Issues Surrounding Venture Capital, Initial Public Offering (IPO) and Post-IPO Equity Financing for Canadian SMEs

Prepared for Industry Canada by E. Wayne Clendenning & Associates

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EXECUTIVE SUMMARY

Equity financing is a vital component of overall financing for SMEs in Canada and the equity financing research program now being initiated by Industry Canada will provide insight into how access to such financing can be improved in the years ahead. The purpose of this study is to develop the issues surrounding equity financing for SMEs in Canada through the venture capital, initial public offering (IPO) and post-IPO stages of development. These issues will then become the basis for the development of future research projects to be undertaken as part of the Industry Canada research program.

The analyses in this study have shown that the issues surrounding venture capital, IPO and post-IPO equity financing vary considerably for each type of financing with issues in some areas having greater significance than in other areas. The majority of issues surrounding equity financing for SMEs in Canada arose in venture capital financing. Not only where there many more issues surrounding venture capital financing but these issues were also more fundamental to the success of SMEs in progressing through the various stages of development and growth. The issues that arose in venture capital financing are also more open to public policy solutions than is the case for issues surrounding IPO and post-IPO financing.

VENTURE CAPITAL FINANCING

The venture capital issues resulted primarily from the structure of the venture capital market in Canada, the behaviour and management expertise of Canadian venture capitalists, the participation of institutional investors in Canada, the taxation environment and the cross-border inter-play between the Canadian and U.S. markets. These specific issues resulted in less access to venture capital, higher financial costs and greater time costs for Canadian SMEs than is the case for SMEs in the U.S. market. These issues include the following:

- How can the availability of, and access to, venture capital financing be increased for SMEs through improving the efficiency and competitiveness of the Canadian venture capital market in allocating the available supply of venture capital financing?

- How can growth-oriented SMEs in lesser developed regions of Canada be identified and developed so that venture capital financing can be attracted to those regions?

- How can the market structure and behaviour of venture capitalists be changed so that a company's management is not required to spend large amounts of time and effort to find the right venture capitalists for their business?
• How can Canadian pension fund managers be encouraged to provide a proportion of funding to Canadian venture capital firms that is comparable to that provided by pension funds in the U.S.?

• How can financial institutions be encouraged to continue their growing interest in venture capital financing through an evolving regulatory environment?

• How can generalist venture capital funds be encouraged and enabled to obtain the specialized knowledge required to participate in new industries where this knowledge is needed?

• Is there a need for specialized consulting and analytical resources that could be available to the venture capital firms on a pooled basis either on an independent basis or through the establishment of a resource facility that would be owned jointly by venture capital firms?

• How can the provision of specialized expertise to syndicates and networks of venture capital firms that work together and rely on each other's investment assessment expertise be facilitated, so as to minimize time and effort for both the firms and the companies seeking investment and result in fair valuations for both parties?

• How can relatively small venture capital firms making up syndicates be provided with sufficient resources to play a more active role in supporting and mentoring a company's management?

• What can be done to encourage Canadian venture capital firms, particularly the LSVCCs, to adopt risk adverse attitudes to venture capital investment that are more similar to those held by U.S. generalist venture capital funds?

• How can more managers that have an industry background rather than a banking background be attracted into the Canadian venture capital industry, so that more specialized industry knowledge can be built up in these firms?

• How can Canadian pension fund managers be encouraged to provide a proportion of funding to Canadian venture capital firms that is comparable to that provided by pension funds in the U.S.? Are changes to regulatory requirements or income tax rules needed?

• Will the recent reduction in the Canadian capital gains tax rate improve the inflow of funding to the venture capital industry? How can this be tracked?
• Would the encouragement of cross border syndicates of Canadian and U.S. venture firms provide larger investments in Canadian companies that require expansion phase funding?

• Could greater integration of the Canadian and U.S. venture capital markets create greater competition in the Canadian market and reduce the flow of Canadian firms to the U.S. through increasing cross-border flows between the two markets?

IPO AND POST-IPO FINANCING

In the case of IPO and post-IPO financing, evidence provided in this study indicates that the Canadian markets are more efficient and less costly for raising this type of financing than the U.S. markets. This is particularly so in the case of financial costs arising from the valuation and pricing of IPO and post-IPO issues where Canadian markets consistently out-performed U.S. markets. The most significant factors surrounding these types of financing revolve around the capacity of the Canadian markets to meet the needs of Canadian SMEs and the other business benefits achieved through going public in the U.S. These factors give rise to the following issues:

• Do capacity limitations in the Canadian market force Canadian SMEs to delay going public until they are large and established enough to meet the more stringent regulatory requirements in the U.S.?

• Since Canadian companies continue to undertake a large volume of IPOs in the U.S. market, despite the cost advantages of going public in Canada, does this indicate that there is a lack of capacity in the Canadian IPO market to meet Canadian financing needs or that other business benefits arising from going public in the U.S. outweigh the Canadian cost advantages?

• Since Canadian post-IPO markets appear to be quite competitive relative to U.S. markets in terms of issuing costs and the valuation and pricing of post-IPO issues, are Canadian companies willing to pay a penalty by issuing in the U.S., either because of a lack of capacity in the Canadian market or of the value of the business benefits from going public in the U.S.?

• Could the capacity of the Canadian markets to absorb relatively large post-IPO issues be increased to meet more of the post-IPO financing needs of Canadian companies by encouraging Canadian institutional investors to play a more active role in post-IPO equity financing?
Equity financing is a vital component of overall financing for SMEs in Canada and the equity financing research program now being initiated by Industry Canada will provide insight into how access to such financing can be improved in the years ahead. The purpose of this study is to develop the issues surrounding equity financing for SMEs in Canada through the venture capital, initial public offering (IPO) and post-IPO stages of development. These issues will then become the basis for the development of future research projects to be undertaken as part of the Industry Canada research program.

The introduction to the study will involve an overview of the nature and significance of equity financing for Canadian SMEs, particularly for those in the knowledge-based sectors of the economy. In addition the recent trends in the sources of equity capital will be analysed as background to the issues development sections of the study. The issues surrounding the provision of venture capital, IPO and post-IPO equity financing will then be developed in three separate sections of the study.

In Section I, an overview of the venture capital markets in Canada and the U.S. will be provided along with the development of issues surrounding the provision of venture capital financing for Canadian SMEs. The overview will examine the market participants, the relative supply of venture capital and the sectoral and regional distributions in the respective markets. Based on these background analyses, issues surrounding access to, the costs associated with, venture capital financing in Canada will be developed, including those arising from differences between the Canadian and U.S. venture capital markets. Emphasis will be placed on issues that impact the structure of the venture capital markets in Canada and the U.S., influence the behaviour of Canadian and U.S. venture capitalists and create limits on the amounts that these venture capitalists are willing and able to invest in Canadian SMEs.

Section II will examine the structure of the Canadian and U.S. IPO markets and the type and size of issues undertaken in the respective markets. The regulatory requirements and market processes applying in each market will also be analysed and issues arising from these factors will be developed. On the basis of these analyses, issues surrounding the management costs, financial costs associated with IPOs and valuation and pricing of IPOs in each market will be developed. These issues will focus on factors such as regulatory impediments, cost elements, market structures and processes and investor attitudes.

Section III will look at factors affecting post-IPO equity financing and the role that this type of financing has played in Canada and the U.S. The issues involved in this type of financing arising from factors such as post-IPO stock performance, the ability to attract strong institutional investor interest in the post-IPO market and regulatory requirements and costs associated with follow-on equity issues will be developed. Because of the relatively large size of post-IPO financings, issues also arise regarding the capacity of the Canadian markets to absorb such issues and the need to list and issue shares on U.S. stock exchanges.
Finally, conclusions will be drawn regarding the relative significance of the issues developed in each section of the study and a summary list of priority issues will be developed as the basis for future research studies.

**The Nature and Significance of Equity Financing for SMEs**

Equity financing is a very significant source of financing for SMEs through all stages of development with the nature of that financing changing as the firms progress through their developmental stages. During the start-up stage, SMEs are almost entirely dependent on equity capital from private investors for financing their initial operations, such as research and product development activities. This equity financing is initially obtained from family and friends and then supplemented by equity investments from other informal private investors, such as wealthy individuals (angel investors). These initial types of financing are not covered in this study but instead will be dealt with in other studies undertaken as part of the research program.

During the growth stage of development, SMEs generally require larger amounts of equity financing to maintain research and development and rapidly expand marketing and sales activities. This is particularly true for knowledge-based companies where the rapid growth characteristics of knowledge-based product markets put great pressure on these companies' ability to access equity capital fast enough to keep up with their required growth rate. During this stage, substantial equity injections are generally required from venture capitalists.

As companies continue to grow, even larger amounts of equity investment are required, which are normally only available through initial public offerings (IPOs) on stock exchanges. Not only do IPOs supply continued growth capital for companies, they also are a major means of providing successful exits for venture capitalists by allowing them to repatriate their original investments and realize their gains on those investments. This then provides the opportunity for venture capitalists to recycle their funds into new investments and increases their confidence in venture financing. If this can be accomplished, it further increases the funds available for the investment programs of venture capital firms.

During the mature stage of development, although internally generated funds can become an important source of financing, further equity investment is often required to meet the growth targets of a company. This need is usually satisfied through post-IPO follow-on stock issues through stock exchanges. Because of their relatively large size, these issues require the development of a strong institutional following for the company in the marketplace and often involve the issuance of shares on multiple stock exchanges across international borders. This type of financing is again particularly important for knowledge-based firms, which do not have sufficient fixed assets to provide security for large debt financings.
SECTION I - VENTURE CAPITAL EQUITY FINANCING

OVERVIEW OF THE VENTURE CAPITAL MARKETS IN CANADA AND THE U.S.

The following overview of the Canadian and U.S. venture capital markets provides analyses of the trends in the two markets and the differences in the structures and performances between the markets. These analyses will then be the basis for the development of issues surrounding the provision of venture capital equity financing to SMEs. The detailed statistical analyses of the Canadian and U.S. markets are provided in Appendices A and B, respectively.

PARTICIPANTS IN THE MARKET

In Canada, the major participants in the venture capital market over the past few years have been the Labour Sponsored Venture Capital Corporations (LSVCCs), corporate funds associated with industrial and financial corporations and private independent funds that raise funds from institutional and individual investors. Among these different types of venture capital firms the LSVCCs have been the largest suppliers of venture capital during recent years, followed by corporate funds and the private independent funds. The dominance of the LSVCCs, along with a growing participation by government agencies, such as the BDC, shows that the Canadian venture capital market is very dependent upon government involvement and support. In 1999, the private corporate and independent funds have a considerably smaller combined share (38%) of venture capital investments under management than the government-related firms (50%) do but in 2000 the private independent funds expanded their share considerably to almost equal that of the LSVCCs. The LSVCCs have also provided much of the growth in venture capital financing since their creation along with a lesser, although growing, contribution from the corporate funds and private independent funds. Over the years, private independent funds seem to have been constrained in their growth by the reluctance of Canadian institutional investors, particularly pension funds, to increase significantly their allocation of funds for venture capital financing.

In the U.S. market, on the other hand, by far the dominant participants in venture capital financing have been the private independent firms that have no affiliation with other financial institutions. These firms generally invest through funds organized on a pooled basis as limited partnerships in which the venture capital firm serves as the general partner with the investors, largely pension funds, being limited partners in the structure. The next most important firms in the U.S. market are venture firms associated with financial institutions, often on an affiliate or subsidiary basis. Corporate venture firms, that are subsidiaries of industrial corporations, also play a significant role, usually by making investments on behalf of their parent companies. Government participation in the U.S. market is very limited and generally takes the form of government programs aimed at augmenting the funds available through private sector venture financing, often through private venture capital firms.

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The major difference between the participants in the Canadian and U.S. markets is the starkly different role played by governments in venture capital financing between the two markets. The Canadian market has a much greater dependence on government participation through both direct financing programs and the provision of tax incentives to investors than is the case in the U.S. The extent of participation by private independent funds is also very different between Canada and the U.S. with these firms playing a very dominant role in the U.S. but only a more limited role in the Canadian market. This, in turn, reflects an underlying difference in the participation of institutional investors in venture financing between the two countries. In the U.S., institutional investors provide the bulk of funding for venture capital financing, whereas in Canada venture financing is more dependent on funding from corporations and individual investors, particularly small investors through the LSVCCs, with pension funds playing a lessor role.

