

Venture Capital, IPOs, and Seasoned Offerings

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Appendix 14A The Financing of New and Small Enterprises

Appendix 14B Hotch Pot's New Issue Prospectus

Bill Gates and Paul Allen founded Microsoft in 1975 when they were both around 20. Eleven years later, Microsoft shares were sold to the public for \$21 a share and immediately zoomed to \$35. The largest shareholder was Bill Gates whose shares in Microsoft then were worth US\$350 million.

In 1976 two college dropouts, Steve Jobs and Steve Wozniak, sold their most valuable possessions, a van and a couple of calculators, and used the cash to start manufacturing computers in a garage. In 1980 when Apple Computer went public, the shares were offered to investors at \$22 and jumped to \$36. At that point, the shares owned by the company's two founders were worth US\$414 million.

In 1996 two Stanford computer science students, Larry Page and Sergey Brin, decided to collaborate to develop a Web search engine. To help turn their idea into a commercial product, the two friends succeeded in raising almost \$1 million from several wealthy investors (known as angel investors) and this was later supplemented by funding from two venture capital firms



Ontario Premier Dalton McGuinty opens the Toronto Stock Exchange (TSX) for trading Wednesday, November 14, 2007, in Toronto.

Courtesy of the Toronto Stock Exchange

that specialized in helping young start-up businesses. The company, now named Google, went public in 2004 at a price of \$85 a share, putting a value on the enterprise of \$23 billion.

Mike Lazardis quit his studies in electrical engineering at the University of Waterloo at 23.¹ In 1984 he started Research In Motion (RIM) with two friends. RIM went public in 1997, offering 13.8 million common shares at \$7.25 each on the Toronto Stock Exchange. RIM's product, the BlackBerry e-mail pager-cum-computer, was such a success that by early 2000 its shares were trading at \$260. Mike Lazardis became a billionaire and recently shared an Academy Award for technical achievement with a co-worker for designing a device that quickened the pace of film editing.

Such stories illustrate that the most important asset of a new firm may be a good idea. But that is not all you need. To take an idea from the drawing board to a prototype and through to large-scale production requires ever greater amounts of capital.

To get a new company off the ground, entrepreneurs may rely on their own savings and personal bank loans. But this is unlikely to be sufficient to build a successful enterprise. Venture capital firms specialize in providing new equity capital to help firms over the awkward adolescent period before they are large enough to "go public." In the first part of this chapter, we will explain how venture capital firms do this.

If the firm continues to be successful, there is likely to come a time when it needs to tap a wider source of capital. At this point it will make its first public issue of common stock. This is known as an *initial public offering*, or IPO. In the second section of the chapter we will describe what is involved in an IPO.

A company's initial public offering is seldom its last. In Chapter 13 we saw that internally generated cash is not usually sufficient to satisfy the firm's needs. Established companies make up the deficit by issuing more equity or debt. The remainder of this chapter looks at this process.

After studying this chapter you should be able to

- Understand how venture capital firms design successful deals.
- Understand how firms make initial public offerings and the costs of such offerings.
- Know what is involved when established firms make a general cash offer or a private placement of securities.
- Explain the role of the underwriter in an issue of securities.

14.1

VENTURE CAPITAL

You have taken a big step. With a couple of friends, you have formed a corporation to open a number of fast food outlets, offering innovative combinations of international dishes such as sushi with sauerkraut, curry Bolognese, and chow mein with Yorkshire pudding. Breaking into the fast food business costs money, but after pooling your savings and borrowing to the hilt from the bank, you have raised \$100,000 and purchased one million shares in the new company. At this *zero-stage* investment, your company's assets are \$100,000 plus the *idea* for your new product.

That \$100,000 is enough to get the business off the ground, but if the idea takes off, you will need more capital to pay for new restaurants. You therefore decide to look for an investor who is prepared to back an untried company in return for part of the profits. Equity capital in young businesses is known as **venture capital**, and it is provided by specialized venture capital firms, financial and investment institutions such as banks and pension funds, and government agencies. If you need very early stage financing for your new enterprise, you may seek financing from an

venture capital Money invested to finance a new firm.

¹ While it is true that some of these highly successful entrepreneurs dropped out of college or university, we do not want to give the impression that quitting school had anything to do with their success.

angel A wealthy individual investor in early-stage ventures.

angel investor. “Angels” are wealthy individual investors who can play a critical role in the creation of new ventures by making small-scale investments in local start-ups and early-stage ventures. They also bring a significant hands-on contribution to such business ventures. We will describe these venture capital providers in more detail in Appendix 14A.

