

PRACTICAL APPROACHES OF ISSUERS TO IPO-IMPLEMENTATION ON THE CZECH CAPITAL MARKET

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Abstract: *Funding of the company development through the „Initial Public Offering“ has a large representation in the world and on the developed capital markets it has been one of the traditional ways for raising funds needed for business development. In Anglo-Saxon countries and Western Europe is the method of financing through IPO used by businesses for several decades already. Initial public offering on these markets began in large numbers from the beginning of the sixties of last century. Since then, the importance of IPO in the world scale is increasing and in recent years there are appearing the public offerings of shares even in the countries of Central and Eastern Europe. Also on the Czech capital market can be identified seven companies that joined this form of financing in the years 2004-2010. This article aims to identify the main characteristics of initial public offerings of shares which took place on the Czech capital market in its modern history, and to identify attitudes, opinions and experiences of each practising company.*

Keywords: *IPO, Initial Public Offering, Czech Capital Market, Practical Approaches.*

JEL Classification: *G32.*

Introduction

Every company is in the course of its existence faced with the need for capital, which is due to non-synchronised flow of income and expenditures. Joint stock companies have theoretically available a wide range of resources that can be used to cover capital needs in connection with the implementation of development investments. It can be stated that long-term financing, particularly in large volume, requires involvement of external sources. An important form in this context represents the issue of securities on public capital markets. Shares and bonds issued on these markets are characterized by their negotiability, which is a great advantage both for the issuers who get by the emissions of long-term securities cash resources, as well as for the investors who can in principle sell them at any time after purchase and thus obtain the desired liquidity. Short-term funds from individual investors are thus converted to long-term resources allowing implementation of large-scale development investments. Due to the fact that the securities are purchased by a large number of investors, the company may raise the capital of such value that an individual investor wouldn't be able, respectively willing to provide.

Acquisition of the basic capital by subscription of shares is associated mainly with the decision between private and public issue. Individual issue represents a direct sale of shares to predetermined number of legal or natural persons. The organized public markets can not trade shares of these companies. The public issue of shares is by contrast associated with their public offering to unlimited number of not predetermined people in order to get the required amount of capital through the primary securities market. The first public issue of shares of a company, which haven't

been publicly traded yet, is often referred in specialised literature with the English term „*Initial Public Offering*“, abbreviated to IPO.

The aim of this paper is to identify the main characteristics of initial public offerings of shares which took place on the Czech capital market in its modern history, and to identify attitudes, opinions and experiences of each practising company. To achieve this goal there was made:

- Secondary research of relevant information sources, i.e. mainly prospectus and annual reports from the issuing companies.
- Primary research in companies that implemented the IPO in the Czech capital market.

During processing of the issue were also used especially logical and empirical methods.

2 Formulation of the problem

2.1 Definition of the term “Initial Public Offering“

When searching for relevant definition of "*Initial Public Offering*", for which is generally used the abbreviation "IPO" I used foreign sources, especially from the United States of America and Western Europe⁸. From the comparative analysis of foreign definitions is obvious that most authors put during definition of IPO emphasis on the fact that *the company offers its securities for the first-time to public, in the strict sense of the word the shares*, and also *enters the public organized securities market*⁹, represented most often by its stock exchange as a top institute. It is essential that the IPO can carry out only the issuer whose securities aren't traded at the given time on the public securities market.

According to the origin of shares offered in IPO can be according to [2, 3, 5] distinguished between:

- *IPO of primary shares*, where it comes to issue of new shares and their placing on the public primary securities market.
- *IPO of secondary shares*, consisting of offering the previously issued shares, which have been still traded only in private secondary securities market.
- *Combined IPO*, in which the newly issued shares complete the public offering of existing shares.