**Supply of Venture Capital Financing**

The supply of venture capital financing has increased substantially in both Canada and the U.S. since 1997 but growth in the U.S. (492%) has far exceeded that in Canada (250%) during the 1997 to 2000 period. In 2000, the Canadian market invested funds equivalent to only 6.1% of the funds invested in the U.S. market, which is proportionately small compared to the relative size of the economies (Canada 15% of the U.S.) and on a per capita basis (approximately $0.35 per capita in the U.S. vs. $0.20 per capita in Canada). This difference again appears to be related to the comparatively weak position of the private independent funds in Canada relative to those in the U.S., which draw on the huge pool of pension fund financing made available for venture financing in the U.S. Although the LSVCCs have been successful in raising funds in Canada they are restricted in making these funds available for venture capital financing by their dependence on small individual investors for their funding and the need to hold large reserves of non-venture investments, equal to 30% of their total holdings, to protect these investors and provide liquidity for withdrawals of funds by investors. The growth of corporate venture firms is also more limited in Canada by the fewer and relatively smaller Canadian industrial and financial corporations that can effectively sponsor and fund such firms compared to the situation in the U.S., where many companies have the capability of doing so, particularly in the technology sector.

**Venture Capital Investment by Stage of Activity**

In Canada, the split between early stage and expansion stage investment on the part of venture capitalists has been very consistent throughout the 1997 to 1999 period, with approximately 35% of total investment going to early stage companies and 53% going to expansion stage companies each year during the period. This represented a well balanced provision of venture capital to companies in accordance with needs as individual investments in expansion stage companies would generally need to be larger than those for early stage companies, thereby resulting in a higher percentage of total investment going to those companies. However, in 2000, investment in early stage companies increased to 45% of total investment and investment in expansion stage companies declined to 49%, reflecting a greater focus on new companies.
in 2000 was the substantial increase in seed investment in very early stage firms. In the U.S., the pattern of investment by stage of activity appears to have been somewhat more volatile but the trend appears to be moving towards an increasing percentage going to expansion stage companies. In addition, in the U.S., a significant portion of total investment also goes to later stage companies that are beyond the initial expansion stage of activity; whereas, in Canada, this type of investment does not appear to have been significant. If these two stages of activity are taken together in the U.S. the percentage of total investment going to companies operating beyond the early stage of activity substantially exceeds the percentage of total investment going to these companies in Canada. On the other hand, the percentage going to early stage companies in Canada significantly exceeds the percentage going to these companies in the U.S. This would appear to be one of the significant differences between the Canadian and U.S. venture capital markets.

**Sectoral Distribution of Venture Capital Investment**

The sectoral distribution of total venture capital investment between the technology sector and traditional industries has been virtually the same in Canada and the U.S. during each year over the 1997 - 1999 period but in 2000 there was further shift away from traditional industries. For example, in 1999, 80% of total investment went to the technology sector while 20% went to traditional industries in both countries but in 2000 the technology sector captured 97% of total investment in the U.S. and 90% in Canada. Within the technology sector the most striking trend in the U.S. was the sharp increase in investment in the Internet sector. Although investment in Internet companies in past years has not been broken out in the Canadian data, 2000 data also showed a significant percentage of investment in Internet investment in Canada. Another significant difference between the two countries was the substantially higher percentage of investment going into biotechnology in Canada compared to that in the U.S. Communications, on the other hand, received a somewhat higher percentage of investment in the U.S. than in Canada until 2000 when Canada had a higher percentage.

**Regional Distribution of Venture Capital Investment**

In Canada, over the 1997 - 2000 period, venture capital investment has been concentrated in Ontario, which in 2000, received almost half of total investment. However, Quebec and Ontario received almost equal percentages of total investment during the 1997 to 1998 period, with the two regions combined receiving approximately 70% of total investment on average during the entire period. The only other region to receive a significant portion of total investment was Western Canada, which averaged approximately 20% during the 1997-1999 period but declined significantly in 2000. The Atlantic region received only a minimal share of total investment throughout the period. In the U.S. a similar regional distribution pattern occurred during this period with the Southwest region, dominated by California, receiving almost 50% of total investment. The only other region to receive a substantial percentage was the Northeast, which consistently received about 20% of total investment. All other regions in the U.S. received almost equal amounts of less than 10% of total investment throughout the period. This evidence suggests that both countries are experiencing difficulties in achieving a balanced distribution of
venture capital investment among the various regions of their countries. In both countries, this pattern also reflects the regional distribution of venture capital investment opportunities and part of the solution to this unbalanced regional activity may be greater promotion of new businesses in these regions that would be available for venture investment.

**ISSUES SURROUNDING VENTURE CAPITAL EQUITY FINANCING**

In this section, the issues surrounding the provision of venture capital equity financing to Canadian SMEs will be developed and examined in some detail. These will involve issues related to overall access to venture capital financing and the costs of venture capital, with particular reference to issues related to the differences between the Canadian and U.S. venture capital markets. These latter issues arise from Canadian and U.S. differences in the structure of the venture capital markets, the behaviour of venture capitalists, the taxation environment and limitations on investments. Related to these issues are issues regarding the cross border flows of investment between the two countries.

**General Issues: Access to Venture Capital**

A fundamental issues regarding venture capital financing in Canada is whether or not Canadian venture capitalists can raise sufficient funds to provide Canadian SMEs with the level of venture capital investment that they require at all stages of activity. In the above statistical analyses of the Canadian and U.S. venture capital markets there is evidence that both the supply of venture capital and total venture capital investment lag behind that in the U.S. relative to the size of the economies and on a per capita basis. This would indicate that Canadian SMEs might not be able to access sufficient venture capital financing in Canada relative to what they need or could effectively use. There are no data available to measure this potential shortfall in access or to indicate how many viable SMEs were unable to obtain venture capital financing. In addition, this shortfall in access, although it may not prevent the establishment of viable SMEs, may restrict their growth and development and, thereby, reduce or threaten their longer-term success in the marketplace.

There is evidence in comparing the Canadian and U.S. venture capital markets that the difference in access between the two markets is focussed in the expansion and later stages of activity where the percentage of total of investment in the U.S. significantly exceeds that in the Canadian market. On the other hand, the percentage of investment in early stage companies in Canada exceeds that in the U.S. market. Given the overall shortfall in venture capital financing relative to that in U.S., this could mean that the squeeze on access to venture financing for Canadian SMEs could be heavily concentrated during the expansion and growth stages of activity. It is during these stages of activity that failure to access this financing means almost certain death for the company.

With regard to sectoral access to venture capital investment, the knowledge-based technology sector has consistently received by far the largest proportion of venture investment in both
Canada and the U.S. Since the knowledge-based sector is almost entirely dependent on equity financing for its development and growth, this is a positive element within the overall access picture and, as a result, there are few issues related to the sectoral provision of venture capital financing in Canada. From an economic perspective, venture capital financing should be concentrated in these high growth sectors of the economy.

There are, however, issues regarding the regional access to venture capital financing in both countries as the bulk of investment is concentrated in one region in each country, although there is anecdotal evidence that access to venture investment is spreading modestly to the have-not regions in both countries. Much of this has to do with the nodal approach to investment in the technology sector and the more limited number of investment opportunities in less populated regions but there is still the issue of providing more equal access to venture capital for viable companies in all regions. However, this is not an issue specific to Canada and until the various regions of the country are able to develop a critical mass of companies in the technology sector, access to venture capital financing is probably going continue to lag in the lesser developed regions of the country.

**Issue:** How can growth-oriented SMEs in lesser developed regions of Canada be identified and developed so that venture capital financing can be attracted to those regions?

**Financial Costs of Venture Capital**

The financial costs involved in obtaining venture capital equity financing are reflected in the valuations that the investee companies receive on the shares and the dividends and interest they pay on other securities that are acquired by the venture capitalists. If the venture capitalist only receives common shares in the investee company the cost to the SME and its owners is the extent to which the valuation on the shares acquired by the venture capitalists compensates for the dilution in ownership of the company suffered by the existing shareholders. The higher the valuation of the shares, the lower the dilution of ownership and, hence, the lower the cost of the venture capital investment. Therefore, any factors that increase the valuation paid by the venture capitalist for the common shares will lower the cost of venture capital investment to the company and its existing shareholders. In the case of other securities, such as preferred shares or convertible debt instruments, acquired by venture capitalists in providing financing, the cost is usually directly measurable by the dividend and interest rates attached to these securities plus the valuation dilution impact, if and when these securities are converted into common shares.

The issues surrounding the valuation costs associated with ownership dilution arise from factors such as the availability of, and competition for, venture capital investment in the marketplace. Within this framework, financial costs are basically determined by the structure of the venture capital market and the attitudes and behaviour of venture capitalists in the marketplace.

**Issue:** How can the availability of, and access to, venture capital financing be increased for SMEs through improving the efficiency and competitiveness of the venture capital market in allocating the available supply of venture capital financing?
**TIME COSTS OF VENTURE CAPITAL**

The time costs of venture capital financing involve the time and effort that management of a company has to put into the process of searching for and obtaining venture capital investment. The major cost associated with these efforts results from the diversion of management personnel from actually initiating and expanding the company's business operations to the search for financing. The greater this diversion, the higher the cost in terms of lost opportunities to grow and strengthen the business. On the other hand, the future of the business is totally dependent on obtaining adequate equity financing and management has no choice but to divert its attention to this task. The major factors that are important in determining these costs are the structure and efficiency of the venture capital market and the attitudes and behaviour of venture capitalists; e.g. because of a lack of specialized knowledge among venture capital firms or if venture capitalists are highly risk adverse. These time costs also tend to vary in accordance with a company's stage of activity with companies in the early stage of development requiring more time and effort to get themselves known within the venture capital community and to explain their business plans to a new audience.

This makes early venture capital financing generally more time costly to obtain than follow-on financing. In this case, the company has already obtained some initial venture financing and the venture capitalists providing this initial financing have a vested interest in championing the company with other venture capital firms with whom they would like to share the next round of financing. Also, venture firms are more interested in pursuing a company with a track record within the venture capital industry and become less risk adverse if another known venture firm has already invested in the company. Finally, the original venture investor is also usually interested in investing further in the company, particularly if the risk can be spread further among other investors in the process. The time costs also vary with the size of the venture investment required by the company, with a very small investment from one investor probably being less time consuming than a large investment requiring negotiations and relationship building with a number of investors, who may also have to build a relationships and reach agreement among themselves.

**Issue:** How can the market structure and behaviour of venture capitalists be changed so that a company's management is not required to spend large amounts of time and effort to find the right venture capitalists for their business?

**SPECIFIC ISSUES: STRUCTURE OF THE VENTURE CAPITAL MARKET**

The structure of the venture capital market can give rise to a number of issues related to access to venture capital and both the financial and time costs of obtaining venture capital investment. In this analysis, the structures of the Canadian and U.S. venture capital markets will be compared to develop issues that could account for the divergence in performance between the two markets. The Canadian market over the 1997 to 2000 period has lagged the U.S. market both in terms of raising funds for venture capital investment and in making venture capital investments on a per capita basis and some of this divergence may be accounted for by the differences in structure.
between the markets. Issues arising from an examination and analysis of these differences in structure, if dealt with, could lead to improvements in the performance of the Canadian venture capital market.

One of the major differences between the Canadian and U.S. venture capital markets is the dominance of the private independent venture capital firms in the U.S. and the greater involvement of government-related firms in the Canadian market. The private independent firms in the U.S. operate funds that are organized as limited partnerships with the firms acting as the general partners. Each firm may have a number of these funds (often as many as 6 or 7), each of which is organized independently of the others with its own investors (limited partners) and general partner. The investment strategies of these related funds may be similar or quite different, with some of them being generalist funds and others being specialist funds. Evidence in the U.S. indicates that currently over 50% of the capital raised by these funds comes from public and private pension funds, with the remainder coming from endowments, foundations, insurance companies, banks and individuals. Analysis of institutional portfolios in the U.S. indicate that the average institutional investor will allocate 2% to 3% of their institutional portfolio for investment in alternative assets, such as venture capital investments through these funds.

**Canadian Market Structure**

In Canada, the largest participants in the venture capital market over the past few years have been the LSVCCs, which raise funds from small investors through the provision of government tax incentives. These funds, over the past few years have provided approximately 50% of the total funds available for venture capital investments. Although these funds have grown rapidly since their creation there are signs that their growth is flattening out as small investors find it difficult to add further to their investments in riskier assets and the tax incentives to do so have been reduced. Over the past year or so, the amount raised by these funds has remained relatively static. As a result, if the Canadian venture capital market is to grow substantially sources other than LSVCCs are going to have to be found. In addition, LSVCCs are not very efficient in terms of raising usable venture capital because of the nature of their investors. Reliance on small investors requires them to hold substantial reserves of liquid investments to protect investors and provide liquidity for withdrawals by small investors when they are eligible to make withdrawals. These withdrawals also tend to come fairly early in the investment cycle as small investors are likely to have less patience than large institutional investors. As a result, only about 60% of the actual funds raised by LSVCCs are available for venture capital investment.

