CAPITAL POOL OFFERINGS AND SME FINANCING

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The Capital Pool Companies initiative of the Canadian Venture Exchange is a means by which early-stage enterprises sell shares to the public, raising equity capital. This study finds that spread and underpricing are high, liquidity is low, and stock price performance varies widely. Details of some qualifying transactions question the integrity of the program.

Introduction

The recent reorganization of Canadian stock markets has changed, and will continue to change, the ways in which Canadian businesses raise capital. Capital Pool Companies (CPCs, formerly known as Junior Capital Pool Companies (JCPs) on what was the Alberta Stock Exchange) are of great potential importance to SMEs. The CPC initiative, described in more detail below, allow new businesses to supplement founders' capital with a public offering of shares and a listing on the Canadian Venture Exchange (CDNX) stock market. The costs of raising as much as $500,000[1] of early-stage risk capital are of the order of $65,000 to $95,000.[1]

Previous studies of the predecessor JCPs have raised questions about the effectiveness of the JCP/CPC process (Alberta Stock Exchange, 1992; Robinson (1997), Catteneo, 1999; Riding, Haines & Madill; 2000). Based on data for JCPs that had been listed on the now defunct Alberta Stock Exchange, these works identified both benefits and shortcomings of the JCPs that needed to be re-visited if the design of CPCs on the new Canadian Venture Exchange was to be optimized. These include "the high costs of launching and then maintaining a public listing, difficulty in raising further funds, lack of support from investment houses after the initial JCP offering, and lack of liquidity" (Riding, Haines & Madill; 2000). This evaluation is particularly important given the recent merger of the CDNX with the TSE and the now national scope of CPC financing.

The empirical research reported here documents an early analysis of the efficacy of the CPC initiative. The basic research questions are:

(a) Do CPCs make investors money and what level of liquidity can be expected from these stocks?

(b) To what extent does the CPC framework provide a legitimate means of helping SMEs raise early-stage equity capital?

This work is also important because it is widely held that early stage firms lack access to the equity capital they require to start, grow, and survive, a belief that has led to numerous public policy and private sector initiatives directed towards facilitating access to capital for SMEs.[2] In part, this importance stems from the job-creation that, since Birch (1979) has been attributed to the birth and growth of SMEs. To the extent that CPCs provide a means through which early

stage SMEs can access risk capital, they warrant attention. To the extent they fall short, researchers and policy makers can learn from the findings. Therefore this paper provides insight into the background and current performance of Capital Pool Companies.[3] This work used standard measures of spread, underpricing, and stock performance to examine the performance of the first generation of CPCs on the CDNX. It presents instances of CPC misuse, the inaccessibility of certain key trading data, and performance outcomes. are also uncovered. This paper examines the population of CPCs listed as of April 30 2002

The findings therefore are essential to investors considering CPCs, to individuals considering the CPC as a means of raising risk capital, and finally to the regulators of the CPC program. Examples of how this program is being used by individuals to further non-arms length parties will be explored and the obvious need for further regulation will become apparent. This paper begins with a brief background on the Capital Pool Company program, its purpose, and requirements. From there the paper is composed of two primary sections; the first of which deals with the standard measures of spread, underpricing, and stock performance for CPCs. The second portion of the paper focuses on former CPCs. Here the issue of trading data availability is addressed, the high frequency of non-arm's length qualifying transactions, and the average time between the listing and the completion of a qualifying transaction.

Background, Previous Research, and Objectives

The CPC program was designed to unite early stage companies with experienced management teams. The program was initiated in March 2000 and consists of two phases. The first phase is the creation of a shell corporation known as a Capital Pool Company, the business of which is to identify and evaluate an asset or business for the purpose of acquisition. The second stage involves the completion of a so-called *qualifying transaction*, which must be accomplished within 18 months of the original listing date or the CPC risks being delisted. The qualifying transaction can be the acquisition of significant assets or common shares. Alternatively, the CPC can also enter into an agreement, amalgamation, merger, or reorganization to fulfill the requirements for the qualifying transaction. The initial public offering can solicit between $200,000 and $500,000, through the issuance of a minimum of one million shares. Further requirements of the program include a contribution of between $100,000 and $500,000 of capital by the founders, directors, and officers to initiate the process.[4]

There has been no previous research on CPCs, in part because the program is so new that data have not yet been available. The Alberta Stock Exchange (ASE, 1992), Robinson (1997), Catteneo (1999), and Riding, Haines & Madill (2000) have examined various aspects of the predecessor JCP program. The ASE and Robinson were generally positive in their findings, but both studies were cursory and based on data that is now out of date. Cattaneo and Riding and his colleagues raised several questions about the efficacy of the program including the ability of investors to realize a fair risk-related rate of return owing to low liquidity of JCP shares.