According to Huyghebaert and Van Hulle [3] the reason for IPO of *the primary shares* is especially need for more capital for company development, limited creation of internal financial resources and increasing share of bank loans in the financial structure of the company. On the contrary, stable companies with solid market position and high production of internal financial resources tend to offer *secondary shares*. This also comes into consideration in case of the privatization of state shares through

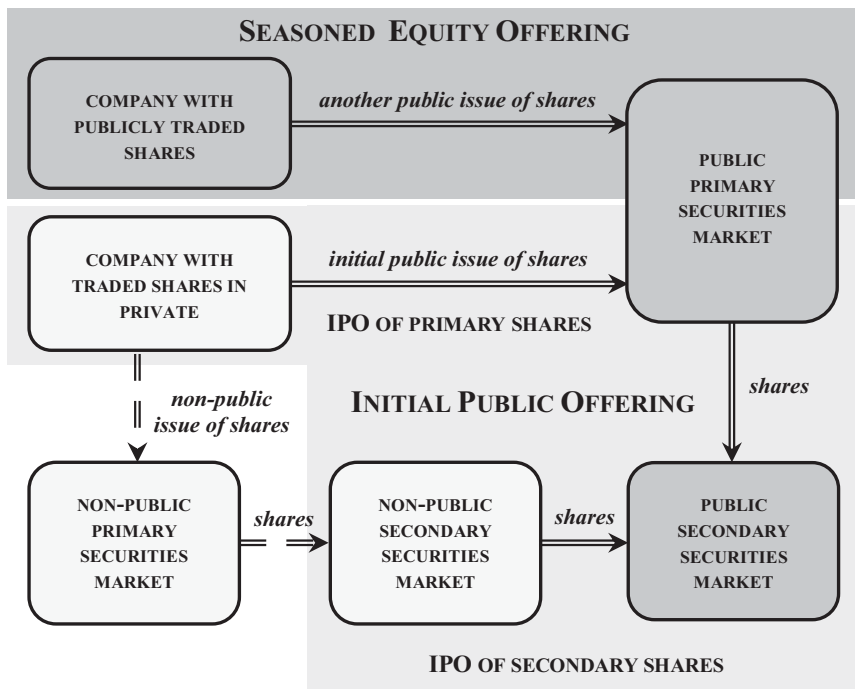
⁸ Financing of the company development through IPO has especially in these countries a long tradition and it is well established way of funding business plans of corporations.

⁹ Public organized securities market in the Czech Republic is defined according to Act no. 256/2004 on the Capital Market as a regulated market with investment instruments.

the capital market or in the case of exit of an investor from the venture capital company.

From the foregoing is obvious that the decision to offer primary or secondary shares is important for both the company itself and for its shareholders. During IPO of the primary shares the issuer offers newly issued securities and by selling them obtains the necessary funds for its business activities. During IPO of secondary shares acquire funds the existing shareholders whose shares are issued in IPO on the public secondary market for securities for the first time. It can be stated that *for funding further development of the company by its own external sources is important only IPO of the primary shares*, when the company in order to obtain the necessary financial resources issues new shares, which can be completed to improve their liquidity and attractiveness also with the existing shares.

Fig. 1: Comparison of IPO and SEO shares



Source of data: own processing

In the Czech literature the definition of the term “Initial Public Offering” may be found for example in publication from Pavlát [10]: “IPO is represents underwriting of new securities to the first acquirers” or in publications from Ježek et al. [6], Liška and Gazda [8], where IPO is called “primary emission of shares”. Some authors consider as IPO also *following emission of shares of companies* whose shares are already publicly traded on the securities market. However, it has to be pointed out that publicly traded companies can not implement an IPO, and that is just because their shares are already traded on the public securities market. Another public subscription of shares of these companies, is according to foreign literature [4, 2] most often referred to as

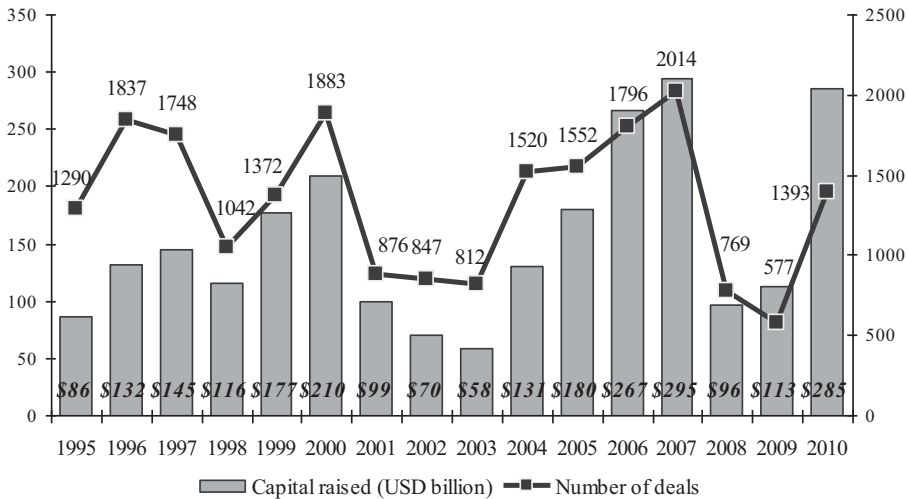
“Seasoned Equity Offering“ abbreviated as “SEO“. The difference between the IPO and SEO of shares can be schematically illustrated in figure 1.