Although the Canadian market also includes a substantial number of independent private funds, which have traditionally accounted for about 20% of total venture capital funds raised in the market, although in 2000 this percentage increased significantly to about 25%. However, the growth of these funds has been rather volatile as institutional investors have fluctuated in their participation in venture capital investment. In recent years, there has been evidence of growing institutional interest in venture investment and these funds have been able to expand significant to offset the static performance of the LSVCCs. Canadian pension funds have by far the largest
pool of capital in the country and unless they are prepared to allocate a significant and stable portion of their portfolios to venture capital investments, it will be impossible for the private independent firms to play the type of role that these funds play in the U.S. market. Pension plans are the ideal investors to participate in the venture capital market because of their ability to diversify widely across asset types and the long time horizons on their portfolios. Recently, there is also evidence that larger pension funds, such as Ontario Teachers, OMERS and Quebec's CDP, are making direct venture capital investments instead of participating through private independent funds.

*Issue:* How can participation by Canadian pension funds in the venture capital market be increased to a proportion of the market more similar 50% share of venture capital financing by U.S. pension funds?

A positive development in the Canadian venture capital market has been the growth of corporate venture capital firms, affiliated with both industrial corporations and with financial institutions, particularly the chartered banks. This parallels a similar trend in the U.S. where major corporations have substantially increased their involvement in venture capital financing. In Canada, in 1999, these funds accounted for 17% of total funds raised for venture capital investment while in the U.S. these types of funds made up about 10% of total venture capital investment in the same year. Following regulatory changes involving these types of subsidiaries, the chartered banks became more aggressive in the involvement in venture capital financing both directly and indirectly through investing in independent private venture capital funds. This trend of greater financial institution participation should continue when the new financial institution regulatory framework is in place allowing financial institutions greater flexibility to hold these subsidiaries under holding company structures where they can be regulated differently from the parent institution.

*Issue:* How can financial institutions be encouraged to continue their growing interest in venture capital financing through an evolving regulatory environment?

**Efficiency of the Canadian Market**

The efficiency of the Canadian venture capital market may also be less than that of the U.S. market due to the fact that most of the venture capital funds in Canada are generalist funds, that invest in a wide variety of industries, rather than specialist funds. This means that there could be a lack of specialized knowledge in the market with which investments can be analyzed and assessed, particularly in knowledge-based sector. As a result, generalist funds without this knowledge may pass up investment opportunities simply because they do not have the expertise to assess them properly. In a small venture capital market like Canada's there is likely to be far fewer specialized funds than in the large U.S. market and it may not be possible to have a sufficient number of funds that specialize in particular emerging industries.

The absence of specialist venture funds and analytical expertise in the Canadian venture capital market may also increase both the financial and time costs associated with venture investing.
This could happen because a lack of specialized knowledge is likely to result in lower valuations being applied to companies receiving venture capital investment, particularly in the knowledge-based sector. This could result in higher financial costs to the companies and their shareholders through greater ownership dilution. In addition, the absence of specialized funds is likely to result in greater time costs for management in terms of their efforts to explain their business to non-experts. In the case of knowledge-based companies it may take a considerable period of time to find a generalist fund that is interested in their business and then to find the people in that fund that have the expertise to understand their business. This is compounded further when a number of generalist funds have to come together in a syndicate to undertake a financing and the company's management has to go through an educational process with multiple firms.

**Issue:** How can generalist venture capital funds be encouraged and enabled to obtain the specialized knowledge required to participate in new industries where this knowledge is needed?

As an alternative to having more specialist funds, the provision of more specialized expertise jointly to generalist funds could also lower the financial and time costs of venture financing. This could result in greater access for emerging industry companies and could encourage more institutional, particularly pension fund, participation in venture capital investment by increasing confidence in the expertise that is available to venture firms in the investment assessment process.

**Issue:** Is there a need for specialized consulting and analytical resources that could be available to the venture capital firms on a pooled basis either on an independent basis or through the establishment of a resource facility that would be owned jointly by venture capital firms?

**Syndication of Investments**

In both Canada and the U.S., follow-on and later stage venture capital financing is often done through syndicated investments among a number of venture capital funds. In the U.S. these syndicates usually involve one venture capital firm that acts as the lead investor and then other firms come in behind the lead to share the portion of the investment not taken up by the lead. The lead investor is normally one of the major independent private firms that already has a network of other firms established, with which they syndicate investments. Within this network, the lead may change for different investments, particularly on a regional basis, but the network of firms often remains relatively constant for each investment. As a result, the company seeking the investment usually has to focus on getting one of the firms in the network (probably the largest and best known) to take the lead position and after that the lead firm usually arranges for the syndication of the remaining investment amount, with the other firms relying on the lead for analysis of the investment. This means that, in many cases, the company has to spend less time in obtaining its financing and probably gets a better valuation based on the lead investor's interest in the company, which will be more readily accepted by the other members of the syndicate.

In Canada, because of the relatively small and equal size of many of the venture capital firms, there is an even greater reliance on syndicated investments, simply because no single firm has the
resources to take on the whole investment, particularly in the case of larger follow-on investments. However, again because there is no dominant group of firms in the Canadian market, there is unlikely to be very many firms that will take a strong lead position on an investment or that can establish a network of firms that will follow its lead in a syndication. As a result, in Canada, syndicates tend to be one-off groups that come together for a specific investment after each has analyzed and assessed the investment. In other words, the company seeking the investment almost has to build the syndication group for its investment opportunity by itself with little help from any particular venture capital firm. This can be even more complicated when attempting to build syndicates between independent private firms and LSVCCs, each of which operates in accordance with different mandates and risk tolerances. As a result of this lack of leadership in building syndicates in Canada, valuations tend to be lower and the amount of management time required higher than in the U.S. This means that both the financial and time costs of venture capital investment are relatively higher in Canada than in the U.S.

Issue: How can the provision of specialized expertise to syndicates and networks of venture capital firms that work together and rely on each other's investment assessment expertise be facilitated, so as to minimize time and effort for both the firms and the companies seeking investment and result in fair valuations for both parties?

Support and Mentoring

Another aspect of concern regarding syndicated venture capital investments is that the venture capital firms may not provide sufficient support and mentoring for the management of the investee company. In the U.S. this is overcome to large extent by the role played by the lead investors in syndicates. These large firms normally also take the lead in providing assistance, support and mentoring to the management of the companies in which they invest and almost always have representatives on the company's Board of Directors. This again increases the confidence level of the other syndicate investors and makes it attractive for them to participate in the investment. In Canada, the risk of management neglect is greater because of the general absence of a strong lead role in most syndicates, which are more syndicates of equals. In these circumstances it is often unclear which members of the syndicate are responsible for supporting and mentoring management of the company in which they have invested. Again, there may be a need for joint resources that syndicates can call upon to support and mentor their investee companies.

Issue: How can relatively small venture capital firms making up syndicates be provided with sufficient resources to play a more active role in supporting and mentoring a company's management?

Behaviour of Venture Capitalists

The overall behaviour of venture capitalists at any specific time is very dependent upon the state of the economy and capital markets at that particular point in the economic cycle. If the economy
is strong and the capital markets are in a bullish frame of mind venture capitalists are more optimistic and, therefore, less risk adverse than under the reverse of these economic and market conditions. In addition, suppliers of funding for the venture capitalists are also in a similar state of mind as the venture capitalists in any particular economic and market circumstances. As a result, during these optimistic times venture capitalists are able to raise greater volumes of funds for venture capital purposes and are willing to invest these funds in new ventures more aggressively. This has been clearly demonstrated in the past few years when strong economic and market conditions created an explosion of venture capital activity in the U.S. and pushed Canadian venture capital investment to record levels. More recently, as economic and market conditions deteriorated, the supply of venture capital investment has declined as venture capitalists find it harder to raise funds and become more cautious in their investment strategies. Within this economic and market framework, however, other factors can also affect the behaviour of venture capitalist and the investors that supply the funds to venture capitalists and these factors can vary between the Canadian and U.S. venture capital markets.

**INVESTMENT STRATEGIES**

On the investment side of the market, U.S. venture capitalists appear to be more aggressive in their investment strategies than Canadian venture capitalists, particularly in the knowledge-based sector. This may be partly due to the very large size of many of the major venture capital firms in the U.S., which enables them to diversify their investments over a wide range of investments in many sectors and industries. As a result, they are in a position to allocate a larger proportion of their portfolios for higher risk investments than is the case for Canadian venture capital firms, which are all substantially smaller than their U.S. counterparts. These large U.S. firms also have greater analytical resources with which they can assess riskier investments more thoroughly and usually have a variety of funds made up of both generalist and specialist funds to which they can allocate investments that suit the mandate of each fund, some of which will be higher risk and more specialized. In the U.S. there are also a wide variety of smaller specialized funds that only deal in particular types of venture capital investments and these tend to make higher risk investments within their limited areas of interest. In Canada, the major suppliers of venture capital investment, the LSVCCs, because of the nature of their mandates and funding, tend to be more risk adverse than the independent private funds or corporate funds, particularly in the knowledge-based sector. The relative absence of specialist funds in Canada also makes it more difficult to finance riskier investments in specific sectors or industries that require specialist knowledge of their businesses.

**Issue:** What can be done to encourage Canadian venture capital firms, particularly the LSVCCs, to adopt risk adverse attitudes to venture capital investment that are more similar to those held be U.S. generalist venture capital funds?

**MANAGEMENT EXPERIENCE**

In addition, the background of management personnel in the venture capital firms can also impact on the attitudes and behaviour of venture capitalists in the marketplace. In the U.S.,
people that have come out of industrial firms, particularly high-technology companies, manage many of the leading venture capital firms. Many of them are also industry analysts that come out of the investment banking industry in the U.S. These managers already have extensive and often specialized experience in the industries within which their firm is investing and as a result they can probably assess the risk attached to investments in these industries more accurately and quickly. As a result, these managers tend to be more confident and aggressive in their investment strategies. In Canada, on the other hand, the managers of venture capital firms have tended to come out of the banking community and, therefore, tend to approach the risk assessment process from a banking perspective as opposed to an industry perspective. This has probably resulted in a more risk adverse investment strategy in most Canadian funds, which often lack the intimate industrial experience that U.S. funds tend to have. This is particularly vital in the case of the knowledge-based sector where such knowledge is key to being able to develop a more aggressive investment strategy in Canadian venture capital firms at the senior management level.

**Issue:** How can more managers that have an industry background rather than a banking background be attracted into the Canadian venture capital industry, so that more specialized industry knowledge can be built up in these firms?

**Suppliers of Funds**

On the supply side of the market, the attitudes and behaviour of investors that supply funds to the venture capital firms are also very important in determining the overall availability of venture capital in the marketplace and the willingness of venture capitalists to accept risks in their investment strategies. Canadian pension funds, in particular, are in strong financial shape and there appears to be little reason for an overly risk adverse attitude to venture capital investment on their part. If there are regulatory issues restraining their ability to allocate sufficient proportions of their portfolios to this asset class then the pension fund industry should bring these to the attention of their regulators and seek changes to these regulator provisions. On the other hand, if it is a fear that they do not have sufficient expertise to assess the risks associated with these types of investment they should either invest their funds with venture capital firms that have clearly demonstrated expertise in venture investing or bring on board expertise that will provide them with a higher comfort level regarding this type of investment. Another factor that may be making it difficult for pension funds to be less risk adverse towards these investments is a lack of confidence on their part regarding the level of expertise and experience in Canadian venture capital firms.

**Issue:** How can Canadian pension fund managers be encouraged to provide a proportion of funding to Canadian venture capital firms that is comparable to that provided by pension funds in the U.S.? Are changes to regulatory requirements or income tax rules needed?

**Taxation**

Taxation, primarily in the form of capital gains taxes, can have a major impact on the availability of funding for venture capital investment. If capital gains tax rates are not substantially lower
than general income tax rates they provide a disincentive for investors to provide funding for venture capital investment. Under these circumstances, investors are not being rewarded for investing in high-risk investments because they receive much the same tax treatment on high-risk income as they do on risk free income. Another impact of high capital gains tax rates is the disincentive to realize capital gains earned on successful venture capital investments and the locking in of not only the capital gains but also the original investment. This means that there is less recycling of funds from successful investments into new venture investments than otherwise would be the case if capital gains rates were substantially lower. If there is an incentive to exit successful investments, in many cases the original investment and a portion of the gains are likely to be re-deployed into new venture investments, thereby increasing the overall supply of funding to the venture capital market.

In the U.S., capital gains rates have traditionally been approximately half the tax rates levied on other personal and corporate forms of income and this provided an incentive for high income tax payers, paying the top personal and corporate income tax rates, to invest in riskier investments and obtain lower tax rates on capital gains arising from these investment. Until recently, Canadian capital gains rates where much closer to income tax rates because of the inclusion of 75% of capital gains in the calculation of taxable income, for both individuals and corporations. This substantially reduced the incentive for Canadian investors to invest in riskier assets, such as venture capital investments, and this undoubtedly had a negative impact on the flow of funds into the venture capital market. With the recent reduction in the capital gains inclusion rate to 50%, Canadian capital gains tax rates are now more comparable to those in the U.S. and a stronger incentive has been established for investment in riskier assets and the realization of existing venture capital gains.