There have been 159 new CPC issues from March of 2000 to April of 2002 for which a qualifying transaction has not yet been completed and an additional 50 qualifying transactions have been completed by Capital Pool Companies. The newly listed CPCs achieved average gross proceeds of approximately $279,000. Overall cost of issuance is normally $60,000 to $90,000. These costs include legal fees, agent's commission (normally 10% of issue size), stock exchange fees ($9,000 to $15,000), and associated legal etc. expenses of $10,000 to $20,000.

The first part of this work focuses exclusively on firms currently listed as CPCs: that is, those for which a qualifying transaction has not yet taken place. It employs standard measures of spread, underpricing, and share price performance for the population of CPCs.

The second portion of this study deals with former CPCs, those that have completed a qualifying transaction and are now (April 30, 2002) no longer classified as a CPC. The work examines details of the qualifying transactions including the extent to which the transaction was conducted on an arm's length basis (or not) and if the spirit of the principles of the program had been violated. Finally, the length of time between the listing date and qualifying transaction will also be evaluated.

To undertake the work, the population of CPCs that had listed between March of 2000 to April of 2002, (159 companies) was employed.

Empirical Findings

Spread

Spread is measured as the percentage difference between the listing price of the shares and the price the authorized price of the shares. The gross proceeds of the IPOs aggregated across the 153 firms for which data was available was estimated to be $48.3 million. The average spread for these firms was found to be 88 percent. That is, the prices at which the shares were first listed on the CDNX were, on average, almost twice the authorized price. Potentially, the agent/underwriters may have realized almost as much from the sale of the shares as did the companies themselves.

Underpricing

Underpricing is calculated as the percentage difference between the listing price at the end of the first day of trading and the price at which it was listed. The average underpricing for the 153 CPCs for which data was available was 15 percent, somewhat higher than new issues of common shares on the Toronto Stock Exchange. This finding is consistent the argument that the degree of underpricing is governed by *ex ante* uncertainty.

Performance and Liquidity

Charts 1 and 2 depict patterns of share price movements and trading volume. Share price performance is measured by the cumulative holding period returns on the shares over the weeks following listing. The time period that was considered for the analysis of performance and liquidity begins from the second day of trading (to exclude effects of underpricing) and extends to the close of trading on of the 40th business day following listing. The cumulative holding period return for the 39-day period averaged across the 153 companies is 10.8 percent. However, this result was sensitive to a small number of outliers. For example, when those seven firms that had traded for more than 35 of the 39 days were excluded from the return calculation, the cumulative average holding period return decreased to 5.04 percent.

Liquidity was measured by means of by analysis of trading volume. In general, the (lack of) liquidity of CPCs' shares is noteworthy. Four different approaches were used here to assess

liquidity. First, the number of days on which each CPC actually traded during the 39-day period was calculated. More than one-quarter of the 153 firms (27 percent) traded on fewer than 11 days during the 40-day period; 68 percent of the CPCs traded on fewer than 21 days. Second, the first 5 days of trading were assumed to be the peddling period, during which the agent/underwriter may have actively been marketing the new issue. Therefore, a second measure of liquidity was calculated as the sum of shares traded during the first 5 trading days divided by the float. While 29 percent of the CPCs have peddling period volumes of less than one-half the float, the peddling period volumes of 68 percent were between one and 1.5 times the float.

The next two measures of liquidity assess the volume of the 35-day post-peddling period. The share volume traded in the post-peddling period (sixth to 40th day) was divided by the sum of the shares traded during the peddling period and alternatively by the float. In both cases, this produced a highly skewed distribution. In the former case of (post-peddling period volume divided by peddling period volume), 83 percent of CPCs were less than one. For the latter measure, trading volume for 66 percent of the CPCs was less than 10 percent of the float.

Taken together, the extremely thin trading implies poor liquidity of CPC shares. As a repercussion the CPCs' chances of successful secondary offering may be greatly diminished.

