Letter from the President

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

Evolving Structural Change in Financing and Trading in the Venture Capital Markets

Vol. 82

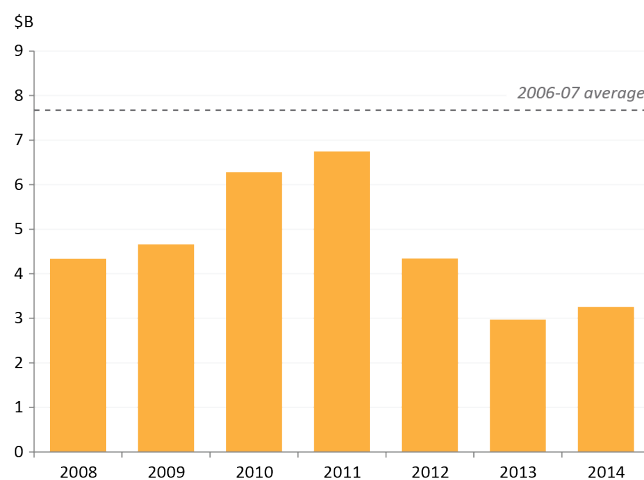
There have been significant changes in the pattern of common equity financings – but you have to look closely to see them. When examined in aggregate on average over the past five years, the pattern does not look much different from five years earlier. Total offerings of common shares in public and private markets averaged about $32 billion a year in the latest three years (2012-14), similar to the amount in the three years just before the 2008 financial crash. Based on these numbers, one concludes domestic primary equity markets have been fairly stable, functioning smoothly before and after the 2008 financial crash.

A closer examination, however, reveals two dramatic differences between the two periods. First, in the more recent five years, the primary equity markets have been punctuated by four distinct economic and financial events (described in detail on p.2) that have interfered with and disrupted financing patterns. While domestic equity markets have always been characterized by resource and business cycles, until recently market adjustments have been less frequent and amplitudes of swing less pronounced.

Second, in the latest five years domestic primary markets have transformed into a large corporate marketplace. While the Canadian markets have been long dominated by trading in large inter-listed stocks, small and mid-sized businesses have accounted for a proportionate share of common equity financings. Not any longer.

Financings in the small and mid-cap markets collapsed in 2012. Not only have they not recovered, but they have weakened further. This protracted weakness in the equity financings for TSX and TSX-V listed small companies is unprecedented in recent history. At a time U.S. and E.U. policy-makers are taking steps to build equity and debt capital markets to finance SMEs and displace reliance on bank financing, the Canadian venture marketplace, the most dynamic and envied small-cap marketplace in the developed world, exhibits serious vulnerabilities.

Small Equity Financing
Deals valued less than $20M



Source: IIAC

There are lessons for policy-makers here. First and foremost, recent developments emphasize the vulnerability of small-cap markets, not just to external global economic trends, such as commodities prices, but to demographic, regulatory and other structural changes in domestic markets. The Policy priority should be to preserve the stability of these equity markets to promote the flow of new equity capital to small enterprise. Equity markets for small and mid-sized businesses are the life-blood of the Canadian economy, providing the external capital to fund start-up and expansion of small business, and the source of most job creation and growth in the economy. In an era of economic retrenchment and deflationary trends, this market for external equity capital is needed more than ever.

Regulatory and tax policy must try to inoculate the market from these sweeping events. In this regard, we think it propitious to implement a federal tax incentive to encourage small business