**Issue:** Will the recent reduction in the Canadian capital gains tax rate improve the inflow of funding to the venture capital industry? How can this be tracked?

### Size of Investments

Another striking difference between the Canadian and U.S. venture capital markets is the large difference in the average size of venture capital investments between the two markets, with average investments in the U.S. being almost 5 times larger than average investments in Canada. This is probably due to a number of factors, including the larger size of investee companies in the U.S., the greater focus of U.S. venture capital investors on expansion and later stage investments and the much larger size of U.S. venture capital funds. In the U.S. many independent private venture firms have individual funds that are up to $1 billion in size and, in some cases, individual firms will have multiple billion-dollar funds under their control. It also reflects the overall greater per capita supply of venture capital funding in the U.S. that permits U.S. venture capital firms to make large individual investments while still being able to effectively diversify their holdings.

In Canada, where a large venture fund would be in the $100 million range, the much smaller size of venture funds severely limits the ability of venture capital firms to make large individual
investments and still maintain proper diversification. Even syndicating larger investments in Canada can be a problem because of the number of venture capital firms that would have to be involved to raise the funding for such investments could be unmanageable in terms of negotiating the terms of the investments and of managing these investments. The long-term approach to dealing with this problem would be through growth in the size of Canadian venture funds arising from an increased per capita supply of funding for the venture capital market to levels closer to that in the U.S.

**Issue:** Would the encouragement of cross border syndicates of Canadian and U.S. venture firms provide larger investments in Canadian companies that require expansion phase funding?

**Cross Border Flows**

Over the years, both Canadian and U.S. venture capitalists have been involved in cross border investment flows between the two countries. For Canada, this has resulted in additional venture capital investment on the part of U.S. venture firms but also a loss of venture capital funds raised in Canada to investments in the U.S. Through expanding the flow of venture capital investment from the U.S. the availability of venture capital funds in Canada could be supplemented to make up for the shortfall in per capita venture capital investment in the Canadian market relative to that in the U.S. In order to do this, the Canadian venture capital environment would have to be attractive to U.S. venture capitalists in terms of unique investment opportunities, the presence of acknowledged Canadian expertise in specific industries, and a relatively stable Canadian dollar exchange rate. Another factor would be the ability of the Canadian market to finance early stage companies to the point where they were prospects for larger expansion phase investments that would be more attractive to U.S. investors than small early stage investments. This would also help in filling the gap in the Canadian market for this type of expansion phase investment and could result in substantial inflows of venture investment from a relatively small number of transactions. This would probably result in a significant net cross border inflow into Canada because the outflows to the U.S. on the part of Canadian venture capitalists tend to be relatively small, usually in the form of small participations in U.S. syndicated investments.

In the past, these two flows have both been relatively small but recently there has been a significant increase in U.S. venture investments in Canadian companies, particularly in specific industries with unique Canadian expertise, such as fibre optics. These individual investments have been mainly substantial expansion phase investments and have usually also involved investment syndications with Canadian venture firms. Over the past two years these U.S. inflows have added significantly to the overall supply of venture capital in Canada and have partially filled the expansion phase financing gap in the Canadian market. It also appears that outflows of funds to the U.S. on the part of Canadian venture capitalists have also increased during this period as Canadian venture firms invested funds in both U.S. companies and in Canadian companies that have migrated to the U.S. However, the size of these investments has been much smaller than the large investments that have come into Canada from the U.S. and, it appears, that Canada has experienced a significant net inflow of venture capital over the past couple of years. As long as there is a surplus of venture capital in the U.S. this trend is likely to continue as U.S.
venture capitalists search out opportunities outside the U.S. market but under contracting supply conditions in the U.S. these inflows could dry up quickly.

In order to encourage this trend, Canada must ensure stability for the Canadian dollar and a tax environment that does not penalize U.S. investors. It would also be in the best interests of Canadian venture capitalists to focus on providing adequate early stage financing for companies that would be attractive to U.S. investors in the expansion-financing phase. This could require Canadian venture capital firms to become more specialized and focused in their investment strategies, which could improve the efficiency of the Canadian market and provide Canadian companies with lower financial and time costs for venture capital investment. Overall, because of the disparities in size between the Canadian and U.S. venture capital markets, it would be in the interest of Canada to foster a greater integration with the U.S. market where venture capitalists from both countries could specialize in the type of venture financing in the Canadian market that best suits their circumstances. This could mean the Canadian venture firms would focus on smaller, early stage investments and U.S. firms could provide more of the financing for expansion stage firms. This would tend to reduce the risk profile for Canadian venture firms by holding larger numbers of smaller diversified investments and sharing a greater part of the expansion phase risk with the larger U.S. firms which are in stronger position to accept risks associated with larger investments while still being able to maintain adequate diversification. This reduction in risk could also be a positive factor in encouraging greater flows of venture capital funding from Canadian pension plans.

**Issue:** Could greater integration of the Canadian and U.S. venture capital markets create more competition in the Canadian market and reduce the flow of Canadian firms to the U.S. through increasing cross-border flows between the two markets?

**Exit Strategies**

Another important element that can influence the supply of venture capital and the level and type of venture capital investment are the exit strategies available to venture capitalists for recovering their original investment and realizing their gains on investments. In order to maximize the returns on their investments venture capitalists have to pursue exit strategies that allow them to liquidate their investments on the best possible terms. If they are able to do this, venture capital firms are likely to be more aggressive in their investment strategies and will find it easier to raise funds from investors for venture capital purposes. If adequate exit strategies are not available, venture capitalists are caught in a situation where their investments remain illiquid and they cannot recycle their funds into new investments or provide realized returns to their investors. As a result, the venture capital market tends to seize up with both venture capitalists and their investors being unwilling to provide new funds for venture investment, either for new companies or existing companies in their portfolios that require additional financing. This situation can arise in two circumstances: where the opportunities for successful exits are restricted in the marketplace and where cyclical economic and financial conditions are not favourable.
The most common types of exit are an initial public offering (IPO) of stock in the investee company and a merger or acquisition of the investee company involving either another company or the original founders of the company. In the case of an IPO, the venture capital firm will end up holding publicly traded stock in the company but, as an insider under securities regulations, it is restricted in how the stock can be sold and liquidated. These restrictions usually stay in place for up to two years before the stock becomes freely tradable and during this time the value of the stock varies with equity market conditions. At the end of this period, the venture fund usually distributes the stock or cash to its investors who then can decide to either sell or retain their stock holdings. Generally, an IPO will result in a relatively high initial exit valuation for the company but the funds cannot be realized immediately and are, therefore, subject to market variations, both up and down, over the required holding period. Under strong market conditions the stock can increase in value over the IPO value but under weak market conditions the value can decline or even be virtually wiped out before it can be realized.

Although IPOs are the most glamorous type of exit available, the most common type of exit involves mergers or acquisitions. Under a merger or acquisition exit, the venture firm will receive either stock or cash from the acquiring company and distribute these proceeds to its investors who can then hold the stock holdings or liquidate them immediately. In the case of mergers and acquisitions, investors can realize their values immediately and, hence, with greater certainty than in the case of IPOs. Another advantage of a merger or acquisition over an IPO is that the IPO requires sufficient capacity in the IPO market to absorb a large volume of IPO financing and establish appropriate valuations for IPOs in the marketplace, at reasonable costs in terms of both regulatory pricing and management time costs. These issues will be dealt at length in the next section of this study.
SECTION II - INITIAL PUBLIC OFFERING (IPO) EQUITY FINANCING

OVERVIEW OF IPO MARKETS IN CANADA AND THE U.S.

In this overview of the Canadian and U.S. IPO markets the regulatory requirements and market processes involved in the markets will be outlined and compared, along with a description of the participants and the roles they play in the IPO market.

REGULATORY REQUIREMENTS

Listing Requirements

Before a company can contemplate issuing securities in the IPO market it must meet specific financial, public distribution and management requirements that are established by each stock exchange upon which the securities would be issued and listed. These listing requirements vary from market to market and are important determinants of whether or not a company is ready and able to go public on any particular market. Generally, these requirements differ between markets because of different specialization among markets regarding the type and size of company that each market wants to attract and the role that it wants to play in the IPO marketplace. If a particular stock exchange wants to specialize in smaller companies in higher risk industries the listing requirements will be less onerous; whereas large stock exchanges want to focus on larger, established companies that are attractive to institutional investors. It also depends on the size of companies within a marketplace that are available to become publicly listed companies. In Canada, companies are much smaller than their U.S. counterparts and, therefore, Canadian stock exchanges must have lower listing requirements than U.S. exchanges in order to accommodate the array of companies available in Canada.

In Canada, for the Toronto Stock Exchange (TSE), the largest in the country, listing requirements have been established for three general categories of companies: industrial, mining and oil and gas companies. For industrial companies, profitable companies must have net tangible assets of $2 million, earnings of $200,000, pre-tax cash flow of $500,000 and adequate working capital; whereas companies forecasting profitability must have net tangible assets of $7.5 million, forecast earnings of $200,000, forecast pre-tax cash flow of $500,000 and adequate working capital. All companies must have a minimum of $12 million in the treasury and must have issued and outstanding 1 million freely tradeable shares with an aggregate market value of $4 million. The TSE also considers the background and expertise of management and may conduct reviews of key personnel. Recently, the TSE has also established special listing requirements for technology companies based on the level of investor support, adequacy of funds, management and stage of product commercialization. These companies must have $50 million minimum market value of listed shares, a $10 million public float, $10 million in the treasury and adequate funds to cover development, capital and operating expenses for one year.
In the U.S., the two major markets on which IPOs are undertaken are the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation System (NASDAQ). Of these two markets, the NASDAQ has far less stringent listing requirements that the NYSE but these are still considerably higher the TSE listing requirements. The minimum financial requirements (in U.S.$) for listing on the NASDAQ include: net tangible assets of $6 million, pretax income of $1 million, a public float of 1.1 million shares with a market value of $8 million, a minimum of 400 shareholders holding 100 shares or more and a bid price on the shares of $5.00 or more. In addition, before a security can be listed on the NASDAQ at least three investment bankers must agree to act as “market makers” in the security by offering to buy a security and sell it to any investor who wishes to buy it. The NASDAQ may also scrutinize the management and directors of the company. For Canadian companies, the attraction to going public on the NASDAQ would have to reflect factors other than listing requirements, which are considerably more attractive on the TSE.

**Prospectus Preparation**

Once a company has qualified under the listing requirements of the stock exchange upon which it wants to go public it must then prepare a prospectus, which is an information document that must be provided to potential investors and filed with the relevant securities regulators. In Canada, they must be filed with provincial securities commissions, primarily the Ontario Securities Commission (OSC), while in the U.S. the major regulator is the federal Securities and Exchange Commission (SEC). The prospectus is used both as a selling document by the underwriters of the securities and as a regulatory document to ensure that investors receive full, true and plain disclosure of all material facts related to the securities being issued, as required by securities legislation. As a result, it must provide a balanced view of both the positive and negative views of the company issuing the securities. The prospectus must contain the following types of information: the business of the company, financial statements and projections, corporate and share structures, risk factors relating to the company and securities, use of the proceeds of the issue, statutory rights of investors and certifications of full, true and plain disclosure of all material facts on the part of the company and its underwriters. Initially, the company must file a preliminary prospectus for review by the securities commissions. Once this review has been completed, the prospectus is then revised to reflect the comments from the regulators and again re-filed with the securities commissions, who then clear the company for filing.

**Escrow Provisions**

Another regulatory element that is established at the time of issuing the securities are the escrow provisions attached to the newly issued securities. These provisions determine when major investors, who held positions prior to the IPO (such as venture capitalists) and senior management are eligible to sell their holdings of the securities on the open market. In the past, these requirements have established escrow periods of up to two years before these holders can liquidate their holdings but more recently the maximum escrow period has generally been reduced to 18 months, e.g. on the TSE. Larger companies can also receive exemptions from the escrow requirements or negotiate a shorter escrow period with the stock exchange. This
regulation is particularly important to the founders of newly listed companies and the investors who funded the company prior to the IPO as it determines when they can recover their investments and realize their gains. It also introduces greater uncertainty for these shareholders as market conditions can change significantly during the escrow period.

Disclosure Regulations

Once the IPO has been completed, the company immediately encounters ongoing disclosure regulations and requirements in order to keep the secondary market for the securities informed of all relevant conditions surrounding the company. First, companies must disclose and send to its shareholders quarterly financial statements, annual audited financial statements and management's discussion and analyses of financial results and operations, usually in the form of an annual shareholders' report. They must also provide proxy circulars and solicitation documents before annual shareholders' meetings to provide information relevant to matters being voted on at the meeting. All material changes in the business, operations or capital structure of the company, that may have an impact on the price of the securities, must be disclosed in a timely manner through press releases and filings with the stock exchanges and securities commissions. Insider trading reports (for directors, senior officers and investors holding more than 10% of the outstanding voting shares) must be filed within 10 days after the end of the month during which any of these “insiders” traded their shares.