Due to the nature of this work, which is focused on initial public offerings of shares, the term “Initial Public Offering“ will be used hereinafter *in the strict sense and the “IPO“ will be a shorthand for an initial public offering of shares.*

2.2 Trends of IPO numbers in global markets

This chapter aims to provide an overview of the development of initial public offerings of shares and of value of capital raised through this financing form on world markets. First is analysed global developments in this field and then is described the situation in Central and Eastern Europe.

Fig. 2: Number of IPO and value of the acquired capital in the world in the years 1995-2010



Source of data: [12]

Basic overview of global development of IPO is shown in figure 2. From there it is evident that the activity in IPO-field closely follows the business cycle. The period of sixteen years, shown in the figure, can be divided into several sub-periods. After a period of economic stagnation in the early nineties, particularly in the U.S. and Great Britain, it comes during 1995-1997 to a new growth in the number of initial public offerings of shares. Interest in IPO peaked in 2000 when it was carried out by 1883 companies. In the U.S. markets these were mainly the companies from *high-tech* sector and therefore this period of excessive optimism in the market is often referred to as the “Internet bubble“. After this period came in 2001-2003 cooling of the interest in initial public offerings of shares and therefore their number does not exceed the value of 900 per year. From the figure 2 is also obvious that in 2004 there is a change in this trend and the number of realised public offerings of shares got back on an upward trajectory. To increase of the number of IPO and also of the value of capital raised

through this financing in 2004-2007 contributed very significantly so-called *emerging markets*, i.e. dynamically developing markets, particularly Brazil, Russia, India and China. In 2007 was made worldwide 2014 of initial public shares offerings with total proceeds worth of USD 295 billion. These values can be considered as historical record. The most significant contributions came from China (259 bids worth USD 66 billion), USA (172 bids worth USD 34.2 billion) and Brazil (64 bids worth USD 27.3 billion).

But in 2008 it came – because of the global economic crisis – in all global stock markets to a cooling of interest in the IPO. In this year was made worldwide a total of 769 initial public offerings of shares worth USD 96 billion, representing in comparison with 2007 decrease of 62% in the number of IPO and decrease of 67 % in the amount of capital raised. The year 2009 was the year with historically the lowest number of IPO, as on the world's stock markets were made only 577 initial public offerings of shares with total proceeds worth USD 113 billion. From figure 2 is obvious that in 2010 there was a revival of business interest in the implementation of the IPO. On world markets were realised 1393 IPO with total proceeds of USD 285 billion. In 2010, the implementation of the IPO obtained the second highest level of capital over the past 16 years. To this value significantly contributed privatization of state enterprises in China through the IPO, which amounted to tens of billions of USD (the number of IPO in China = 509; value of the capital acquired = USD 131 billion).

Development of number of initial public offerings of shares realised on the major stock markets of selected countries in Central and Eastern Europe is given in table 1.

Tab. 1: Development of the IPO number on major markets of selected exchanges in the countries of CEE-region in 1998-2009

EXCHANGE	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GPW w Warszawie	57	28	13	9	5	6	36	34	35	68	29	10
Burza CP Praha	0	0	0	0	0	0	1	0	2	1	1	0
Budapesti Értéktőzsde	3	1	0	0	0	0	1	0	3	0	1	2
Burza CP v Bratislave	0	0	0	0	1	0	0	0	0	0	0	0
Ljubljanska Borza	0	0	0	0	0	0	0	0	2	1	1	0
Total	60	29	13	9	6	6	38	34	42	70	31	12

Source of data: [15, 16, 17]

From the table 1 is obvious that in the CEE countries it is not very common for companies to use capital markets to finance their development yet. The exception is Poland whose stock market is generally regarded as the most developed in this region. This confirms the number of IPO that were carried out on the Polish stock market in recent years. Warsaw Stock Exchange is currently among the exchanges with the highest number of IPO in continental Europe.