In addition, the CDNX stipulates that each CPC must have a minimum of 300 public shareholders each of whom is required to hold at least 500 shares. This implies a minimum issue size of at least 150,000 shares (this is obviously an underestimate since shareholders can and do buy CPCs in greater increments than 500). At first glance one would assume this to be a rather easy task since the maximum for a share price is set no greater than 30 cents per share. However, 27 out of the 153 CPCs for which data was available fail to trade a volume equal to or in excess of 150,000 shares within the first 40 days. Although 40 days is not the official deadline for the distribution requirement it is disturbing that almost 18% of CPC issues fail to realize the stipulation within the most likely time frame. This adds to concerns about liquidity and the prospect that some CPC's may go public prematurely with little after-market for their shares.

Qualifying Transactions

The population of CPCs who have completed their qualifying transaction, 50 companies, was used for this portion of the study. The study examined transaction details, filing and listing dates, specific company information such as directors and officers, as well as the history of name changes.[5] Based on data for 45 of the 50 companies, this study found that 53% of the qualifying transactions have been on a non-arms length basis.[6] This begs questions related to how the funds raised through the CPC were deployed, the rights of minority shareholders, the motives of the directors, the role of the agent/underwriter, and the oversight of securities regulators. Two related questions also arise. First, one must ask if the capital being raised from the public is in fact for the purpose of a cash injection into a company for which owner(s) are already involved. Second, it seems possible that the CPC program presents an inexpensive way to take a company public through a quasi back-door listing.

> The acquisition of 50% working interest in a horizontal oil well prospect by Longview Petroleum Corporation illustrates a qualifying transaction that seems to fulfill the spirit of the CPC initiative. In this instance, an experienced team of directors came together and identified an opportunity. There were no conflicts of interest and this deal was conducted on an arm's length basis. Additionally no name change has taken place; therefore, all of the initial trading data during the CPC stage is still available. More importantly, there is no evidence of an established firm exploiting the program for a quick cash inflow or an easy and inexpensive way to go public.

One example of a non-arm's length qualifying transaction is that of Avalon Works Corporation's purchase of Danek Associates Inc. Jirka V. Danek, the sole founder of Danek Associates Inc. was also the controlling shareholder of Avalon Works Corporation, holding 73.9% of the outstanding shares. Avalon had raised $500,000 through its initial CPC public offering and their press release stated that they: "…will use the proceeds of this offering to provide Avalon with a minimum of funds with which to identify and evaluate businesses or assets for acquisition" (Avalon, 2000).

Since the controlling shareholder of Avalon is the founder of the acquired company the aforementioned example seems to contradict one of the distinct goals of the CPC program, which is to unite experienced management with early stage companies. In this instance, Danek has personally maintained control of his original business, raised the maximum funding allowed by the CPC program, and taken Danek Associates Inc. public at a cost much lower than the traditional route while raising $500,000 from the public. The time interval between listing and the completion of the qualifying transaction was 95 days. It seems counterintuitive that the owners of Avalon (includes Jirk Danek) required $500,000 "to identify and evaluate a business" that the director of Avalon founded personally.

A further example of a qualifying transaction for which the motives may be questionable is one done by Advanced Sensing Systems Inc. in the purchase of IROC H2S Consulting Ltd. "The acquisition of IROC would be considered non-arm's length in that Dennis G. Featherstone, a director, promoter and principal Shareholder of Advanced, and Laura M. Featherstone, a principal Shareholder of Advanced, are also directors, officers and principal shareholders of IROC" (Advanced, 2000). Although the exact motives cannot be known for certain, three outcomes are clear. First, majority control of IROC remained with the same individuals throughout the acquisition. Second, IROC is now publicly traded. Finally, it is once again unlikely the capital raised by the CPC was used in its entirety to identify and evaluate a potential business.

http://www.sedar.com/csfsprod%2Fdata21%2Ffilings%2F00307937%2F00000001%2Fs%3A%5C12049%5CInfo-Cir.pdf "Advanced Sensing Systems Inc." [web page] October 2000; [Accessed 10 July 2002].

Time Between Listing and Qualifying Transaction

According to Heenan Blaikie (2002): "A company will not be able to use the [CPC] program if prior to completion of its IPO, it has reached an agreement in principle for its qualifying transaction. In this regard, there are rules to prevent abuse in the case of a qualifying transaction between a company and a party related to it." Therefore, it may be revealing to examine the time between initial offering and the nature of the qualifying transaction.