Market Processes

The process that a company must go through in going public is often a long and complex, with most IPOs taking anywhere from 3 to 6 months to complete. The first step in the process is to deal with corporate, tax and accounting matters that must be undertaken to prepare the company for going public. These include the preparation of a proper business plan that will serve as a blueprint for the preparation of the prospectus. This plan should include a description of the business, a market analysis, a description of the company's products and services, management structure and financial information and projections. In order to become a public company appropriate reporting systems and procedures must be put in place before starting the IPO process. The company must then choose lawyers, accountants and underwriters who will provide the leadership required to carry out the public offering. In making these choices a first priority is to obtain the services of firms that have considerable experience in public offerings and securities expertise with regard to the legal, accounting and auditing requirements for an IPO. Any required changes to corporate structure and the capital structure of the company should be undertaken and a strengthening of senior management implemented well in advance of the IPO.

Choosing an Underwriter

The choice of an underwriter for the IPO is of critical importance in achieving success in the marketplace. The underwriter must be able to provide a realistic valuation for the company in order to raise the necessary amount of financing while at the same time achieving success in
selling the issue in the market. Much of this will depend upon the reputation, experience and
distribution capability of the underwriter. A firm with a strong reputation will attract a strong
banking group syndicate that will be able to sell the shares effectively. The experience of the
underwriter will assist in pricing of the issue, selecting the banking group and providing
credibility in the market. The distribution capacity of the underwriter must be adequate to sell
the required number of shares to a broad base of investors, thereby providing liquidity in the
after-market. Another important aspect is to choose a firm with a strong research department
with the ability and desire to follow the company after the IPO so that the reputation and status of
the company can be maintained in the after-market. The company must then balance these
factors against the commission that the underwriter proposes to charge for their services and the
level of assistance they and their legal counsel will provide during the process.

Choice of Markets

The company must then choose the market in which they are going to offer their securities. In
the U.S. the choice is largely between the NYSE and the NASDAQ, with larger industrial
companies generally choosing the NYSE and smaller technology-oriented companies usually
going public on the NASDAQ. Canadian companies have somewhat wider and more complex
choices available to them in that they can either use Canadian stock exchanges or U.S. exchanges
or both in going public. The usual reason for a Canadian company to go public on a U.S.
exchange is to gain access to a larger, deeper capital market and, often, more specialized capital
market analysts, particularly in the case of technology companies. However, offsetting this is the
fact that Canadian companies must comply with stringent SEC rules governing foreign-based
IPOs. In Canada, companies have basically two choices of markets, the TSE or the new CDNX
market that specializes in small company financings. In making a choice between all markets, a
Canadian company must weigh these market attributes against the costs of going public in the
various market alternatives. If a Canadian company wants to take advantage of the larger, more
developed U.S. market it may have to accept higher costs, greater legal risks and different
valuations than those they would face in the Canadian market.

Process Phases

The process by which a company goes public involves a number of distinct phases, starting with
the preparation phase that could begin about six months before the completion of the IPO. This
includes completion of all the items discussed above that are required to initiate the IPO process.
The next phase is preparation of the preliminary prospectus that should start anywhere from three
months to six weeks prior to the closing of the IPO. This involves completion of due diligence
analyses, the preparation of audited financial statements and the drafting of the preliminary
prospectus that will be filed with the securities commissions. The final preparation phase
involves the development of information summaries from the prospectus that will be used as
selling tools and the organization and undertaking of the “road show”, made up of a series of
presentations to institutional investors and investment dealers that feature key members of the
company's management team. During this period the underwriting agreement is negotiated and
finalized and application for listing on the chosen stock exchange is made. Comments from the
securities commissions on the prospectus are now received and revisions are made to the prospectus to reflect these comments. In the final prospectus phase, once the issue has been cleared for filing, the issue is priced, the final prospectus filed and printed and the underwriting agreement executed. This is followed by the closing phase in which the securities and proceeds from the issue are exchanged and the company's stock starts trading on the stock exchange.

MARKET PARTICIPANTS

Underwriters

The underwriters are key participants in the IPO market as they perform both risk-taking and marketing roles in the IPO process. There are two common types of underwriting arrangements for IPOs: best-efforts and firm-commitment agreements. Under a best-efforts agreement, the underwriters simply use their best efforts to sell the shares on behalf of the company as agents but are not obligated to purchase any of the shares at their own risk. Usually, there are a minimum number of securities that must be sold for the IPO to be completed. These agreements are usually used in the case of smaller companies whose securities are more difficult to sell. Under a firm-commitment agreement, the underwriters agree to purchase all of the shares offered by the company and then resell them to the public. These commitments are made at the time that the final prospectus is filed, when the “road show” has been completed and the underwriters have assurances that they will be able to sell the shares immediately. However, any shares remaining unsold must be purchased by the underwriters at their own risk, except in cases where escape clauses relieve the underwriters of this obligation under conditions where the market for the shares collapses just prior to the offering date or where there has been misrepresentation by the company. In the case of a best-efforts IPO the underwriters are paid a commission for selling the securities; while under a firm-commitment IPO they receive a combination of discounts and commissions, along with pre-IPO “items of value”, as compensation for their risk-taking and selling roles.

Institutional Investors

The other major players in the IPO market are institutional investors who influence the establishment of share valuations prior to the IPO and usually purchase the majority of the securities offered in the IPO, at least initially. The success of an IPO largely depends on the reception the issue receives from institutional investors during the “road show” and their reaction to the proposed valuation of the company. They base their response on their impressions of the company's management and the validity of the company's business plan and financial projections. After the “road show” the institutional investors are canvassed by the underwriters for commitments to purchase the securities to be issued in the IPO. Base on these commitments, the underwriters and the company decide on whether or not to proceed with the IPO and on the valuation to be placed on the shares, if they decide to go ahead. If the underwriters do not receive sufficient interest from institutional investors, they are unlikely to enter into a firm-commitment agreement. If the IPO proceeds, the institutional investors take up their commitments to purchase the securities and then decide whether to retain them as part of their
portfolios or to resell all or part of their holdings in the after-market. In recent years, when many new issues gained sharply immediately after the IPO, many institutional investors re-sold their shares to realize these substantial immediate gains and then waited to purchase shares later if they wanted to hold them in their portfolios. As a result, in many cases, institutional investors were only short-term holders of the newly issued shares. Under these circumstances they favoured low IPO valuations, which tended to influence the underwriters to under-price new issues.

Retail Investors

Individual retail investors are the final group of participants in the IPO market, who are generally introduced to new issues through investment dealers. During the pre-IPO “road show”, investment dealers are also introduced to the proposed stock issue through attendance at meetings with the underwriters and the company's management. The investment dealers are also canvassed for their support of the issue in terms of their requests for allotments of the new issue for resale to their retail investor clients. This also has an influence on the success and valuation of the new issue but not to the degree that views of institutional investors impact on the issue. Generally, the investment dealers receive their allotments out of the shares remaining after institutional demand for the shares has been satisfied, so retail investors tend to be residual investors that may or may not receive sufficient shares to satisfy their demand for the new issue. As a result, individual investors are price-takers in the market whereas institutional investors are price-makers in the market. However, retail investors play an important role in that they absorb any excess supply beyond institutional demand and, therefore, reduce the degree of risk faced by the underwriters. This probably makes the underwriters somewhat more aggressive in their pricing of the issue and, thereby, marginally improves the valuation received by the company. The retail investors also are the prime group of investors that absorbs the supply of shares that are resold in the after-market by the institutional investors and this helps to maintain value and stability in the post-IPO market. This further reduces the risk faced by the underwriters in their post-IPO role as market makers for the shares.

ISSUES SURROUNDING IPO EQUITY FINANCING

Based on the above overview analyses, both the general and specific issues surrounding IPO equity financing will be developed. The general issues will involve those related to overall access to IPO markets and the determination of costs associated with new issues of securities through the stock exchanges. Following this, more specific issues arising from a comparison of Canadian and U.S. IPO markets will be outlined relating to differences in regulatory needs, issuing costs, time costs, the valuation and pricing of IPOs, management requirements and the role of institutional investors between the two markets.
**General Issues**

**Access to IPO Markets**

Access to IPO markets, fundamentally, depends on the state of the economy and equity market conditions at the time a company is ready to undertake an IPO. If economic and market conditions deteriorate around the time that a company wants and needs to go public, it is very difficult to complete a successful IPO. Under these conditions, a valuation acceptable to the marketplace may not provide sufficient capital to the company and could unduly dilute the ownership and valuations of existing shareholders to the point where it is not feasible to undertake the IPO. This could lead to immediate failure or prolonged problems for a company, if other sources of capital are not sufficient to see the company through the economic and market downturn. On the other hand, if optimism reigns in the economy and equity markets, a company could achieve a relatively high valuation and more than sufficient funds to meet its growth needs. As a result, the success of any given IPO very much depends on market timing in terms of whether or not it comes to market in strong economic and market conditions. No matter how ready a company may be for an IPO, economic and market conditions ultimately determine when and whether the company can access the IPO market and under what terms.

**Financial Position**

Over and above the timing issue, however, a company must prepare itself internally to be ready to go public. In order to achieve internal readiness management and the underwriter must together decide whether the company's financial position is supportive of an IPO. Usually, a history of strong earnings is required to make a company attractive to investors but other factors such as management expertise, innovative new products and a new business concept can allow a company to go public even with little or no earnings. The key to any company's ability to undertake an IPO is a strong, capable and experienced management team and a prominent Board of Directors. Preferably this team should include at least one well-known executive and a number of executives, including either the CEO or CFO or both, that have successfully gone through the IPO process before.

**Growth Potential**

High growth potential is another key sign of readiness as demonstrated by either a consistent record of high growth or, at least, the potential for high growth. A new product, large market share or the potential to emerge as a leader in a new or fast growing industry usually indicates this potential. A company's position in an industry is often linked to holding patents, copyrights, trademarks, and other proprietary advantages and investors often look to these as evidence that the company can earn higher than average profits and return on assets. Before going public, a company ideally should have strong tangible net asset holdings that would be sufficient to get it through a difficult post-IPO environment. For technology companies this is a difficult criteria to achieve because of their lack of fixed assets. Finally, investors are interested in the amount to be
raised and the uses to which the proceeds of the IPO will be put. This needs to be backed up be a solid business plans and cash flow projections.
SECTION III - SELECTION OF ADVISORS

Another important factor in achieving access to the IPO market is the selection of financial and legal advisors for the company. This often involves a team approach where specialist legal and accounting firms are retained to work with the company's existing advisors just for the purpose of leading the company through the IPO process. It is critical that this team have sufficient expertise with IPOs so that they can initiate and complete the process in a timely and non-disruptive manner. Otherwise, the company could miss its window of opportunity in the marketplace and fail to access the market on advantageous terms or, possibly, not at all. The team must also be able to work effectively with the underwriter's advisors and be strong enough to act as a counter-point to these advisors to ensure that the company's interests are fully taken into account during all negotiations with the underwriters. An experienced team of advisors is also usually less costly to the company than an inexperienced team, which may offer lower fees but could make very costly mistakes during the process that would add substantially to costs and could even jeopardize their access to the IPO market.

COST FACTORS

Direct Costs

The first cost of raising funds through an IPO consist of the direct costs that are charged to a company during the IPO process, including: the underwriting commission, legal and accounting fees, regulatory filing fees and printing costs for the prospectus and other documents. These costs are influenced by the size of the issue with larger IPOs having lower costs as a percentage of the total proceeds of the issue. In other words, these direct costs are largely fixed costs and do not vary significantly between a larger and smaller issue, except for the underwriting commissions which are normally calculated as a percentage of the amount raised in the issue. One of the main variables in determining these costs are the professional fees charged by the legal and financial advisors and the company must watch these costs carefully and negotiate agreements with these advisors that provide for interim reviews and limits on fees being charged rather than open-ended agreements without accountability.

Pricing Costs

Pricing costs resulting from the under-pricing of the issue relative to the trading price of the issue in the secondary market, represent a cost to the company because the company receives less financing than it would have had the IPO been priced to the market price established in the secondary market immediately after the IPO. If securities are under-priced, relatively more money is “left on the table” for the IPO buyers, and relatively less is available as proceeds for the issuing company. This also means that owners of the firm prior to the IPO suffer a higher dilution of their ownership and have a lower level of wealth than if the issue had been priced at market. Under-pricing of IPOs has been found to be a common characteristic of all equity markets and contradicts the assumption of market efficiency in these markets. If markets were
efficient, issuers should generally receive market value for the shares issued, and investors should not regularly be able to purchase IPOs at a discount to their market value.