Most entrepreneurs are able to spin a plausible yarn about their company. But it is as hard to convince a venture capitalist to invest in your business as it is to get a first novel published. Your first step is to prepare a *business plan*. This describes your product, the potential market, the production method, and the resources—time, money, employees, facilities, and equipment—needed for success. It helps if you can point out that you are prepared to put your money where your mouth is. By staking all your savings in the company, you *signal* your faith in the business.

The venture capital company knows that the success of a new business depends on the effort its managers put in. Therefore, it will try to structure a deal where you have a strong incentive to work hard. For example, if you agree to accept a modest salary (and look forward instead to increasing the value of your investment in the company’s stock), the venture capital company knows you will be committed to working hard. However, if you insist on a watertight employment contract and a fat salary, you won’t find it easy to raise venture capital.

You are unlikely to persuade a venture capitalist to give you as much money as you need all at once. Rather, the firm will probably give you enough to reach the first major checkpoint. Suppose you can convince the venture capital company to buy one million new shares for \$.50 each. This means it owns half of the firm: It owns one million shares, and you and your friends also own one million shares. Because the venture capitalist is paying \$500,000 for a claim to half your firm, it is placing a \$1 million value on the business. After this *first-stage* financing, your company’s balance sheet looks like this:

First-Stage Market-Value Balance Sheet
(\$ millions)

Assets		Liabilities and Shareholders’ Equity	
Cash from new equity	\$.5	New equity from venture capital	\$.5
Other assets	.5	Your original equity	.5
Value	\$1.0	Value	\$1.0



Check Point 14.1

Why might the venture capital company prefer to put up only part of the funds upfront? Would this affect the amount of effort put in by you, the entrepreneur? Is your willingness to accept only part of the venture capital that will eventually be needed a good signal of the likely success of the venture?

Suppose that 2 years later your business has grown to the point where it needs a further injection of equity. This *second-stage* financing might involve the issue of another one million shares at \$1 each. Some of these shares might be bought by the original backers and some by other venture capital firms. The balance sheet after the new financing would then be as follows:

Second-Stage Market-Value Balance Sheet
(\$ millions)

Assets		Liabilities and Shareholders’ Equity	
Cash from new equity	\$ 1.0	New equity from second-stage financing	\$1.0
Other assets	2.0	Equity from first stage	1.0
		Your original equity	1.0
Value	\$3.0	Value	\$3.0

Notice that the value of the initial one million shares owned by you and your friends has now been marked up to \$1 million. Is this beginning to sound like a money machine? It works only if you have made a success of the business and new investors are prepared to pay \$1 to buy a share in the business. When you started out, it wasn't clear that sushi and sauerkraut would catch on. If it hadn't caught on, the venture capital firm could have refused to put up more funds.

You are not yet in a position to cash in on your investment, but your gain is real. The second-stage investors have paid \$1 million for a one-third share in the company. (There are now three million shares outstanding, and the second-stage investors hold one million shares.) Therefore, at least these impartial observers—who are willing to back up their opinions with a large investment—must have decided that the company was worth at least \$3 million. Your one-third share is therefore also worth \$1 million.

Venture capital firms are not passive investors. They are usually represented on each company's board of directors, they help to recruit senior managers for the company, and they provide ongoing advice. This advice can be very valuable to businesses in their early years and helps them to bring their products more quickly to market.

For every 10 first-stage venture capital investments, only two or three may survive as successful, self-sufficient businesses, and only one may pay off big. From these statistics come two rules of success in venture capital investment: First, don't shy away from uncertainty; accept a low probability of success. But don't buy into a business unless you can see the *chance* of a big, public company in a profitable market. There's no sense taking a big risk unless the reward is big if you win. Second, cut your losses; identify losers early, and if you can't fix the problem—by replacing management, for example—don't throw good money after bad.

The same advice holds for any backer of a risky start-up business—after all, only a fraction of new businesses are funded by card-carrying venture capitalists. Some start-ups are funded directly by managers or by their friends and families. Some grow using bank loans and reinvested earnings. But if your start-up combines high risk, sophisticated technology, and substantial investment, you will probably try to find venture capital financing.

14.2

THE INITIAL PUBLIC OFFERING

Very few new businesses make it big, but those that do can be very profitable. For example, an investor who provided \$1,000 of first-stage financing for Intel would by mid-2000 have reaped US\$43 million. So venture capitalists and angel investors keep sane by reminding themselves of the success stories²—those who got in on the ground floor of firms like Intel, Lotus Development Corporation, and Research In Motion.³

Some very large companies, such as Levi Strauss or Cargill in the United States or McCain Foods in Canada, have been able to continue and prosper as independent private businesses. But for many other successful start-ups there comes a time when they need more capital than can comfortably be provided by a small number of individuals or venture capitalists. At this point one solution is to sell the business to a larger firm. But many entrepreneurs do not easily fit into a corporate bureaucracy and would prefer instead to remain the boss. In this case, the company may choose to raise money by selling shares to the public.