3 Solving the problem

3.1 Main characteristics of the IPO on the Czech capital market

In modern history of the Czech capital market, respectively of Prague Stock Exchange was not implemented any initial public offering until 2004.¹⁰ Only from this year on can be identified a few companies that made IPO in the Czech Republic. These companies became the subject of a research aiming to identify the main characteristics of initial public offerings of shares made in the Czech Republic in the years 2004-2010.

For the *main characteristics of the IPO* have been selected:

- Number of issued shares before and after implementation of the IPO.
- Structure of the subscribed shares (the share of primary and secondary shares in initial public offering, including over-allotment option).
- Free float (part of basic capital, which can be publicly traded and is not owned by strategic investors).
- Structure of investors (the proportion of institutional and retail investors in subscription of shares in the initial public offering).
- Size of emission (total number of subscribed shares multiplied by their issue price).
- Gross proceeds of the company from the IPO (the number of newly issued shares multiplied by their issue rate).
- IPO costs (broken down the charges to subscribers and other direct costs),
- Company's net income (part of the proceeds from the IPO which the company uses to finance its development).
- Underpricing (underestimate of the issue price of shares).

Overview of the main characteristics of initial public offerings of shares which were took place in the Czech capital market in the years 2004-2010, is shown in Table 2.

The research results show that the IPO on the Czech capital market held solely *multinational companies of the holding type* which do business in the Czech Republic, but their parent company is located abroad, in a country in which it is common that companies use capital market to obtain the necessary financial resources. For this reason, the IPO were mostly realized in form of *dual listing of shares* on domestic and foreign stock market.

¹⁰ The reasons for low number of IPO in the Czech Republic are described in publications from Liška, Gazda (2001) and Meluzín, Zinecker (2009).

Tab. 2: The main characteristics of the IPO on the Czech capital market in the years 2004-2010

Characteristics of IPO	Issuing Company							
	ZENTIVA	ECM	PEGAS	AAA	VGP	NWR	FORTUNA	
Date of the IPO implementation	28.6.2004	7.12.2006	18.12.2006	24.9.2007	7.12.2007	6.5.2008	22.10.2010	
Number of shares before the IPO (pc)	33 806 334	2 460 000	7 419 400	50 000 000	15 000 000	250 239 999	50 000 000	
Structure of the subscribed shares								
primary shares (pc)	4 329 896	1 275 000	1 810 000	17 757 875	3 278 688	13 500 000	2 000 000	
over-allotment option (pc)	0	127 500	0	0	304 362	0	0	
secondary shares (pc)	5 670 104	315 030	2 575 000	0	0	69 513 344	13 830 000	
over-allotment option (pc)	1 500 000	0	657 750	0	0	12 452 001	1 194 670	
Total number of subscribed shares (pc)	11 500 000	1 717 530	5 042 750	17 757 875	3 583 050	95 465 345	17 024 670	
Number of shares after the IPO (pc)	38 136 230	3 862 500	9 229 400	67 757 875	18 583 050	263 739 999	52 000 000	
Free float	30,16%	44,47%	54,64%	26,21%	3,28%	36,20%	32,74%	
Structure of investors								
institutional investors	100,00%	90,00%	90,00%	61,00%	—	90,00%	90,00%	
retail investors	0,00%	10,00%	10,00%	39,00%	17,00%	10,00%	10,00%	
Issue rate (EUR / share)	15,21	47,00	27,00	2,00	15,25	16,56	4,30	
Size of emission (EUR)	174 898 087	80 723 910	136 154 250	35 515 750	54 641 513	1 581 144 777	73 206 081	
Gross proceeds (EUR)	65 851 350	65 917 500	48 870 000	35 515 750	54 641 513	223 593 750	8 600 000	
IPO costs (% of emission size)								
charges to subscribers	4,00%	5,00%	3,50%	2,96%	—	3,00%	2,50%	
other direct costs	2,60%	1,86%	3,78%	3,78%	—	2,61%	—	
total	6,60%	6,86%	7,28%	6,76%	9,00%	5,61%	—	
Company's net income (EUR)	58 670 430	61 119 875	42 000 000	33 115 750	49 723 777	175 667 489	—	
Final rate on 1st day of trading (EUR / share)	15,82	52,50	28,22	2,00	15,60	17,81	4,32	
Underpricing	4,02%	11,70%	4,53%	0,05%	2,30%	7,55%	0,47%	

