwhile also for further business development, since particular projects and plans can be implemented (e.g. the attraction of top-talent managers through employees' stock ownership plans).

Finally, an IPO could represent a perfect exit strategy, when a business owner (e.g. a venture capitalist) wants to get out of an investment made in the past. Thus, going public is a way of "cashing out" an investment.

The IPO provides also some other benefits for the company: for example, a considerable amount of prestige and an increased public awareness. Increased public awareness of the company means that IPOs often generate publicity by making products of the firms known to a new group of potential customers, with subsequent increase of market share.

2.2. However, as already said, going public is a long and stressful process, which can bring distraction from corporate core business.

It should be taken into account also that, as a consequence of the listing, there are a loss of total control over the business and a loss of privacy concerning data and information.

In fact, in addition to initial and ongoing expenses, demands of periodic reporting from the investors arise.

Finally, shareholders' expectations can burden the board of directors; hence, the pressure of the market may cause more focus on short-term results rather than long-term growth.

3. The Relationship between IPOs and Corporate Governance. The Thai Case

3.1. The expression corporate governance comprises several meanings, but it is possible to agree with a recent definition: corporate governance is "*every device, institution, or mechanism that exercises power over decision-making within a corporation is part of the system of corporate governance for that firm.* […] *The purpose of corporate governance is to persuade, induce, compel, and otherwise motivate corporate managers to keep the promises they make to investors.* […] *Good corporate governance, then, is simply about keeping promises. Bad governance (corporate deviance) is defined as promise-breaking behavior*"[1].

Good corporate governance means that a company has efficient, transparent and auditable management structures and processes.

Moreover, corporate governance promotes trust and confidence between board, managers, shareholders, investors and other firm stakeholders.

Its structure specifies the distribution of rights and responsibilities among the different participants in the corporation and spells out the rules and procedures for making decisions on corporate affairs.

These structures and processes also stimulate competitiveness, boost long-term shareholder value, and moreover present excellent opportunities for sustainable growth.

Good corporate governance contributes significantly to a firm's value, investors' confidence and overall sustainable growth. In addition, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.

3.2. The importance of reliable corporate governance can be outlined by analyzing the recent past.

In fact, the Asian financial crisis affected Thai corporations, also because of their poor corporate governance. Thai governance problems were the result of the highly concentrated ownership and control structure of Thai companies. In fact, the board was appointed by the owner family with majority votes. As a result, the board of directors was normally staffed with family and friends of majority shareholders, who do not oppose nor monitor top management.

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[1] Jonathan R. MACEY, *Corporate Governance. Promises Kept, Promises Broken,* Princeton University Press, 2008.

The board of directors of most Thai companies was neither independent from top management nor accountable to minority shareholders.

In 2002, the Stock Exchange of Thailand (SET) introduced the *Fifteen Principles of Good Corporate Governance*. The *Fifteen Principles* of 2002 were a preliminary implementation guidelines conceived for listed companies in Thailand.

The *Principles* can be sorted in six main categories:

a. Transparency and information disclosure;
b. Internal control and risk management;
c. Shareholders' rights and equitable treatment;
d. Stakeholders' rights;
e. Role and responsibilities of board of directors;
f. Business ethics.

In 2006, the *Principles* were revised to become comparable to the *Principles of Corporate Governance* provided by the Organisation for Economic Co-operation and Development (OECD).

In 2012, the *Principles* were made compatible with the *ASEAN Corporate Governance Scorecard Criterion*, which assesses and ranks listed companies' corporate governance practices in ASEAN (*Association of Southeast Asian Nations*).

In 2013, the World Bank, in the Report on the *Observance of Standards and Codes*, confirmed the Kingdom of Thailand as a regional leader in corporate governance.

In fact, Thailand has a relatively comprehensive framework and has achieved high levels of compliance in a number of key areas.

According to this international institution, corporate governance reforms implemented in the Kingdom have enhanced investors' trust and protected investors' rights (especially non-majority shareholders), increased board professionalism and promoted high levels of corporate transparency.

However, the World Bank identified some issues that can be improved through new regulations and the guidance of the Securities and Exchange Commission of Thailand (SEC), by involving also private actors, such as the Associations of Thai Listed Corporations.

In particular, the suggestions of the World Bank concerned:

a. Improving State Owned Enterprises (SOEs) governance, thus making the state a more effective owner;
b. Protecting the independence and effectiveness of the Securities and Exchange Commission (SEC) and the Bank of Thailand (BOT);
c. Making rules and regulations clearer for market participants;
d. Improving shareholder redress, including through SEC enforcement;

e. Enhancing beneficial ownership disclosure and non-financial disclosure, and finalizing convergence to and compliance with International Financial Reporting Standards (IFRSs);
f. Strengthening effectiveness of market intermediaries and auditors independence;
g. Continuing to increase board independence and effectiveness.

3.3. The board of directors is considered by Thai regulators as the most important and effective mechanism for achieving good corporate governance. A reliable board of directors means a decrease in terms of agency costs.

In fact, agency costs, such as auditing, budgeting, control and compensation systems, arise when there is a "conflict of interest" between managers and shareholders. Of course, reducing agency costs increases a firm's value.