A firm is said to go *public* when it sells its first issue of shares in a general offering to investors. This first sale of stock is called an **initial public offering**, or **IPO**.

initial public offering (IPO) First offering of stock to the general public.

² Fortunately, the successes have outweighed the failures. The National Venture Capital Association (NVCA) estimated that net returns on venture capital funds averaged about 20 percent a year for the 10 years ending June 2007.

³ The founder of Lotus took a class from one of the authors. Within five years the student had become a multimillionaire. Perhaps that will make you feel better about the cost of this book.



An IPO is called a *primary* offering when new shares are sold to raise additional cash for the company. It is a *secondary* offering when the company's founders and the venture capitalist cash in on some of their gains by selling shares. A secondary offer, therefore, is no more than a sale of shares from the early investors to new investors, and the cash raised in a secondary offer does not flow to the company. Of course, IPOs can be, and commonly are, both primary and secondary: The firm raises new cash at the same time that some of the already-existing shares in the firm are sold to the public. Some of the biggest secondary offerings have involved governments selling off stock in nationalized enterprises. For example, the Japanese government raised US\$12.6 billion by selling its stock in Nippon Telegraph and Telephone, and the British government took in US\$9 billion from its sale of British Gas. The Canadian government received about \$2.2 billion in 1996 in the biggest initial public offering in Canadian history—when 84 million shares of the newly privatized Canadian National Railway hit the stock market. The world's largest IPO took place in 1999 when the Italian government raised \$19.3 billion (US) from the sale of shares in the state-owned electricity company, Enel.

ARRANGING A PUBLIC ISSUE

Once a firm decides to go public, the first task is to select the underwriters.



Underwriters are investment dealers that act as financial “midwives” to a new issue. Usually they play a triple role—first providing the company with procedural and financial advice, then buying the stock, and finally reselling it to the public.

underwriter Firm that buys an issue of securities from a company and resells it to the public.

A small IPO may have only one underwriter, but larger issues usually requires a syndicate of underwriters who buy the issue and resell it. For example, the initial public offering by Microsoft involved a total of 114 underwriters.

spread Difference between public offer price and price paid by underwriter.

In the typical underwriting arrangement, called a *firm commitment*, the underwriters buy the securities from the firm and then resell them to the public. The underwriters receive payment in the form of a **spread**—that is, they are allowed to sell the shares at a slightly higher price than they paid for them. But the underwriters also accept the risk that they won't be able to sell the stock at the agreed offering price. If that happens, they will be stuck with unsold shares and must get the best price they can for them. In the more risky cases, the underwriter may not be willing to enter into a firm commitment and will handle the issue on a *best efforts* basis. In this case the underwriter agrees to sell as much of the issue as possible but does not guarantee the sale of the entire issue. Because fees tend to be less in a best efforts distribution, it might also be favoured by a high-quality issuer wishing to reduce issuing expenses. Investment dealers prefer to include a *lock-up period* clause in underwriting agreements. Such a clause prevents the existing equity holders such as the company founders and other private equity investors from flooding the market by selling their shares and cashing out up to a given period of time.

Before any stock can be sold to the public, the company must satisfy the requirements of provincial securities laws and regulations.⁴ Five provinces including Ontario, Québec, Alberta, Manitoba, and British Columbia have commissions while other provinces have securities acts. The stock may have to be registered with an appropriate securities commission. For instance, companies listed on the Toronto Stock Exchange (TSX) come under the purview of the Ontario Securities Commission (OSC), which administers the *Ontario Securities Act*. Generally, securities laws tend to be similar across provinces with the OSC playing a leadership role, given the overall importance of the TSX.

prospectus Formal summary that provides information on an issue of securities.

The first part of the registration statement is distributed to the public in the form of a preliminary **prospectus**. The preliminary prospectus contains some financial information that will also be included in the final prospectus, the company's history and its plans for the future, but it does

⁴ In contrast, in the US, all securities regulation is handled at the federal level by the Securities and Exchange Commission (SEC).

not provide the price at which the security will be offered. It is sometimes called a *red herring* because it contains a printed disclaimer in red letters, which claims that it is not a final document and is subject to amendments because the securities commission has neither approved nor disapproved the registration statement.

One function of the prospectus is to warn investors about the risks involved in any investment in the firm. Some investors have joked that if they read prospectuses carefully, they would never dare buy a new issue. Appendix 14B is an example prospectus for your fast food business.