On the other hand, if over-pricing were the norm, investors would not buy IPOs at the issue price but instead wait and buy the shares at a lower price in the secondary market. As a result, there is probably a bias towards under-pricing in order to successfully market the shares and avoid immediate losses in the post-IPO market and potential legal action by unhappy investors who paid the higher IPO price. Another factor favouring under-pricing is the influence of institutional investors who often want to sell IPO shares immediately after the IPO and realize significant gains rather than suffer losses.

**SPECIFIC ISSUES**

**Regulatory Needs**

Canadian companies generally have a choice of going public on either Canadian stock exchanges (TSE or CDNX) or U.S. stock exchanges (NYSE or, more likely, NASDAQ) and in making this choice they must consider the regulatory requirements that they need to meet in each market. For Canadian issuers, the regulatory requirements are generally more onerous in the U.S. markets than in Canadian markets. In terms of listing requirements, the U.S. markets are far more stringent than Canadian markets which means that Canadian companies have to be larger and more established to go public in the U.S. than is the case in Canadian markets. In the case of other regulatory requirements, such as prospectus preparation, the disclosure requirements are very similar between Canadian and U.S. markets, especially for large, established Canadian companies which can access the U.S. market on a streamlined basis under the Multi-Jurisdictional Disclosure System adopted by Canadian securities commissions. However, smaller Canadian companies undertaking an IPO in the U.S. that do not qualify under this streamlined process must meet more onerous conditions established under SEC rules governing foreign-based IPOs.

In addition, post-IPO escrow provisions have been generally more lenient in the U.S., although the recent reduction in the escrow period to 18 months by the TSE has now reduced the differences with the U.S. These provisions also seem to be more negotiable in the U.S. where escrow periods for even new unestablished companies have often been negotiated down to three to six months in many IPOs. In Canada, exemptions and negotiated escrow period are also possible but only for larger, well-established companies. Finally, ongoing disclosure regulations and requirements in the U.S. are generally more onerous than in Canada, partly reflecting greater activist scrutiny by the markets and investors in the U.S. and the greater tendency towards litigation if disclosure has been in any way inadequate or misleading.

Overall, then, it appears that Canadian markets have less onerous regulatory requirements, particularly for smaller companies, than is the case in the U.S. and, hence, they should have a competitive advantage in attracting Canadian company IPOs. However, Canadian companies continue to go public in the U.S. either solely in U.S. markets or jointly with a Canadian stock
exchange. The Conference Board, though, has shown in their research that there was no evidence of an acceleration of Canadian issues on the NASDAQ and that there was really no trend in the ratio of TSE IPOs to NASDAQ IPOs over the 1993 to 1998 period. However, this analysis did not take into account the high level of IPO activity during 1999 and 2000, when greater listings on the NASDAQ probably took place. This situation must mean that other factors, such as the size and depth of the U.S. markets that allows for easier access to capital, particularly in the case of larger IPOs, must prevail and over-ride the regulatory benefits of going public in Canada.

Issue: Do capacity limitations in the Canadian market force Canadian SMEs to delay going public until they are large and established enough to meet the more stringent regulatory requirements in the U.S.?

Issuing Costs

The issuing costs of going public in the U.S., such as legal fees, auditing fees, printing costs and registration fees, are considerably higher than in Canada. For Canadian companies this is particularly true because they have to have both U.S. and Canadian advisors in order to deal with all of the regulatory and process requirements that impact on them in both countries, especially if they are undertaking a joint U.S. - Canadian issue. Not only are professional fees higher in the U.S., particularly in New York, but Canadian companies have to pay these costs in U.S. dollars. Travel costs can also be a substantial factor in going public in the U.S. in terms of preparing the prospectus and other documents, meeting with their U.S. advisors and in undertaking a “road show” across the U.S. Overall, costs could be substantially higher for a joint U.S. - Canada issue compared to what they would be for a purely Canadian issue. However, these higher costs are unlikely to be a serious impediment if a company that can expect to raise a larger volume of funds in the U.S. market than would be possible in the Canadian market. There are probably other benefits as well that over-ride the extra costs in terms of a higher corporate profile, marketing advantages, executive recruitment, better institutional research coverage for the stock, greater prospects for follow-on stock issues, and wider dispersion of ownership.

Valuation and Pricing

There is considerable research evidence that Canadian markets have generally been more accurate in establishing valuations and pricing of new stock issues than U.S. markets in recent years. The Conference Board of Canada\(^1\), among other researchers, has concluded that there is less under-pricing of IPO shares on Canadian stock exchanges than has been the case on U.S. exchanges during a period from January 1, 1998 to September 30, 1999. Other researchers\(^2\) have studied longer time periods and have come to similar conclusions. The Conference Board concluded that the weighted average under-pricing of IPOs on the TSE was 5.8% compared to

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2 For example, Vijay Jog and John Hitsman undertook a similar study for the 1994 to 2000 period.
10.9% on the NYSE and 49.6% on the NASDAQ during the period covered by their study. This indicates that the pricing cost of IPOs in Canadian markets is considerably lower than in U.S. markets. This should mean that, by providing Canadian companies with more accurate valuations, the Canadian IPO market should have a clear competitive advantage over U.S. markets in attracting Canadian IPOs. However, if the Canadian market cannot satisfy the demand for IPO financing on the part of Canadian companies, these companies will be penalized by being forced to go public in U.S. markets where they will encounter a higher degree of under-pricing and higher pricing costs in their IPOs.

**Time Costs**

The IPO process is complex and time consuming, particularly on the part of a company's senior management, and results in substantial time costs being associated with going public. Surveys have shown that demands on management time are onerous and that up to 50% of senior management time could be absorbed by the IPO process. This is especially true in cases where a Canadian company goes public in U.S. markets, as management has to deal with two regulatory systems, two teams of advisors and extra travel time during the process. The majority of management's time is spent in preparing the business plan, preparing the prospectus and supporting documentation, responding to due diligence activities on the part of underwriters and regulators, and undertaking promotional activities, such as the “road show”. Again these costs are likely to be lower in Canada than in the U.S. because of the greater complexity and effort involved in undertaking a cross-border IPO. This should be another factor in making Canadian IPO markets more competitive for Canadian companies than U.S. markets but is also another penalty to Canadian companies, if they have to go public in the U.S. in order to obtain the financing that they require.

**Management Requirements**

In order to have a successful IPO a company needs an experienced and credible management team that is recognized in the institutional investor community. The valuation of the company and pricing of the issue are determined primarily by the reaction of institutional investors to the prospectus and the performance of the management team during the “road show”. Their reaction tends to be much more positive if the senior executives have experience with other IPOs and are already known among institutional investors. For Canadian companies, with Canadian management teams, this is not a great a problem if they are undertaking an IPO in the Canadian market where senior executives have an opportunity to establish their credibility with Canadian institutional investors. However, if they are doing an IPO in the U.S. market, their Canadian management teams are unlikely to be well known to U.S. institutional investors and the IPO will probably not be as well received as it would be in the Canadian market.

Since it is difficult for Canadian companies to attract high profile management teams that will have credibility with US institutional investors, IPOs undertaken in the U.S. could encounter greater under-pricing and higher pricing costs than those in the Canadian market. It would also be very difficult and costly for a Canadian company to attract a known management team from
the U.S., which would effectively require the establishment of a U.S. head-office facility or the migration of the company to the U.S. The prospect that a company, with a Canadian management team, would receive a higher valuation and less under-pricing in Canada should make the Canadian market more attractive for these companies than the U.S. market and improve the competitive position of the Canadian market. The company is also likely to experience lower management costs by recruiting their management team in Canada, provided, of course, that sufficient management talent pertaining to their industry is available in Canada.

Role of Institutional Investors

Institutional investors play a crucial role in the IPO markets by influencing the pricing of new issues and, hence, the degree of under-pricing in specific IPO markets. The extent to which they can influence valuations and pricing depends on their aggressiveness in the marketplace. If their importance in the market is so great that the success or failure of an IPO depends upon their response to proposed pricing, they can be very aggressive in the pricing process and, in some cases, can literally dictate the pricing of the issue. In the U.S. the large size of many institutional investors gives them enormous power over the IPO process and, because of this, they generally pursue the pricing of issues very aggressively. This aggressiveness probably results in lower valuations and greater under-pricing of new issues in the U.S. market than if they took a more passive role. In Canada, institutional investors, although large relative to the size of the Canadian market, are much smaller on average than U.S. institutional investors and tend to be less aggressive and more passive in the process than their U.S. counterparts. This could mean that they have less ability and desire to influence the pricing of IPOs in Canada. As a result, this could be a significant factor in determining the degree of under-pricing of IPOs in the Canadian market and be one reason why issues tend to be less under-priced in the Canadian market than in the U.S. market. Again, this should result in a more competitive Canadian IPO marketplace make it more attractive for Canadian companies to do IPOs in Canada than in the U.S.

Issue: Since Canadian companies continue to undertake a large volume of IPOs in the U.S. market, despite the cost advantages of going public in Canada, does this indicate that there is a lack of capacity in the Canadian IPO market to meet Canadian financing needs or that other business benefits arising from going public in the U.S. outweigh the Canadian cost advantages?
SECTION IV - POST-IPO EQUITY FINANCING

OVERVIEW OF POST-IPO EQUITY FINANCING

This overview of post-IPO equity financing will provide analyses of the purpose and nature of these financings, the regulatory requirements involved, their size characteristics, and the major market participants in the post-IPO financing market.

PURPOSE AND NATURE

Purpose

The purpose of post-IPO equity financing is to enable a company to move from the expansion phase of development to a more mature stage of development that culminates in its transition to a stable, established company in its industry. In order to do this, the company needs financing to undertake further product development and marketing activities that will enable it to capture a dominant position in its areas of activity and, thereby, establish the company as a market leader. It is also often used to finance acquisitions and joint ventures that are crucial to establishing a dominant position in its product markets. Post-IPO equity financing is required to meet financing needs that exceed those that can be covered by a company's ability to borrow through debt instruments and through the generation of internal cash flow.

For companies that require large amounts of fixed assets in their operations, post-IPO financing can often be largely achieved through internal cash flow and by borrowing on the security of the fixed assets. However, for knowledge-based companies the scope for using debt financing is limited by the relative absence of fixed assets in their operations and, hence, these companies normally have to supplement their internal cash flow by post-IPO equity issues. Companies that can borrow to meet their post-IPO financing needs can often obtain financing at a lower cost since they do not suffer any ownership dilution and the costs of borrowing are deductible for tax purposes. The major costs associated with post-IPO equity financing is the substantial dilution of ownership experienced by existing shareholders and non-deductible dividend payments, if any, to new shareholders. The degree of ownership dilution depends on how accurately the valuation of the company is determined in the marketplace.

Nature

The nature of post-IPO equity financing often varies with market conditions and the degree of risk that investors are prepared to take in considering securities issued by a company. Post-IPO equity issues can take the form of common shares, preferred shares, convertible preferred shares, warrants and convertible debt instruments. If the equity markets are strong and investors are optimistic and, particularly, if a company is well known in the marketplace, the most likely form of post-IPO equity financing would be the issuance of common shares. However, if markets are more bearish and investors are more risk adverse, a company would probably have to issue
preferred shares or convertible preferred shares in order to attract investor interest. If conditions were even less favorable, a company could be forced to issue warrants to existing shareholders (which they could sell in the open market) in the hope that prior to the expiration of the warrants the markets would have recovered sufficiently to entice investors' to exercise their warrants to buy newly-issued common shares. Alternatively, a company could be forced into issuing convertible debt securities which would be interest bearing until market conditions favoured their conversion into common shares. The choice between these various financing vehicles would depend primarily on the state of the equity market and the degree to which the markets had confidence in the company. For purposes of this study only post-IPO equity financing in the form of common shares will be analysed.

**REGULATORY REQUIREMENTS**

**Listing Requirements**

The regulatory requirements associated with post-IPO equity financing are similar to those required in the case of an IPO financing. In terms of listing requirements the company would not have meet any new requirements as long as it undertakes its post-IPO financing on the stock exchanges on which it is already listed as a result of its IPO listing. However, if the post-IPO financing involved raising funds on stock exchanges upon which it has not been listed, the company would have to meet any new listing requirements associated with these new listings. This could be the case, for example, if a Canadian company undertook its IPO exclusively on a Canadian stock exchange and then decided to undertake its post-IPO financing either jointly on a Canadian and U.S. exchange or entirely on a U.S. exchange. In these circumstances, the company would have to ensure that it met the generally more stringent listing requirements demanded by the U.S. exchange. These new listing requirements would be similar to those imposed on a Canadian company undertaking an IPO on a U.S. exchange. It is unlikely though that any new listing requirements would result in any significant regulatory restraints on the company as it is likely to more than meet these listing requirements because of the size and financial requirements that would have to be established before a company could consider undertaking a post-IPO financing.