Since 1999, SET has established two important requirements for Thai listed companies:

a. At least one-third of the board must be comprised of independent directors;
b. All Thai listed corporations must have an audit committee composed of at least three independent directors.

Independent directors are top level professionals, expected to be independent from the management, and act as the trustees of shareholders. They are obligated to be fully aware of, and question the conduct of organizations on relevant issues. In other words, independent directors are not connected to the company and work for the safeguard of the interests of shareholders, who cannot look after their interests.

It could be interesting to point out that, in contrast to the US SEC, which utilizes a mandatory approach by enforcing the Sarbanes - Oxley Act, Thai SEC's approach is to gradually encourage listed firms to improve their corporate governance, by conducting campaigns, distributing educational materials, providing a 50 percent fee discount to companies with a high corporate governance rating, and offering one-year coaching to the audit committee of newly-listed firms.

4. Equity Capital Market in Thailand

4.1. In 1963, the Bangkok Stock Exchange Co., Ltd. (BSE) was established. However, it did not achieve the expected success, mainly because of a lack of official government support and the inactivity due to limited investors' understanding of the equity market.

Therefore, on 30 April 1975, a new legal entity, the Stock Exchange of Thailand, officially started trading.

According to the Securities and Exchange Act of 1992 (SEA), SET's primary roles are:

a. Serving as a centre for the trading of listed securities, and providing the essential systems needed to facilitate securities trading;
b. Undertaking any business related to the Securities Exchange, such as a clearing house, securities depository centre, securities registrar, or similar activities;
c. Undertaking any other business approved by the SEC.

SET is a full member of: Asian and Oceanian Stock Exchanges Federation (AOSEF), International Organization of Securities Commissions (IOSCO), and World Federation of Exchanges (WFE).

During 2013 and 2014, Thai stock market was affected by uncertainties due to internal political instabilities and global economic problems.

Nonetheless, very good results have been achieved, since the SET index rose and reached a 20-year record peak.

Current SET market capitalization is THB[2] 14,423,349.24 ml (corresponding to USD 440,018 ml) and its trading value constantly grew over the last years.

In 2013, the daily trading marked its highest level since the market opened, and it was recognized as the best equity capital market among the other ASEAN stock markets.

4.2. As already pointed out, trading value of Thai stocks significantly increased, especially regarding "small stocks", that doubled their value.

In particular, as regards small-medium enterprises (SMEs), Thai regulators conceived a specific financial market for trading their shares. It is called *Market for Alternative Investments* (MAI) and it was established under the SEA in 1992.

MAI officially started trading on 21 June 1999.

Its main objective is to give the opportunity to entrepreneurs and small and medium-sized firms in order to:

a. Access to funds;
b. Achieve sustainable growth through transparency and good corporate governance;
c. Strengthen competitiveness through powerful networking.

Currently, one hundred and ten companies are listed at MAI and the number is constantly growing.

[2] Thai Baht (Thai: บาท, sign: ฿; code: THB), the official currency of the Kingdom of Thailand.

At the end of 2014, market capitalization of MAI was THB 368,703.14ml (corresponding to USD 11,248.15ml), with a +94.8% increase compared to the same period of 2013.

In the last years, MAI particularly focused on renewable energy. In fact, Thai regulators sought to improve the competitiveness of renewable power generation companies (involved in the fields of solar, wind, hydro, biomass, biogas and waste energy).

According to the MAI, these companies "*support the economic growth as well as encourage the sustainability of Energy and Environment. Therefore, the Stock Exchange of Thailand (SET) and the Market for Alternative Investment (MAI) help promoting the listing of these companies in MAI by easing the requirement on Track Record, Market Capitalization and Net Profit, while the other general listing criteria maintains*".

A part from the particular case of renewable power generation companies, MAI quantitative listing criteria are less strict than those of SET, since it is devoted to SMEs; however, qualitative listing criteria (regarding corporate governance, duties of directors, audit committee, etc.) are exactly the same required by the SET.

As regards qualitative listing criteria, three main red flags should be taken into account.

i) In the last years, institutional investors hold on average only 3.3% of common shares of MAI listed companies.

In fact, start-up companies often have a family origin, thus institutional investors are unsecured to take risk with start-up companies

ii) The financial *ratio* of debt against firm assets is on average 47.5% and it is not significantly different from that of the overall stock market.

However, at an early stage, companies should not have such high level of leverage. Hence, for MAI companies' debt remains an essential source of funds, aside from public equity fund raising.

It is worth noting that debt is "harder" than equity and start-up companies may take risk bankruptcy, if the operational profit is not yet satisfactory.

iii) On average, the director independence *ratio* of MAI companies is 32%, below the minimal level of the SET requirements for independence of directors.

In order to shift corporate governance quality level, MAI companies should comply at least with the minimal level of SET requirements for independence of directors.

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[i] Please note that this article shall not be deemed as exhaustive and does not constitute a legal opinion or advice. For any further information, the Author can be contacted at the following e-mail address: Mr Pietro BORSANO, Associate - Business & Legal Advisory at *AdvisingAsia*, *pietro@advisingasia.com*.