The securities commission, while reviewing the preliminary prospectus, may require it to be revised before approving it. Recent Canadian prospectuses can be found at the System for Electronic Documents and Retrieval (SEDAR) Web site (www.sedar.com).

The company and its underwriters also need to set the issue price. To gauge how much the stock is worth, they may undertake discounted cash flow calculations like those described in Chapter 6. They also look at the price-earnings ratios of the shares of the firm's principal competitors.

Before settling on the issue price, the underwriters may arrange a "roadshow," which gives the underwriters and the company's management an opportunity to talk to potential investors. These investors may then offer their reaction to the issue, suggest what they think is a fair price, and indicate how much stock they would be prepared to buy. This allows the underwriters to build up a book of likely orders. Although investors are not bound by their indications, they know that if they want to remain in the underwriters' good books, they must be careful not to renege on their expressions of interest.

The managers of the firm are eager to secure the highest possible price for their stock, but the underwriters are likely to be cautious because they will be left with any unsold stock if they overestimate investor demand. As a result, underwriters typically try to underprice the initial public offering. **Underpricing**, they argue, is needed to tempt investors to buy stock and to reduce the cost of marketing the issue to customers.

underpricing Issuing securities at an offering price set below the true value of the security.



Underpricing represents a cost to the existing owners since the new investors are allowed to buy shares in the firm at a favourable price. The cost of underpricing may be very large.

It is common to see the stock price increase substantially from the issue price in the days following an issue. Such immediate price jumps indicate the amount by which the shares were underpriced compared to what investors were willing to pay for them. A study by Ibbotson, Sindelar, and Ritter of approximately 9,000 new issues from 1960 to 1987 found average underpricing of 16 percent.⁵ Sometimes new issues are dramatically underpriced. In January 2000, for example, six million shares in 724 Solutions were sold in an IPO simultaneously on the Toronto and Nasdaq stock exchanges, priced at \$37.29 and US\$26, respectively, per share. When the issue opened, the stock started trading at \$108 on the TSX and US\$73 on Nasdaq. Greg Wolfond, the co-founder of 724 Solutions, owned eight million shares in the company and ended the day \$828 million richer than when he woke up that morning. Unfortunately, the bonanza did not last. By July 2001, the stock price had fallen to a little over \$10 on the TSX.

Example 14.1

UNDERPRICING OF IPOs

Suppose an IPO is a secondary issue, and the firm's founders sell part of their holding to investors. Clearly, if the shares are sold for less than their true worth, the founders will suffer an opportunity loss.

⁵ R. G. Ibbotson, J. L. Sindelar, and J. R. Ritter, "Initial Public Offerings," *Journal of Applied Corporate Finance* 1 (Summer 1988), pp. 37–45. Note, however, that initial underpricing does not mean that IPOs are superior long-run investments. In fact, IPO returns over the first three years of trading have been less than a control sample of matching firms. See J. R. Ritter, "The Long-Run Performance of Initial Public Offerings," *Journal of Finance* 46 (March 1991), pp. 3–27.

But what if the IPO is a primary issue that raises new cash for the company? Do the founders care whether the shares are sold for less than their market value? The following example illustrates that they do care.

Suppose Cosmos.com has two million shares outstanding and now offers a further one million shares to investors at \$50. On the first day of trading, the share price jumps to \$80, so that the shares that the company sold for \$50 million are now worth \$80 million. The total market capitalization of the company is $3 \text{ million} \times \$80 = \$240 \text{ million}$.

The value of the founders' shares is equal to the total value of the company less the value of the shares that have been sold to the public—in other words, $\$240 - \$80 = \$160 \text{ million}$. The founders might justifiably rejoice at their good fortune. However, if the company had issued shares at a higher price, it would have needed to sell fewer shares to raise the \$50 million that it needs, and the founders would have retained a larger share of the company. For example, suppose that the outside investors, who put up \$50 million, received shares that were *worth* only \$50 million. In that case the value of the founders' shares would be $\$240 - \$50 = \$190 \text{ million}$.

The effect of selling shares below their true value is to transfer \$30 million of value from the founders to the investors who buy the new shares.



Unfortunately, underpricing does not mean that anyone can become wealthy by buying stock in IPOs. If an issue is underpriced, everybody will want to buy it and the underwriters will not have enough stock to go around. You are therefore likely to get only a small share of these hot issues. If it is overpriced, other investors are unlikely to want it, and the underwriter will be only too delighted to sell it to you. This phenomenon is known as the *winner's curse*.⁶ It implies that, unless you can spot which issues are underpriced, you are likely to receive a small proportion of the cheap issues and a large proportion of the expensive ones. Since the dice are loaded against uninformed investors, they will play the game only if there is substantial underpricing on average. An unsavoury explanation for the underpricing phenomenon is *spinning*, through which the underwriter may allocate shares in an initial public offering to preferred clients who, in turn, are able to reap windfall profits by selling the shares. In the late 1990s during the time of the internet bubble, this practice enabled some investment dealers to provide favours to clients.