Source of data: own processing

Regarding the *structure of the shares* offered in IPO, it was found that most initial public offerings of shares were with the nature of the combined IPO, where the investors have been offered both primary and secondary shares. Money obtained by selling newly issued shares were used mainly for further development of the issuing companies and to repay their debts. Offer of secondary shares was mainly associated with withdrawing of venture capital fund from the company and the appreciation of its investment by selling shares on the stock market. The total *number of shares* offered in the IPO didn't exceed in most cases 50% of the basic capital of the company.

The main group of investors were institutional investors who came from the European Union. Their interest usually exceeded the number of shares offered to such extent that it allowed the issue manager to exercise an option for subscribe of additional shares. Retail investors were usually getting 10 % of the total number of shares offered in the IPO.

The size of issue was very different, the minimum value was EUR 35.5 million, the maximum value of EUR 1.58 billion and the median was EUR 80.7 million. Based on calculations, it was found that the total direct costs of IPO in the Czech capital market range from 5.6 to 9.0% of the volume of emission. The biggest cost item represents *fees to the issue manager*. Their size was in the analysed IPO 2.5 to 5.0% of the volume of emission.

Regarding the indirect cost associated with the IPO, so-called undervaluation of issue rate of shares, there can't be made definite conclusion about its size in the Czech conditions. This value varied considerably for individual issues.

3.2 Research on practical approaches of issuers to financing in the form of IPO

In the companies, which realised IPO on the Czech capital market, was also conducted *qualitative research* to identify practical approaches to this form of financing. A meeting was held with four issuers who on the basis of semi-structured interview expressed their attitudes, knowledge and experience with this form of financing. Topics of the asked questions were:

Issuing companies, in accordance with the theoretical approaches to the IPO, reported that one of the main reasons for its implementation was acquiring of the capital without having to discharge it. This enabled them to optimize capital structure and reduce the cost for obtaining additional capital, particularly with debt character. Companies give great weight to the fact that successful implementation of the IPO increased their credibility with banking institutions, which offered them more favourable credit terms, including lower interest rates than in the period before implementation of the IPO.

A significant impetus to the realization of the IPO came from the owner of the surveyed firms, particularly from a venture capital fund, who used IPO to termination and improvement of its investment. Companies indicate that in this case admission to public trading with shares on the stock markets was their long-term goal for which they were gradually preparing.

Another reason for implementation of the IPO, which is, however, in the professional literature not so often emphasized, has been reported the fact that

admission of shares to trading on the stock market is one of the attributes for successful activities of the company and its management. The entrance of the company on the capital market is linked to increased publicity and direct or indirect knowledge of the supply of its products and services, which ultimately has a positive impact on its goodwill. The companies with shares traded on the stock exchange are generally regarded as the most successful in the field in which they operate.

With regard to the financial disadvantages of the IPO, surveyed businesses agree that the initial public offering of shares is associated with high costs for external advisers, for internal human resources and new processes in the enterprise that are associated especially with the periodic reporting obligations. Issuers point out that the total costs for IPO, which are usually expressed as a percentage of the issue volume, do not represent unique given reward for obtaining the necessary financial resources, as in the case of loan financing.

Issuing companies do not consider underpricing as a significant expense for IPO, but they perceive it rather as a one of tools to increase the likelihood of IPO success. Issuers agree that underpricing helps to ensure sufficient demand from institutional and private investors for shares offered in the IPO. The possibility of capital gains during the first days of trading shares on the secondary market is attracting media attention and increases the publicity of the issuer.

As access to capital markets requires transparency of current and past information on the activities of the company, the surveyed companies report that their management spent most of his time preparing the IPO, which to some extent reflected in retard of growing business of the company. It should be noted that the IPO represents a retrospective evaluation of the company activities and its in-depth examination by legal and financial auditors. To make initial public offer of shares it is therefore necessary to have legal and financial certainty for all businesses that are part of the issuing company.