**Prospectus Preparation**

The company would be required to prepare a prospectus for its post-IPO share issue that would be quite similar to the prospectus required for its IPO. The post-IPO prospectus would focus primarily on the company's business and financial track record during the period subsequent to its IPO and the post-IPO share performance. The prospectus would fulfill the same purposes as an IPO prospectus in that it would provide full disclosure to prospective investors and also serve as a marketing document for the underwriters in selling the issue to investors, particular to institutional investors and investment dealers. This process would involve the filing of a preliminary prospectus for review by the appropriate securities commissions and then the filing of a final prospectus just prior to clearance of the companies stock issue. Once the prospectus
has been approved by all relevant regulators, the underwriters can then acquire the newly issued shares from the company and sell them to investors, usually on a firm-commitment basis.

**Escrow Provisions**

Post-IPO stock issues do not usually involve escrow provisions as the shares are already trading on the stock exchanges and the price of the share issue is normally closely related to the stock price established in the marketplace. As a result, there is less prospect than in the case of an IPO for arbitrary valuations and pricing that could favour specific groups of investors, such as founders, management and venture capitalists. This means that there is little risk to the new investors if existing investors are also free to trade the shares after the post-IPO financing. In addition, a post-IPO issue is often undertaken after all previous escrow provisions associated with the IPO have terminated and major investor groups have already been free to trade their shares on the exchanges, subject to insider-trading rules and disclosure requirements.

**Disclosure Regulations**

Post-IPO financing also does not subject the company to any further ongoing disclosure regulations and requirements. Once the shares have been listed through an IPO the company must always meet these requirements and the only impact that a post-IPO financing is likely to have is that the company will have more investors to deal with in terms of providing disclosure documents and proxy materials. The post-IPO financing itself, however, will require extensive disclosure and proxy activity on the part of the company as existing shareholders must be kept fully informed of the nature and impact of the financing and be prepared to vote on any issues raised by the decision to undertake such financing. This would clearly, raise the volume of these activities in the short-term prior to undertaking the post-IPO financing. Insider trading rules and reporting requirements will continue to apply after the post-IPO stock issue, with the prospect that some new investors could be subject to these rules if they hold greater than 10% of the outstanding voting shares subsequent to the post-IPO financing.

**Size of Post-IPO Share Issues**

Post-IPO share issues tend to be considerably larger than is the case for IPO share issues. The company must now be substantially larger than it was at the time of its IPO in order to undertake a post-IPO financing and the financing requirements at that stage of development are also usually much larger. This means the size of a post-IPO financing is normally a multiple of the company's IPO financing in terms of both number of shares issues and the amount of capital received by the company. If the shares of the company have performed well in the marketplace subsequent to its IPO, the valuation of the company will have increased significantly as reflected in its higher share price. This means that the company can raise a large amount of capital with less dilution of ownership than often occurs in an IPO where valuations are still modest. As a result, the stock markets are called upon to raise substantial capital for the company in post-IPO issues. This raises the question of market capacity to raise these volumes of funds for companies undertaking post-IPO financings. In many cases, Canadian companies find that they cannot raise
the required volume of post-IPO financing solely by issuing shares in Canadian equity markets and are forced to conduct all or part of their post-IPO financing in U.S. markets.

**Market Participants**

**Underwriters**

Underwriters usually participate in post-IPO financings on a firm-commitment basis under which they acquire all the shares being issued by a company and then resell the shares, often through a banking group of investment dealers, to institutional and retail investors. The lead underwriter usually forms a syndicate of investment dealers that shares the risk associated with the share issue by allocating the commitment to purchase the shares among them. Each member of the banking group takes on the responsibility to sell their allocated portion of the shares to their institutional and retail clients and to other dealers who are not part of the syndicate. This process does not necessarily involve a “road show” to sell the issue to institutional investors and other investment dealers as the company is already listed and known to the investor community. If the company has a strong track-record and is well known to institutional investors they may be no need for a formal “road show” in order to sell the shares. This is likely to be the case for companies that have established a strong and active investor relations program involving extensive interaction of senior management with the institutional investor community. However, if the company is weaker and less well known, the selling process may have to be very similar to that employed during the company's IPO.

**Institutional Investors**

Institutional investors are the prime target investors for a post-IPO stock issue as they are probably already holders of the shares and have the resources to acquire substantial amounts of the new issue. By marketing the issue extensively to institutional investors it is also an opportunity to increase the institutional and financial analyst interest in the stock and provide a wider following for the stock by these groups in the future. This is important if the market for the stock is to be expanded among the institutions and to initiate coverage of the stock by financial analysts. This process is somewhat more complicated if the stock is being issued on more than one market, particularly on cross-border markets, for the first time. Although the company may be well known among investors in its original listing market, it may have very little coverage or interest in the new market on which it will be listed. As a result, the selling job may be considerably more difficult in the new market, particularly in the U.S., where the institutions tend to be very large and uninterested in smaller, less-liquid stocks. It is also more difficult to attract analyst interest in the U.S. where the number of companies makes it impossible for analysts to follow every stock listed. As a result, cross-border issues provide substantial marketing challenges to Canadian companies and their underwriters and selling groups. In this situation, it is vital to have a number of major U.S. investment dealers involved in the issue either as joint underwriters or members of a U.S. selling group. In this way, the reputation of the U.S. dealers may rub-off on the Canadian company and provide credibility in the U.S. institutional marketplace.
Retail Investors

Retail investors are also important participants in post-IPO financings as a broad base of these investors provide for wide-spread ownership of the company and a higher degree of liquidity in the marketplace. The key to attracting their interest is to have a number of dealers in the banking group that have large retail investor client bases. These firms tend to focus more of their selling efforts on their retail clients, partly because of the greater margins they can usually achieve in pricing shares for the retail market. In their selling campaigns these firms normally ensure a widespread distribution of shares among their retail clients by limiting the number of shares that they allocate to individual stockbrokers who, in turn, ration the available allocations among their retail clients. As a result, a company is virtually assured that their shares will be widely dispersed among retail investors and that they will have a permanent base of these investors. This also attracts wider analyst coverage for the stock and greater trading activity on the stock exchange.
SECTION V - ISSUES SURROUNDING POST-IPO EQUITY FINANCING

The nature and purpose of post-IPO financing raises a number of general and specific issues regarding this type of financing by Canadian companies. These include general issues, such as: the role of post-IPO stock performance in determining the success of post-IPO financing and the role of institutional investors in the pricing of the issue. More specific issues relate to regulation, issuing costs and the valuation and pricing of the issues. These issues are more complex for Canadian companies because of the importance of the issuance and listing of shares in both Canadian and U.S. markets.

GENERAL ISSUES

Role of Post-IPO Stock Performance

The performance of a company's stock on the stock exchanges in the period following its IPO will largely determine the acceptance of any post-IPO share issues in the marketplace and the valuation that will be placed on the company at the time of a post-IPO financing. If the post-IPO stock performance provides a strong track-record in the equity markets, investors are likely to view a post-IPO stock issue favourably and be willing to accept a valuation of the company that is considerably higher than the company's IPO valuation. If, however, the stock has performed poorly in the post-IPO period, it will be difficult to generate much support for a post-IPO issue on the part of investors, particularly institutional investors. This would weaken the valuation of the company and make it difficult to sell a post-IPO issue. In general, the stock price established for a post-IPO issue will closely reflect the price level established in the equity markets just prior to the issue. Since market conditions may not be favorable just prior to the post-IPO issue, this price may not provide an accurate underlying valuation for the company. As a result, in order to determine whether or not the post-IPO issue is appropriately valued, the performance of the shares should be assessed over the entire post-IPO period and compared to the performance of the overall market during that same period. Research has also shown that generally stocks underperform the overall market in the post-IPO period both in terms of price and overall returns to investors. This could indicate that post-IPO issues are typically somewhat undervalued, with the degree of under-valuation varying from market to market.

Role of Institutional Investors

Institutional investors play a less direct role in establishing the valuation of companies in the case of post-IPO stock issues than in the case of IPOs. However, they do have a significant influence on the company's post-IPO stock price performance which determines the market price and valuation of the company between the time of the IPO and the post-IPO financing. As a result, institutional investors have an impact on the market price of the shares just prior to the post-IPO financing and, hence, on the company valuation and share price to be used as the basis for valuing the post-IPO share issue. This is a lesser impact than in the case of an IPO share issue where there is no established market valuation and the valuation and pricing are largely based
directly on the reaction of institutional investors to the proposed valuation and pricing put forward by the company and its underwriters. In the case of a post-IPO share issue, the reaction of institutional investors is governed primarily by the share price already established in the equity markets. However, if a company was proposing a somewhat higher price than currently established in the marketplace institutional investors could reject that pricing and, in some cases, could favour pricing just below the current market price. This would depend on the power of the institutional investors in the marketplace and their aggressiveness in exercising that power. In the case of post-IPO financing their power to influence pricing is probably reduced somewhat by the likely greater participation of retail investors in post-IPO issues.

**Specific Issues**

**Regulatory Needs**

The regulatory requirements facing a Canadian company in undertaking a post-IPO share issue will vary depending upon how many markets they are using for the issue. If they are only using the Canadian markets on which they undertook their IPO financing, their regulatory needs would be minimized because they would already have met listing requirement and established their required ongoing disclosure and shareholder communication systems. They would have to prepare a new prospectus but a significant portion of the document could be drawn from their IPO prospectus, which would be updated with results and analyses pertaining to the post-IPO period. This would also largely apply to a company that undertook its IPO either entirely or partially in U.S. markets and was going to use these same markets for the post-IPO issue. Regulatory needs would only increase substantially if a company that did its IPO exclusively in Canada now decided to undertake its post-IPO issue either partially or entirely in the U.S. market. Under these circumstances it would then have to ensure that it could meet the listing requirements of the U.S. markets and prepare a prospectus that fulfilled the disclosure obligations established in these markets. This would involve considerable more work and expense on the part of the company and its underwriters. If, however, it had used U.S. markets in its IPO, the additional regulatory costs involved with that process could act as an off-set to the costs associated with using U.S. markets in its post-IPO financing. Overall though, it is likely that regulatory costs would be lower if Canadian markets were used for both IPO and post-IPO financings than would be the case if U.S. markets where used in either or both of these financing processes. The issue surrounding this choice is whether or not the Canadian markets could have supplied the volume of funds required in these combined financings.

**Issuing Costs**

Issuing costs associated with a post-IPO financing are very similar in nature and as a percentage of funds raised to those encountered in an IPO financing. However, an extensive “road show” is often not required for a post-IPO issue unless the company is undertaking the post-IPO issue in U.S. markets that were not utilized during their IPO. The required extent of the “road show” will depend primarily on how well the company has become known in the investment community during the post-IPO period and its post-IPO stock performance in the markets. If investors are
knowledgeable about the company and know the management team there is much less need for a “road show” to sell the issue to institutional investors and investment dealers. This is likely to be the case for a Canadian company that undertook its IPO either exclusively or partially in Canadian markets and developed strong relationships with the Canadian investment community. Similarly, if the IPO had been undertaken entirely or partially in U.S. markets the company could be relatively well known, although the sheer size of the U.S. investment community would make this more difficult to achieve than is the case in the smaller Canadian community. On the other hand, if U.S. markets had not been used at all in the IPO process and the company wanted, or needed, to undertake all or part of its post-IPO financing in U.S. markets, the company would have to establish its presence among U.S. investors, primarily through an extensive “road show”, which would involve substantial time costs for the company's management team. Again there would be an advantage to using Canadian markets for the post-IPO financing if they could provide sufficient financing for the company.

Valuation and Pricing

The valuation and pricing of post-IPO issues do not involve the same degree of under-pricing relative to market valuations and pricing as in the case of IPOs. However, the post-IPO valuation of a company may be reduced by the fact that post-IPO share prices under-perform the overall stock market, thereby, resulting in a valuation at the time of the post-IPO issue below what it could have been if their price performance had matched the performance of the market. This indicates that, although valuations of post-IPO issues are based primarily on market pricing of the shares just prior to the post-IPO issue, shares issued in a post-IPO financing could still be under-valued as a result of a shortfall in post-IPO price performance from overall market performance. For Canadian companies that undertook their IPOs either totally or partially in U.S. markets, the degree of under-performance in the post-IPO period will be determined in the U.S. markets, where the company is likely to be less well known.

From a Canadian perspective, research has shown that Canadian company IPOs on U.S. exchanges have tended to under-perform similar IPOs undertaken in Canadian equity markets. This would indicate that Canadian companies that have undertaken IPOs either entirely in the U.S. or jointly on U.S. and Canadian exchanges could suffer a larger under-valuation of their companies in subsequent post-IPO financings in those markets compared to what they could have received in Canadian markets. As a result, post-IPO issues of Canadian companies could be more under-valued in the U.S. than in Canada, based on the relative degree of post-IPO price under-performance in the two countries.