Example 14.2

UNDERPRICING OF IPOs AND INVESTOR RETURNS

Suppose that an investor will earn an immediate 10 percent return on underpriced IPOs and lose 5 percent on overpriced IPOs. But because of high demand, you may get only half the shares you bid for when the issue is underpriced. Suppose you bid for \$1,000 of shares in two issues, one overpriced and the other underpriced. You are awarded the full \$1,000 of the overpriced issue, but only \$500 worth of shares in the underpriced issue. The net gain on your two investments is $(.10 \times \$500) - (.05 \times \$1,000) = 0$. Your net profit is zero, despite the fact that on average, IPOs are underpriced. You have suffered the winner's curse: You "win" a larger allotment of shares when they are overpriced.



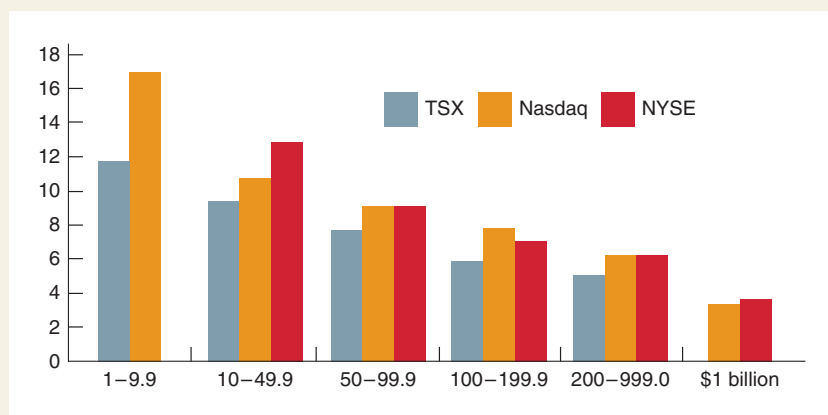
Check Point 14.2

What is the percentage profit earned by an investor who can identify the underpriced issues in Example 14.2? Who are such investors likely to be?

⁶ The highest bidder in an auction is the participant who places the highest value on the auctioned object. Therefore, it is likely that the winning bidder has an overly optimistic assessment of true value. Winning the auction suggests that you have overpaid for the object—this is the winner's curse. In the case of IPOs, your ability to "win" an allotment of shares may signal that the stock is overpriced.

FIGURE 14.1

Direct cost as a percentage of total proceeds (by size category, figures in millions, US dollars)



Source: Financial Post DataGroup, Securities Data Company. Excerpted from T. Shutt and H. Williams, "Going to Market: The Cost of IPOs in Canada and the United States," The Conference Board of Canada (June 2000), pp. 1-4.

flotation costs The costs incurred when a firm issues new securities to the public.

The costs of a new issue are termed **flotation costs**. Underpricing is not the only flotation cost. In fact, when people talk about the cost of a new issue, they often think only of the *direct costs* of the issue. For example, preparation of the registration statement and prospectus involves management, legal counsel, and accountants, as well as underwriters and their advisers. There is also the underwriting spread. (Remember, underwriters make their profit by selling the issue at a higher price than they paid for it.)

According to the Toronto Stock Exchange, Canadian companies raised over \$42 billion in new equity financing in 2006, including about \$10 billion through 108 initial public offerings. Figure 14.1 summarizes the results of a study that compared the direct costs of going public, expressed as a percentage of total proceeds for IPOs on the TSX, Nasdaq, and NYSE over the period of January 1, 1998, and September 30, 1999.⁷ Direct costs include underwriting commissions, legal, accounting, and other administrative costs. In general, larger IPO issues have lower direct costs as a percentage of total proceeds. For a small IPO of no more than \$10 million, the underwriting spread and administrative costs are likely to absorb over 11 to 17 percent of the proceeds from the issue depending on the exchange. For the very largest IPOs, these direct costs may amount to only 3.5 percent of the proceeds.

Figure 14.2 details the extent of underpricing on the three exchanges for a sub-sample of the group of IPOs discussed above. This is estimated by calculating the percentage difference between the offer price of the share and its closing price after the first day of trading. For the TSX, the simple average of the underpricing was 10 percent while the weighted average was 5.8 percent. For the American exchanges, the numbers were found to be higher.