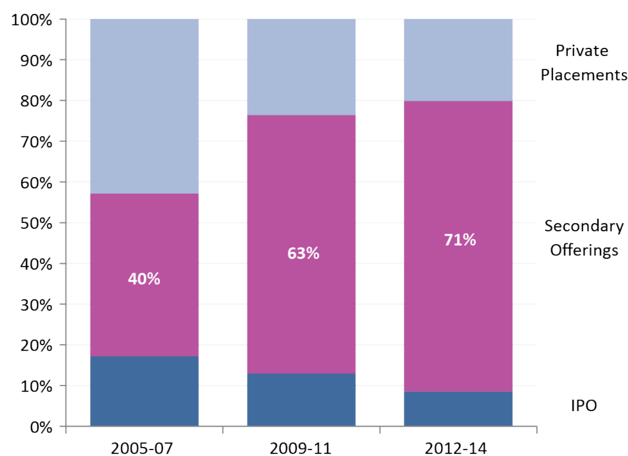
capital-raising and support efforts to build a cooperative securities regulator, to align securities regulations for trading and financing securities, and deliver clear, accountable and responsive reforms to the marketplace.

Recent ups and downs in secondary equity markets

Early in 2009 the domestic equity markets for large and small companies rebounded strongly from the financial crash in the autumn of the previous year. The prevailing view was the resource super-cycle was intact, resource markets and the economy would quickly recover, and financing and trading patterns would resume. However, the picture rapidly changed in early 2011 when global growth faltered in the developed and emerging worlds, and the European debt crisis erupted. It dawned on capital markets that given the legacy of over-borrowing and over-extended financial institutions, corporations and households would require a long period of deleveraging and spending retrenchment to repair balance sheets and financial positions. The air quickly went out of the commodities balloon, and share prices for resource stocks, especially for base and precious metals fell sharply, dragging down growth expectations and broadly-based equity markets. Financing activity turned turtle.

Secondary Offerings Dominate

Common Equity Issuance by Issue Type



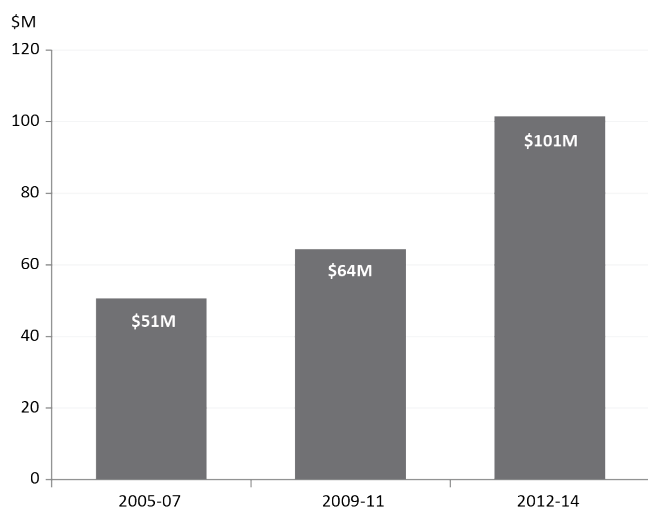
Source: IIAC

Primary equity markets managed to rebound last year, led by financings in the energy and financial sectors. Equity financings in the financial sector rose nearly two-thirds in value terms from the previous year to fund new regulatory capital requirements. Indeed, common equity offerings across the corporate sector in 2014 alone totaled $38 billion, close to an all-time annual record. Financing activity then hit the skids in the fourth quarter of last year, and has continued as all issuers, led by energy sector, withdrew from markets in response to the dramatic collapse in world oil prices and increased uncertainty in the outlook. This poor financing trend has continued to date. Moreover, competitive pressures for the shrinking deal flow of small and mid-sized issuers intensified as the larger integrated dealers have moved steadily downstream to compete for smaller sized offerings, with the advantages of large capital base and diversified service such as lending.

An ominous trend: Large corporate issuance dominates primary markets

The steadily increasing dominance of large corporate offerings has been an ominous trend throughout the period of recent volatility in primary equity markets. Secondary offerings, typically of large-sized corporate deals, accounted for over 70% of issuance activity in the last three years, compared to a 40% share of financings in a similar period just before the 2008 crash. The average size of offerings in dollar terms has doubled in the same period, to $101 million from $51 million. Offerings over $500 million in individual size accounted for one-third of total equity financings in 2012-14 versus less than 10% in 2005-07.