The average time between the listing date and the completion of a qualifying transaction was 253 days based on 44 companies for which data was available. However, for arm's length qualifying transactions, the average time between IPO and transaction was 322 days and for non-arm's length transactions, 179 days.[7] These findings may provide further circumstantial evidence to the effect that some CPCs may be using the program as a means of obtaining a cash injection into a related organization and the legitimization that a stock exchange listing affords.

An example of a firm that utilized a very short time period between the listing date and completion of the qualifying transaction is Ripper Oil and Gas Inc.: "…the Company acquired all the assets of 911320 Alberta Ltd. ('911320') in a non-arm's length transaction" (Ripper, 2001). This qualifying transaction took 56 days to complete after listing.

Another concern with this phenomenon is that other opportunities, possibly at arm's length to the directors, are not being given proper review. The directors must have a successful history with public companies and their expertise is considered the company's key asset by the CDNX. Thus, some CPCs may not be utilizing their most valuable asset and as a result they may

overlook lucrative alternative prospects. Furthermore, it is also possible that some CPC companies are simply going public prematurely.

Summary and Discussion

This paper has reviewed several aspects of the CPC initiative available to early-stage Canadian firms. Ostensibly, the program appears to provide a relatively inexpensive means by which new enterprises can supplement founders' capital with an initial public offering of shares through agent/underwriters and the Canadian Venture Exchange. Approximately 1,200 Canadian businesses have used this vehicle and its predecessor, the JCP available through the ASE. At first glance this seems a useful program because of the widely-cited need for SMEs to be able to access growth capital. However, this research has documented several issues that need to be addressed if the program is to gain wide acceptance.

First, one could argue that agents and underwriters are among the primary beneficiaries of this program. In addition to fees, this study suggests that they may also benefit from a substantial spread in the price of the shares on issuance.

Second, share price performance does not appear to be commensurate with risk. Underpricing (share price performance on the first day of issue) averages 15 percent subsequent to which shares appreciated by an average of just over five percent during the eight-week period following the issue (after allowing for a small number of outliers). For the decade of the '90s, during which markets were generally rising, this implies little (if any) net of market returns. Moreover, trading activity was found to be relatively low and it is not clear that investors seeking to sell would be able to find a buyer without giving up a liquidity premium.

Third, the prevalence of non-arm's-length qualifying transactions provide a means by which the CPC allows owners of establish firms to take advantage of the proceeds (and perhaps the stock market listing) of related CPC issuers. What appear to be specific examples of this practice were cited. To the extent that business owners use the CPC as a scheme by which their existing businesses are enriched may compromise the CPC initiative as a means of SME financing: "bad coin drives out good coin" may be an *a propos* adage.

Given the gravity of these findings, it is evident that further research is warranted to provide independent confirmation. In addition, with the passage of additional time a yet larger number of CPC issues spanning additional geographic locales could then be considered. Based on these preliminary outcomes, further analysis and regulatory changes may be required.

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Chart 1: Longer Term Performance of CPC Issues