Example 14.3

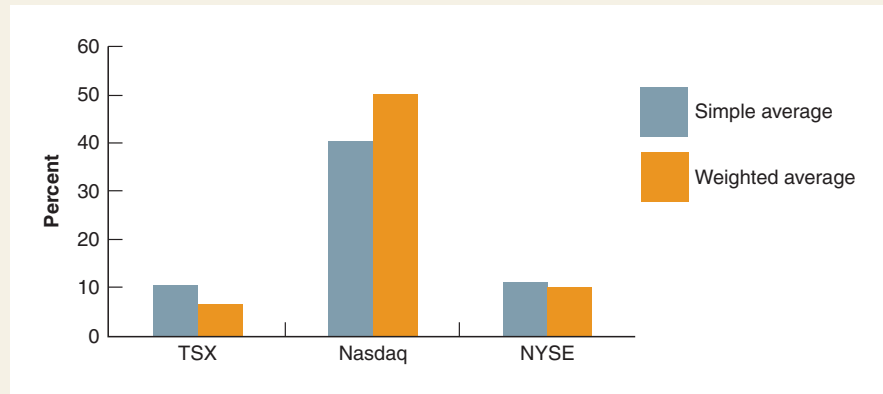
COSTS OF AN IPO

When the American investment bank Goldman Sachs went public in 1999, the sale was partly a primary issue (the company sold new shares to raise cash) and partly a secondary one (two large existing shareholders cashed in some of their shares). The underwriters acquired a total of 69 million Goldman Sachs shares for US\$50.75 each and sold them to the public at an offering price of \$53.⁸ The underwriters' spread was therefore $53 - 50.75 = \$2.25$. The firm and its shareholders also paid a total of \$9.2 million in legal fees and other costs. By the end of the first day's trading, Goldman's stock price had risen to \$70.

⁷ For complete details of the study, see T. Shutt and H. Williams, "Going to Market: The Costs of IPOs in Canada and the United States," The Conference Board of Canada (June 2000), p. 1-4.

⁸ No prizes for guessing which investment bank acted as lead underwriter.

FIGURE 14.2
Degree of underpricing



Source: Financial Post DataGroup, Securities Data Company. Excerpted from T. Shutt and H. Williams, "Going to Market: The Cost of IPOs in Canada and the United States," The Conference Board of Canada (June 2000), pp. 1–4.

Here are the direct costs of the Goldman Sachs issue:

Direct Expenses	(US\$ in millions)
Underwriting spread	69 million × \$2.25 = \$155.25
Other expenses	9.2
Total direct expenses	\$164.45

The total amount of money raised by the issue was 69 million × \$53 = \$3,657 million. Of this sum, 4.5 percent was absorbed by direct expenses (that is, 164.45/3,657 = .045).

In addition to these direct costs, there was underpricing. The market valued each share of Goldman Sachs at \$70, so the cost of underpricing was 69 million × (\$70 – \$53) = \$1,173 million, resulting in total costs of \$164.45 + \$1,173 = \$1,337.45 million. Therefore, while the total market value of the issued shares was 69 million × \$70 = \$4,830 million, direct costs and the costs of underpricing absorbed nearly 28 percent of the market value of the shares.



Check Point 14.3

Suppose that the underwriters acquired Goldman Sachs shares for US\$60 and sold them to the public at an offering price of \$64. If all other features of the offer were unchanged (and investors still valued the stock at \$70 a share), what would have been the direct costs of the issue and the costs of underpricing? What would have been the total costs as a proportion of the market value of the shares?

14.3

THE UNDERWRITERS

We have described underwriters as playing a triple role—providing advice, buying a new issue from the company, and reselling it to investors. Underwriters don't just help the company make its initial public offering; they are called in whenever a company wishes to raise cash by selling securities to the public.



Most companies raise capital only occasionally, but underwriters are in the business all the time. Established underwriters are careful of their reputation and will not handle a new issue unless they believe the facts have been presented fairly to investors. Thus, in addition to handling the sale of an issue, the underwriters, in effect, give it their seal of approval. This implied endorsement may be worth quite a bit to a company that is coming to the market for the first time.

For large issues, a group of underwriters called a *syndicate* or *banking group* will usually be formed to handle the sale. Syndication helps to market and distribute the issue more widely and also to spread its risks. The principal underwriter acts as the lead manager to the issue while other underwriters in the group are also responsible for buying and reselling the security, but play *non-lead roles*.