Average Size of Secondary Offerings



Source: IIAC

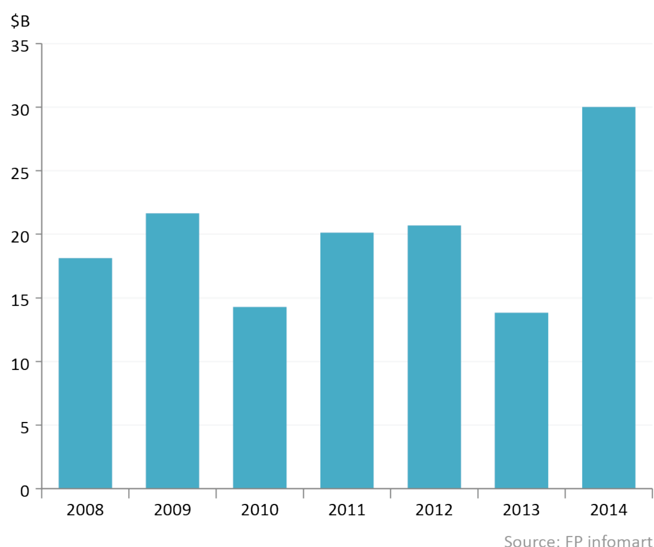
The shift to large-sized deals reflects the recent pattern of financing in the primary markets. Large financial institutions floated large-size offerings to strengthen balance sheets. Second, in the past two years large energy companies have tapped equity markets to fund large-scale project development.

Last year reliance on bought deal equity transactions increased significantly. Bought deals totaled $30 billion in 2014, more than double the previous year. Institutional investors increased their appetite for attractively priced shares of well managed companies across the corporate sector, notably in the energy group. Corporate issuers, on the other hand, were attracted to bought transactions to lock in the cost of capital once the decision was reached to tap the market. The trend of bought deal financings by energy companies continued in the first quarter this year as companies seized the opportunity to issue new shares, even at low prices, to build cash and pay down debt.

As well, the dominance of large-sized deals reflects the ongoing difficulties of small and mid-sized companies to access equity

markets. Common financings for small business, proxied by issue size of $20 million or less, in the last three years have ground to a fraction of pre-crash levels, and small business IPOs have been virtually non-existent in the past two years. Low share prices of the many small and mid-cap mining companies from weak metals prices, and poor shape of their balance sheets, have been a key factor behind the financing collapse. Common financings for small companies, both public and private offerings, averaged $3.5 billion in the three years ended 2014, one-half of the offerings in the same period prior to the 2008 crash.

Common Equity: Bought Deal Transactions



As we have said elsewhere, the sharp decline in small and mid-sized business offerings reflects a series of structural factors.

i. Considerable uncertainty about the business outlook, coupled with heightened risk aversion, has contributed to a reduced appetite for small speculative deals.

ii. The aging demographic has made wealthy retail investors less receptive to speculative shares and attracted to fixed income and dividend-paying blue-chip equities.

iii. Recent regulatory reforms, including a cautious approach by advisors to interpreting investor suitability requirements given intense regulatory scrutiny, and the higher costs passed on to investors from higher transaction and market data costs.

iv. The foreign property rule has discouraged institutional investment in small speculative equities, as foreign equities became an effective alternative to gain alpha returns.

A future of narrower small-cap domestic equity markets?

The issuance of the shares of small and mid-sized companies, and related trading in secondary markets, have fallen steadily. While financing and trading volumes in small business equity markets will eventually respond positively to improving economic conditions, in the immediate future protracted weak business conditions and competitive pressures will continue, driving further structural changes in small cap markets. The institutional dealer boutiques will continue to consolidate, reflecting tighter financing and trading spreads, reduced financing activity, and higher cost structures, leaving the field to fewer and fewer players. It is instructive that fifteen IIROC-registered institutional boutiques disappeared from the capital markets in the past two years, nearly 20% of the institutional group. These dealers have closed up shop, merged with other registered dealers or transferred registration to the EMD category.