Investigated companies indicate that another more demanding activity in the IPO process is creation of a prospectus, which describes both past and present of the issuing company and outlines its future. It should be noted that all data which are presented in the prospectus, should be based on demonstrable facts. After the creation of this document it is necessary to ensure its presentation to investors, what means creation of a new department for relations with investors and implementation of road show, that is a personal meeting with potential investors, especially of institutional character.

Issuing companies stated that the main reasons for implementation the IPO on the Czech capital market was the fact that the Czech Republic is a major market for the implementation of their business and also the market opportunity which related to the low number of IPO in the Czech capital market.

Surveyed companies have agreed that entering the capital market through IPO should be a natural part of business development, and should not be viewed solely as one of sources for obtaining the funds needed for a specific investment. When deciding on the implementation of the IPO it is also not possible to consider only the financial criteria, since entry of the company on the capital market, in comparison with

other forms of financing, is an irreversible process for which the company must be prepared in the long term.

Conclusion

Initial public offering of shares represent in more developed capital markets one of the options how to obtain the necessary capital for company development. This form of financing is important not only for the stock companies themselves, for who it is a particular alternative especially to debt financing, but also for further development of the capital market as a whole. Through the initial public offerings of shares is namely fulfilled one of the basic functions of capital markets, that means the allocation function. In Anglo-Saxon countries and Western Europe is the method of financing through IPO used by businesses for several decades and it is a well established source of corporate financing. Initial public offering on these markets began in large numbers from the beginning of the sixties of last century. Since then, the importance of IPO in the world scale is increasing and in recent years there are appearing the public offerings of shares even in the countries of Central and Eastern Europe. Also in the Czech Republic can be identified since 2004 some companies that have accepted this form of financing. These companies became the subject of a research aiming to identify the main characteristics of initial public offerings of shares made in the Czech Republic in the years 2004-2010.

Regarding the prospects for external financing of corporations through a public share issue, it should be noted that the IPO activity closely follows the development of economic cycles. As that financial and economic systems are closely linked, the development of financial markets is strongly influenced not only by immediate, but also anticipated future development in national and world economies. For this reason it is necessary during issue of shares and other securities to take into account the effects of the business cycle. From a macroeconomic point of view, the most favourable period for implementation of the IPO could be marked the growth phase of the business cycle, i.e. a period of economic boom. Equity capital becomes available in a growing economy, because there are high profit expectations from both the issuers and the investor side. In 2008-2009 there was almost in all world markets due to global economic crisis a significant decrease in the number of IPO and also in the amount of capital raised. In 2010, however, activity in the IPO filed as a consequence of economic recovery in most countries of the world got back on an upward trajectory. So, it can be expected that also in 2011 will gradually enter the capital market additional companies through IPO, both in the developed world and in the CEE region.

Also important for an increase in the number of IPOs in the CR are micro-economic pre-requisites and issue size requirements. One of the reasons for the absence of this type of financing in the CR prior to 2004 was poor performance of Czech companies. At present, problems lie particularly in the area of the fulfilment of corporate governance requirements. One of the requirements the issuer must satisfy is that of the transparency of the company's ownership and organizational structures. Another problem is the requirements for the company presentation to investors. It follows from research the author conducted in 2007 that the unwillingness of Czech companies to implement an IPO is, among other things, connected with their

management's fear of "public supervision" over their operations, which must be completely transparent after companies enter the capital market, and also the unwillingness of companies to agree to a regular disclosure obligation. From the issue-size-requirement point of view, the question is whether capital needs of Czech companies are sufficiently big to make IPOs on the Prague stock exchange a viable proposition. Thirty million EUR is considered an approximate minimum volume of funds for IPO implementation. The Prague stock exchange thus lacks a platform such as the Polish NewConnect market developed for smaller companies.

In spite of that I believe that the number of successful issuers in the Czech Republic will show further growth in the nearest future. In this context it should be noted that in the same way as companies diversify their assets, they should also use multi-source funding. This allows them to offset the disadvantages of debt financing together with limited formation of internal resources against the benefits provided by the IPO.

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