Underwriting is not always fun. On October 15, 1987, the British government finalized arrangements to sell its holding of British Petroleum (BP) shares at £3.30 a share. This huge issue involving more than \$12 billion was underwritten by an international group of underwriters and simultaneously marketed in a number of countries. Four days after the underwriting arrangement was finalized, the October stock market crash occurred and stock prices nose-dived. The underwriters appealed to the British government to cancel the issue but the government hardened its heart and pointed out that the underwriters knew the risks when they agreed to handle the sale.⁹ By the closing date of the offer, the price of BP stock had fallen to £2.96, and the underwriters had lost more than US\$1 billion. Needless to say, the business is very competitive resulting, at times, in participants being accused of unethical behaviour. As the nearby Finance in Action box describes, this is what happened when Canadian Imperial Bank of Commerce (CIBC) recently sued some high-profile former employees who defected from the bank to form Genuity Capital Markets, a new investment banking firm. CIBC alleged that the employees had taken with them privileged information from the bank when they left.

SEE BOX P. 444



Companies get to make only one IPO, but underwriters are in the business all the time. Wise underwriters, therefore, realize that their reputation is on the line and will not handle an issue unless they believe the facts have been presented fairly to investors. If a new issue goes wrong and the stock price crashes, the underwriters can find themselves very unpopular with their clients. For example, in 1999 the software company VA Linux went public at \$30 a share. The next day trading opened at \$299 a share, but then the price began to sag. Within 2 years it had fallen below \$2. Disgruntled VA Linux investors sued the underwriters for overhyping the issue. VA Linux investors were not the only ones to feel aggrieved. As the nearby box explains, investment banks soon found themselves embroiled in a major scandal as evidence emerged that they had deliberately oversold many of the issues that they underwrote during the dot-com boom years. The underwriter's seal of approval for a new issue no longer seemed as valuable as it once had.

SEE BOX P. 445

WHO ARE THE UNDERWRITERS?

Since underwriters play such a crucial role in new issues, we should look at who they are. Several hundred investment banks, security dealers, and brokers are, at least, sporadically involved in underwriting. However, the market for the larger issues is dominated by the major investment

⁹ The government's only concession was to put a floor on the underwriters' losses by giving them the option to resell their stock to the government at £2.80 a share. The BP offering is described and analyzed in C. Muscarella and M. Vetsuypens, "The British Petroleum Stock Offering: An Application of Option Pricing," *Journal of Applied Corporate Finance* 1 (1989), pp. 74–80.



Allegations of Unethical Conduct: The Controversy Surrounding Ex-Employees of CIBC and Genuity Capital Markets

Bank alleges poaching 'conspiracy,' wants Ontario court to force return of bonuses. Canadian Imperial Bank of Commerce is suing another three former employees who defected to Genuity Capital Markets, and has accused some partners at the fledgling brokerage firm of masterminding a "conspiracy" to poach colleagues from the bank.

CIBC filed a statement of claim against Genuity late Friday, and added David Morrison, Ted Hirst and Gunnar Eggertson to its original list of defendants. The bitter legal battle erupted this month when CIBC sued six former employees, including star investment banker David Kassie and several other top deal makers, for allegedly taking confidential information from the bank and planning a "scheme" to lure co-workers to Genuity. The bank is asking an Ontario court to force the departed executives to return any bonuses received last year prior to embarking for Genuity.

Mr. Morrison was head of institutional equity sales at CIBC World Markets Inc. before he resigned from the bank's brokerage arm in mid-December, shortly after year-end bonuses were paid. Mr. Hirst and Mr. Eggertson are a Vancouver-based investment-banking team specializing in the mining sector, and are among the more than 20 CIBC traders, analysts, and bankers who have already left for Genuity.

Marie Cordero, a business specialist at the bank, is the only member of the Genuity defendants who CIBC has not accused of participating in the alleged conspiracy. The bank claims Ms. Cordero copied files before she departed that may have contained privileged information relating to the bank's clients.

CIBC now claims that Ms. Cordero was induced to duplicate these files.

Ms. Cordero has denied taking any material from the bank, and Genuity partners maintained recently that she was merely compiling an invitation list for an anniversary celebration next month at CIBC Wood Gundy.

Alan Lenczner, a lawyer for Genuity, said he was not surprised that CIBC has added more names to the suit.

"They're just making sure they get everyone [included] that they want to get," he said.

Despite the conspiracy allegations, he played down the latest legal manoeuvring as routine, and said he expects to file a statement of defence in the next few weeks.

A spokesman for CIBC declined to comment on the matter.

The original filing spanned more than 600 pages, much of it filled with e-mail discussions between Genuity's founding partners and other CIBC employees that the bank cited as evidence of a "well-orchestrated" recruitment scheme.

Genuity's founders have denied CIBC's allegations.

In a recent interview, Mr. Kassie insisted he did not recruit former colleagues or spirit away confidential information from the bank, pointing out that potential employees signed confidentiality agreements with Genuity in which they confirmed they had not been solicited. However, the bank is still seeking a court-imposed injunction that would prevent Genuity from soliciting any of its staff.