A steadily smaller segment of investment dealers catering to small-cap equity markets will be left to provide research, client advice and an after-market in traded small business equity shares. In this circumstance, as small businesses move beyond their angel investor and venture capital networks, and seek more equity capital, they will turn increasingly to alternative channels for placement of new shares, notably through managed investment funds (IC-PM registrants) and Exempt Market Dealers (EMDs).

We anticipate greater reliance on online electronic platforms to distribute the shares of listed small companies and the private equity of emerging businesses to accredited investors, a version of crowd funding. Smaller managed funds may also build and use electronic trading platforms to offer online advice and investment products, notably portfolios of speculative equities, catering to a broad cross section of retail investors. Online trading platforms, for cost-efficiency reasons, may play a larger role in the distribution of small business equities. Regulatory oversight to these platforms will be crucial to ensure appropriate suitability standards and investor protection.

The emergence of these alternative distribution channels relying on direct placement, coupled with the higher cost of trade execution and complications for market making, will reduce trading and liquidity for small and mid-sized companies. This erosion of share liquidity and greater reliance on direct placement of small business shares will feed back to reduced issuer activity, and narrow the depth and breadth of the domestic small cap equity markets, increasing the difficulties and costs of accessing equity capital, even as economic conditions improve. This narrowing in public markets for small business will be another factor encouraging small companies to stay private.

Conclusion

The dealer boutique brokerage model in venture markets is under stress. The conflation of poor business conditions, widespread structural change in capital markets, and regulatory reform, has forced adjustments in the structural framework of the venture marketplace. Further, the increased costs for trade execution and market data, and complications of dealing in multiple equity markets, and a diminishing presence of dealer boutiques, have contributed to a falloff in secondary market liquidity for venture shares.

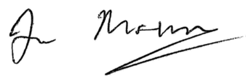
Finally, in an effort to reduce issuance costs and compensate for the loss of dealer competition, corporate issuers have turned to direct placement of securities through managed funds, and distribution agents such as EMDs. These alternative distribution channels, unlike investment dealers, don't provide an after-market or liquidity in these shares.

Electronic platforms will play a larger role in the distribution of venture securities, and accelerate the shift to direct placement of shares. These direct distribution channels and their platforms fit well for corporate issuers that have decided to limit costs by avoiding listing and staying private longer. Greater reliance on these distribution channels, however, will further dampen trading and listing activity in venture markets.

The withdrawal of dealer boutiques from the small-cap marketplace, and displacement by alternative channels of direct securities placement, will further reinforce the erosion of liquidity in secondary venture markets. This weakening in secondary market liquidity will in turn increase the capital raising difficulties for small business.

Special recognition to Eon Song, Capital Markets Analyst, for analytical and technical support.

Yours sincerely,



Ian C. W. Russell, FCSI
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March 2015

Summary of Equity Issuance

	Quarter-over-Quarter				% Change			Annual Year-over-Year			% Change	
	Q4	Q3	Q2	Q1	Q4/Q3	Q3/Q2	Q2/Q1	2014	2013	2012	2014/2013	2013/2012
$ Billions **Issuance**												
Common equity	5.9	12.9	12.2	7.3	-54.5%	6.0%	66.0%	38.3	26.9	32.0	29.7%	-19.1%
Income trusts	1.1	0.9	1.1	1.3	25.2%	-20.4%	-13.6%	4.4	6.5	8.2	-48.6%	-24.7%
Preferred shares	2.2	3.6	3.9	2.5	-37.7%	-8.8%	58.6%	12.2	5.3	7.2	56.2%	-34.8%
Limited partnerships	0.1	0.1	0.3	0.3	-19.1%	-79.0%	4.9%	0.8	0.4	0.3	50.6%	12.3%
Total Equity Issuance	**9.2**	**17.4**	**17.5**	**11.4**	**-47.4%**	**-0.6%**	**53.8%**	**55.5**	**39.2**	**47.8**	**29.5%**	**-22.1%**
Number **Issues**												
Common equity	408	368	495	531	10.9%	-25.7%	-6.8%	1,802	1,862	2,305	-3.3%	-23.8%
Income trusts	18	11	21	8	63.6%	-47.6%	162.5%	58	82	93	-41.4%	-13.4%
Preferred shares	15	17	16	12	-11.8%	6.3%	33.3%	60	34	37	43.3%	-8.8%
Limited partnerships	4	3	1	12	33.3%	200.0%	-91.7%	20	17	18	15.0%	-5.9%
Total Number of Issues	**445**	**399**	**533**	**563**	**11.5%**	**-25.1%**	**-5.3%**	**1,940**	**1,995**	**2,453**	**-2.8%**	**-23.0%**

