Box 5

Activity in the euro area initial public offering market

Initial public offering (IPO) activity in the euro area, measured either by total transacted amounts or by the number of transactions, surged after the mid-1990s (see Chart A below). The market was particularly active in 1999 and reached a peak in the first quarter of 2000. Since then activity has fallen off markedly and by the third quarter of 2002 it reached levels as low as those seen in the mid-1990s. While several factors may have played a role in these swings, this box focuses on the link between IPO activity and its cost, as proxied by the cost of equity.

Chart A: Initial public offering activity
(four-quarter moving average, quarterly data)

A commonly accepted definition of the cost faced by firms in raising equity capital is the return demanded by investors to bear the risk of an equity investment. It can be broken down into a risk-free interest rate, usually the return that investors would obtain from investing in a government bond, plus an equity risk premium, the additional return demanded by the investor to bear the specific risk attached to equity. From a conceptual
viewpoint the definition of the cost of equity is straightforward; in practice, however, its measurement is rather
cumbersome, notably because it is difficult to measure the size of the equity risk premium.

Stock prices reflect the discounted value of future dividends. The discount rate that equates the current stock
price with the net present value of future dividends is the return demanded by shareholders for holding stocks.
If the return demanded by shareholders rises, this will, assuming dividends cannot be raised and all else being
equal, bring about a decline in stock prices and a rise in the dividend yield, i.e. the anticipated annual dividend
as a percentage of the share price. Such a rise in the dividend yield then implies a higher cost of equity capital.

Chart B: Initial public offering activity and the price/dividend ratio
(four-quarter moving average, quarterly data)

Source: Bondware and Datastream.

1) Share price as a percentage of the anticipated annual dividend.

Chart B shows the amounts transacted in IPOs in the euro area since 1995 together with the price/dividend
ratio (i.e. the inverse of the dividend yield) of the euro area Datastream stock index. The two series show a
very high correlation. The IPO market was more active when the price/dividend ratio was high or, in other
words, when the cost of equity was low. In the period since 1995, the price/dividend ratio has been driven
mainly by stock price developments. Hence it would seem that there is a close link between IPO activity and
stock price developments, which impact on the cost of equity. This result sheds light on one of the transmission
mechanisms between asset prices and the real economy, namely the cost-of-capital channel. It illustrates how
the decline in stock prices over the past two years has made access to equity financing more difficult.