Issue: Since Canadian post-IPO markets appear to be quite competitive relative to U.S. markets in terms of issuing costs and the valuation and pricing of post-IPO issues, are Canadian companies willing to pay a penalty by issuing in the U.S., either because of a lack of capacity in the Canadian market or the value of other business benefits from going public in the U.S.?
Cross-border Issuing and Listing of Shares

Even though Canadian markets are competitive with U.S. markets, in terms of regulatory requirements, issuing costs and valuation and pricing, for Canadian companies undertaking post-IPO equity financing, there is still a strong attraction to issue and list shares on a cross-border basis. This indicates that there are other important factors, beyond regulatory and cost issues, that cause Canadian companies to undertake cross-border post-IPO share issues. The primary factor would appear to be the much greater capacity of the U.S. markets to absorb these issues in sufficient size to meet the capital requirements of Canadian companies. Other factors are also probably at play, including the need to have a high profile in the U.S. to attract customers, suppliers and management personnel, given the dependence of most Canadian companies on the U.S. market for their goods and services. As a result, Canadian companies when they are considering a post-IPO share issue must strike a balance between factors favouring each of the markets. In general, this seems to involve a trade-off between potentially lower costs and better valuations in Canada and greater market capacity and marketing and management advantages that could be realized from financing in the U.S. In these circumstances, the lack of capacity in the Canadian market essentially forces Canadian companies to forego any advantages offered by the Canadian market in order to be able to raise the funding that they require.

Issue: Could the capacity of the Canadian markets to absorb relatively large post-IPO issues be increased to meet more of the post-IPO financing needs of Canadian companies by encouraging Canadian institutional investors to play a more active role in post-IPO equity financing?
CONCLUSIONS

The analyses in this study have shown that the issues surrounding venture capital, IPO and post-IPO equity financing vary considerably for each type of financing with issues in some areas having greater significance than in other areas. The relative significance of issues across the three areas of equity financing, the definition of priority issues for further research in each area and the next steps required to undertake further research will now be outlined.

RELATIVE SIGNIFICANCE OF ISSUES

In this study it was shown that the majority of issues surrounding equity financing for SMEs in Canada arose in venture capital financing. Not only where there many more issues surrounding venture capital financing but these issues were also more fundamental to the success of SMEs in progressing through the various stages of development and growth. The issues that arose in venture capital financing are also more open to public policy solutions than is the case for issues surrounding IPO and post-IPO financing. The venture capital issues resulted primarily from the structure of the venture capital market in Canada, the behaviour and management expertise of Canadian venture capitalists, the participation of institutional investors in Canada, the taxation environment and the cross-border inter-play between the Canadian and U.S. markets. These specific issues resulted in less access to venture capital, higher financial costs and greater time costs for Canadian SMEs than is the case for SMEs in the U.S. market. As a result, the issues surrounding venture capital financing are highly significant in terms of determining the level and cost of equity financing that is available to Canadian SMEs.

In the case of IPO and post-IPO financing, evidence provided in this study indicates that the Canadian markets are more efficient and less costly for raising this type of financing than the U.S. markets. This is particularly so in the case of financial costs arising from the valuation and pricing of IPO and post-IPO issues where Canadian markets consistently out-performed U.S. markets. The most significant issues surrounding these types of financing revolve around the capacity of the Canadian markets to meet the needs of Canadian SMEs. This is apparent from the fact that many Canadian companies undertaking IPO and post-IPO issues do so in U.S. markets despite the efficiency and lower costs evidenced in the Canadian market. This indicates that the volume of these issues is limited by a lack of capacity in the Canadian market and that other non-financial benefits may be achieved through financing in U.S. markets. If this is the case, many Canadian SMEs are being penalized in terms of higher costs because they are forced to go to the U.S. market for these types of financing. These issues are also more difficult to deal with from a public policy perspective as they involve overall size constraints on the Canadian market and non-financial attractions in the U.S. market. Although these issues are important they are longer-term in nature and not subject to easy or quick public policy solutions.
SUMMARY OF ISSUES FOR FURTHER RESEARCH

Based on the analyses undertaken in this study, there are a number of issues that should be given priority in any further research to be undertaken in the future. The primary purpose of future research would be to obtain factual information regarding these issues and their underlying causes, so that public policy responses can be developed aimed at resolving them to the benefit of Canadian SMEs. The priority issues to be dealt with in both venture capital equity financing and IPO and post-IPO financing are:

Venture Capital Financing:

• How can the availability of, and access to, venture capital financing be increased for SMEs through improving the efficiency and competitiveness of the venture capital market in allocating the available supply of venture capital financing?

• How can growth-oriented SMEs in lesser developed regions of Canada be identified and developed so that venture capital financing can be attracted to those regions?

• How can the market structure and behaviour of venture capitalists be changed so that a company's management is not required to spend large amounts of time and effort to find the right venture capitalists for their business?

• How can Canadian pension fund managers be encouraged to provide a proportion of funding to Canadian venture capital firms that is comparable to that provided by pension funds in the U.S.?

• How can financial institutions be encouraged to continue their growing interest in venture capital financing through an evolving regulatory environment?

• How can generalist venture capital funds be encouraged and enabled to obtain the specialized knowledge required to participate in new industries where this knowledge is needed?

• Is there a need for specialized consulting and analytical resources that could be available to the venture capital firms on a pooled basis either on an independent basis or through the establishment of a resource facility that would be owned jointly by venture capital firms?

• How can the establishment of syndicates and networks of venture capital firms that work together and rely on each other's investment assessment expertise be facilitated, so as to minimize time and effort for both the firms and the companies seeking investment and result in fair valuations for both parties?
• How can relatively small venture capital firms making up syndicates be provided with sufficient resources to play a more active role in supporting and mentoring a company's management?

• What can be done to encourage Canadian venture capital firms, particularly the LSVCCs, to adopt risk adverse attitudes to venture capital investment that are more similar to those held by U.S. generalist venture capital funds?

• How can more managers that have an industry background rather than a banking background be attracted into the Canadian venture capital industry, so that more specialized industry knowledge can be built up in these firms?

• Will the recent reduction in the Canadian capital gains tax rate improve the inflow of funding to the venture capital industry? How can this be tracked?

• How can Canadian pension fund managers be encouraged to provide a proportion of funding to Canadian venture capital firms that is comparable to that provided by pension funds in the U.S.? Are changes to regulatory requirements or income tax rules needed?

• Would the encouragement of cross border syndicates of Canadian and U.S. venture firms provide larger investments in Canadian companies that require expansion phase funding?

• How could greater integration of the Canadian and U.S. venture capital markets be achieved in order to increase cross-border flows between the two markets?

**IPO and Post-IPO Financing:**

• Do capacity limitations in the Canadian market force Canadian SMEs to delay going public until they are large and established enough to meet the more stringent regulatory requirements in the U.S.?

• Since Canadian companies continue to undertake a large volume of IPOs in the U.S. market, despite the cost advantages of going public in Canada, does this indicate that there is a lack of capacity in the Canadian IPO market to meet Canadian financing needs or that other business benefits arising from going public in the U.S. outweigh the Canadian cost advantages?

• Since Canadian post-IPO markets appear to be quite competitive relative to U.S. markets in terms of issuing costs and the valuation and pricing of post-IPO issues, are Canadian companies willing to pay a penalty by issuing in the U.S., either because of a lack of capacity in the Canadian market or of the value of the business benefits from going public in the U.S.?
• Could the capacity of the Canadian markets to absorb relatively large post-IPO issues be increased to meet more of the post-IPO financing needs of Canadian companies by encouraging Canadian institutional investors to play a more active role in post-IPO equity financing?

**Next Steps**

The next steps in exploring the issues surrounding equity financing for SMEs would be to obtain factual information regarding these issues and their underlying causes directly from participants in the Canadian venture capital, IPO and post-IPO markets. This undertaking could involve two phases of consultations with these participants:

**Phase I:**

• Preparation of questionnaires for use in direct consultations with each group of participants, including SMEs seeking equity financing at various stages of development; venture capital investors, broken down into the various types of venture capital firms and funds active in Canada; institutional investors, including pension funds, life insurance companies and chartered banks; and investment dealers and stock exchanges involved in IPO and post-IPO financing.

• Questionnaires for SMEs could explore their experience in obtaining equity financing at various stages of development, including the financial, time and issuing costs involved for various types of equity financing, regulatory requirements, the behaviour of venture capital investors, the structure of the Canadian and U.S. markets, their reasons for choosing between Canadian and U.S. markets, and their ability to attract management personnel under various scenarios.

• Questionnaires for venture capitalists could explore their structure and operating procedures, sources of funding, attitudes towards risk management, participation in syndicates, analytical and risk assessment resources, mentoring and advisory services, management background and experience, typical size and stage of investments, regional and sectoral portfolio breakdowns, rates of return on portfolios, etc.

• Questionnaires for institutional investors could explore their degree of participation in venture capital and IPO financing, the nature of their involvement with venture capital funds, attitudes towards risk management, the percentage of portfolios allocated to these classes of investment, regulatory and tax considerations impacting on these allocations, attitudes towards the analytical and risk assessment capabilities of venture capital firms, degree of participation in IPO and post-IPO financings, rates of returns on venture capital investments, track records with IPO and post-IPO issues, etc.
• Questionnaires for investment dealers and stock exchanges could explore their involvement in IPO and post-IPO issues, experience regarding comparative costs and regulatory requirements associated with these issues in Canada and the U.S., management requirements for firms undertaking these issues, the reasons why Canadian companies choose to undertake these issues in U.S. markets, the capacity of the Canadian markets to meet the needs of Canadian issuers, the track record of Canadian company IPO and post-IPO issues in Canada and the U.S., the role of institutional and retail investors in IPO and post-IPO issues, etc.

• Preparation of lists of potential firms for selection to participate in the questionnaire consultations for the various types of market participants. These participants would be contacted in order to explain the purpose of the questionnaire consultations and to solicit their participation in the consultations. Questionnaires would then be forwarded to the final selection of firms.

Phase II:

• Questionnaires returned by the participants in the questionnaire consultations could be compiled for each group of equity financing participants into a format that would provide a factual background for the various issues raised regarding equity financing for Canadian SMEs.

• Based on these factual analyses, the role that could be played by public policy in dealing with the issues surrounding equity financing for SMEs in Canada could be determined and assessed.

• A summary of the trends and conclusions arising from the factual information compiled from the questionnaires could be developed and distributed back to the participants in the questionnaire consultations for their information and comments.

• Focus groups could be established for the various groups of market participants to review the outcomes of the questionnaire consultations and assess the role that public policy could play in improving access to equity financing for Canadian SMEs.
APPENDIX A


<table>
<thead>
<tr>
<th>Overview of the Venture Capital Market in Canada (1997 - 2000)</th>
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<tr>
<td>Supply of Venture Capital</td>
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<tr>
<td>Industry Resources (mm. $):</td>
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<tr>
<td>Assets under Management</td>
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<tr>
<td>% of Assets:</td>
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<tr>
<td>LSVCCs</td>
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<tr>
<td>Private Independent Funds</td>
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<tr>
<td>Others</td>
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<tr>
<td>New Funds Raised (mm $)</td>
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<tr>
<td>Venture Capital Investment</td>
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<tr>
<td>Total Investment (mm. $)</td>
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<tr>
<td>% of Total Investment:</td>
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<tr>
<td>New</td>
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<tr>
<td>Follow-on</td>
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<tr>
<td>Investment by Number and Size of Investments</td>
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<tr>
<td>Number of Investments</td>
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<tr>
<td>Average size (m. $)</td>
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<tr>
<td>Investment by Stage of Activity</td>
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<tr>
<td>% of Total Investment:</td>
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<tr>
<td>Early Stage</td>
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<tr>
<td>Expansion Stage</td>
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<tr>
<td>Other</td>
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<tr>
<td>Sectoral Distribution of Investment</td>
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<tr>
<td>% of Total Investment:</td>
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<tr>
<td>Technology:</td>
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<tr>
<td>Biotechnology</td>
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<tr>
<td>Computer Related</td>
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<tr>
<td>Communications</td>
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<tr>
<td>Other</td>
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<tr>
<td>Traditional Industries</td>
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<td>Regional Distribution of Investment</td>
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<tr>
<td>% of Total Investment:</td>
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<td>Ontario</td>
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<tr>
<td>Quebec</td>
</tr>
<tr>
<td>Western Canada</td>
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<tr>
<td>Atlantic Canada</td>
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<tr>
<td>Outside Canada</td>
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<tr>
<td><strong>Supply of Venture Capital</strong></td>
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<tr>
<td>Industry Resources (b.$):</td>
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<tr>
<td>Capital under Management</td>
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<tr>
<td>New Funds Raised</td>
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<tr>
<td>Total Investment (b.$)</td>
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#### Investment by Number and Size of Investments

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#### Investment by Stage of Activity

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#### Sectoral Distribution of Investment

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<td>% of Total Investment:</td>
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#### Regional Distribution of Investment

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<tbody>
<tr>
<td>% of Total Investment:</td>
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<td>Southwest</td>
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