Common Equity Issuance

	Quarter-over-Quarter				% Change			Annual Year-over-Year			% Change	
	Q4	Q3	Q2	Q1	Q4/Q3	Q3/Q2	Q2/Q1	2014	2013	2012	2014/2013	2013/2012
$ Billions **Issuance**												
Initial public offerings	0.9	0.6	2.4	0.0	62.2%	-76.0%	n/a	3.9	2.2	2.2	44.1%	-0.4%
Secondary issues	3.1	10.8	7.8	5.9	-71.2%	38.5%	32.2%	27.6	19.5	22.2	29.6%	-14.3%
Private placements	1.8	1.5	2.0	1.4	20.6%	-22.9%	38.0%	6.7	5.3	7.7	21.8%	-45.7%
Total Common Equity	**5.9**	**12.9**	**12.2**	**7.3**	**-54.5%**	**6.0%**	**66.0%**	**38.2**	**26.9**	**32.0**	**29.7%**	**-19.1%**
Number **Issues**												
Initial public offerings	9	15	9	3	-40.0%	66.7%	200.0%	36	70	158	-94.4%	-125.7%
Secondary issues	29	69	76	65	-58.0%	-9.2%	16.9%	239	210	232	12.1%	-10.5%
Private placements	370	284	410	463	30.3%	-30.7%	-11.4%	1,527	1,582	1,915	-3.6%	-21.0%
Total Number of Issues	**408**	**368**	**495**	**531**	**10.9%**	**-25.7%**	**-6.8%**	**1,802**	**1,862**	**2,305**	**-3.3%**	**-23.8%**

Trading Volume and Value

	Quarter-over-Quarter				% Change			Annual Year-over-Year			% Change	
	Q4	Q3	Q2	Q1	Q4/Q3	Q3/Q2	Q2/Q1	2014	2013	2012	2014/2013	2013/2012
Billions of shares												
Volume												
TSX	25.2	18.9	19.3	22.9	33.8%	-2.2%	-15.8%	86.3	82.5	86.1	4.4%	-4.4%
TSX Venture	8.6	8.7	8.8	11.8	-1.2%	-1.1%	-25.1%	37.9	36.9	43.7	2.8%	-18.7%
ATS	20.2	16.3	16.2	19.1	23.9%	0.6%	-15.0%	71.9	61.4	63.9	14.6%	-4.1%
Total Trading Volume	**54.1**	**43.9**	**44.3**	**53.7**	**23.2%**	**-1.0%**	**-17.5%**	**196.1**	**180.7**	**193.7**	**7.8%**	**-7.2%**
$ Billions **Value**												
TSX	380	297	282	307	27.7%	5.5%	-8.1%	1,266	1,152	1,190	9.0%	-3.3%
TSX Venture	3	4	5	4	-26.9%	-21.6%	13.3%	15	13	24	13.4%	-77.6%
ATS	288	239	227	229	20.7%	5.0%	-0.7%	983	786	747	20.0%	4.9%
Total Trading Value	**670**	**540**	**514**	**540**	**24.2%**	**5.0%**	**-4.8%**	**2,264**	**1,951**	**1,960**	**13.8%**	**-0.5%**

Source: TSX