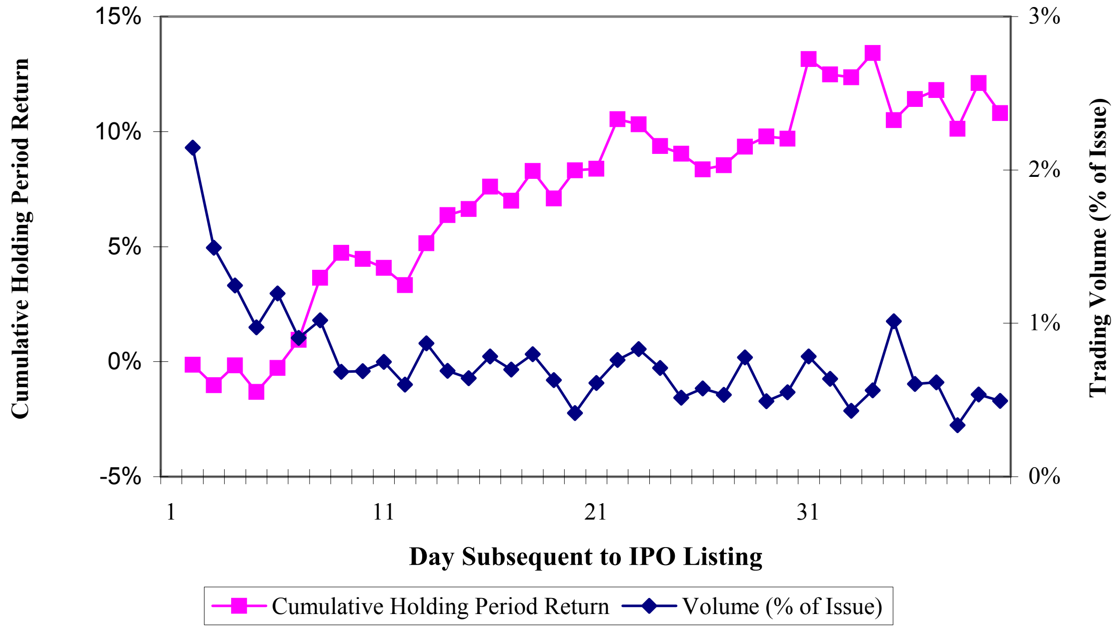
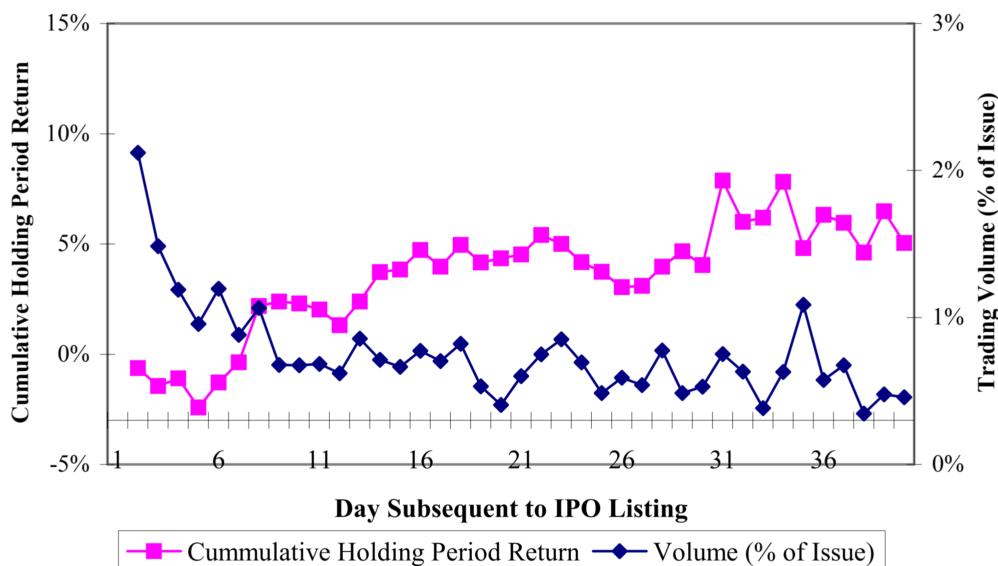


Chart 2: Longer Term Performance of CPC Issues (Outliers Removed)



Notes

[1] For a comprehensive description of the Junior Capital Pool Rules and Regulations, see Armstrong, Derrick, Junior Capital Pool Offerings Rules And Regulations, Armstrong Perkins Hudson, November 26, 1999.

[2] Examples of some of these initiatives include SCORS (Small Corporate Offering Registrations) in the US (see Deeds, 1998; Osteryoung et al, 1996), junior stock exchanges such as MOTHERs in Japan (see Nitani and Riding, 2001), as well as other junior stock exchanges and venture capital stimuli.

[3] This study does not consider Junior Capital Pool Companies, Venture Capital Pool Companies, or Keystone Companies, all of which were initiatives of stock exchanges that have since merged to form the CDNX.

[4] There is also a minimum constraint of 300 public shareholders who must each hold no less than 500 shares. The shares are to be priced at no greater than 30 cents and there is a maximum holding of two percent per shareholder or four percent per family.

[5] Ideally, work would also have examined pre- and post-transaction share trading data; however, trading data for former CPCs that had undergone a change of name were not available. The CDNX does not have trading data available for such firms from the initial CPC listing date to the date of the name change, a time frame that shall be deemed the "gray trading zone." This has been confirmed by Christine McKee of the CDNX and Sylvain Gauthier, the information coordinator for the CDNX. Name changes usually accompany qualifying transactions and are rather common for CPCs. This research showed that 74%, or 37 of the 50 CPCs to complete a qualifying transaction to date, have changed their name and pre-transaction trading data are not available for analysis.

[6] The term arm's-length refers to: "The condition or fact that the parties to a transaction are independent and on an equal footing" ("Arm's Length," 2002).

[7] Based on 39 firms for which both transaction data and arm's length data were available.