Mr. Kassie, an aggressive deal maker once regarded as the heir successor to CIBC chief executive officer John Hunkin, was ousted as head of CIBC World Markets last February as the bank attempted to overhaul its culture and lower its risk profile following a settlement with US regulators over its involvement with disgraced Enron Corp.

Genuity officially opened for business earlier this month, and is regarded as the largest startup investment-banking boutique in Bay Street history. Last week it unveiled its first major deal: an advisory role on Cedara Software Corp.'s planned \$477-million merger with Merge Technologies Inc. of Milwaukee.

In addition to Mr. Kassie, CIBC is suing Phil Evershed, who was the bank's head of mergers and acquisitions; Dan Daviau, a high-ranking investment banker specializing in technology and media; former vice-chair Earl Rotman, one of the architects of CIBC's push into income trusts; and John Esteireiro, who ran the trading operations.

Source: Sinclair Stewart, "CIBC Names Three More in Lawsuit," *The Globe and Mail*, January 24, 2005.

dealers, which specialize in underwriting new issues, dealing in securities, and arranging mergers. These firms enjoy great prestige, experience, and financial muscle.

Table 14.1 lists some of the largest Canadian firms, ranked by total value of issues in 2007. Notice that each of the firms has acted as a lead underwriter and also in a non-lead capacity within a syndicate. RBC Capital Markets, the winner, raised a total of \$32,592 million. Of course, only a small proportion of these issues was for companies that were coming to the market for the first time. Table 14.2 lists the top 10 Canadian corporate equity issues in 2007.

Some of the largest debt and equity issues are in the United States. In Chapter 13, we pointed out that instead of issuing bonds in Canada, corporations can issue eurobonds in London, which are then sold to investors outside Canada. In addition, new equity issues by large multinational companies are increasingly marketed to investors throughout the world. Since these securities are sold in a number of countries, many of the major international banks are involved in underwriting the issues. Have a look at Table 14.3. It shows the names of principal underwriters of global debt and equity issues in 2007.

How Scandal Hit the Investment Banking Industry

Finance in action

FINANCE IN ACTION

For investment banks, 1999 looked like a wonderful year. Not only did they underwrite a near-record number of IPOs, but the stocks that they sold leaped by an average of 71 percent on their first day of trading, earning the underwriters some very grateful clients. Just three years later the same investment banks were in disgrace. Probing by the New York State attorney general, Eliot Spitzer, uncovered a chronicle of unethical and shameful behaviour during the boom years.

As the dot-com stock market boom developed, investment banking analysts had begun to take on the additional role of promoters of the shares they analyzed, in the process becoming celebrities with salaries to match. The early run-up in the stock price of dot-com IPOs therefore owed much to hype by the underwriters' analysts, who strongly promoted stocks that they sometimes privately thought were overpriced. One superstar Internet analyst was revealed in internal e-mails to have believed that stocks he was peddling to investors were "junk" and "a piece of crap." In many cases the stocks were indeed junk, and the underwriters who had puffed the IPOs soon found themselves sued by disgruntled investors who had bought at the inflated prices.

The underwriters' troubles deepened further when it was disclosed that in a number of cases they had allocated stock in hot new

issues to the personal brokerage accounts of the CEOs of major corporate clients. This stock could then be sold, or "spun," for quick profits. Five senior executives of leading telecom companies were disclosed to have received a total of \$28 million in profits from their allocation of stocks in IPOs underwritten by one bank. Over the same period the bank received over \$100 million of business from these five companies. Eliot Spitzer argued that such lucrative perks were really attempts by the banks to buy future business and that the profits therefore belonged to the companies' shareholders rather than the executives. Soon top executives of several other companies were facing demands from disgruntled shareholders that they return to their companies the profits they had pocketed from hot initial public offerings.

These scandals that engulfed the investment banking industry resulted in a \$1.4 billion payout by the banks and an agreement to separate investment banking and research departments, hire independent consultants, and select independent research providers. But the revelations also raised troubling questions about ethical standards and the pressures that can lead employees to unscrupulous behaviour.

TABLE 14.1

Canada's Top Underwriters for Equity and Debt, 2007 (dollar figures in millions)

Underwriter	Lead Number	Lead Amount	Total Number	Total Amount
1 RBC Capital Markets	202	23,993	407	32,592
2 TD Securities Inc.	107	17,997	379	25,678
3 CIBC World Markets Inc.	183	15,834	418	25,260
4 Scotia Capital Inc.	84	9,982	329	17,981
5 BMO Capital Markets	81	9,307	356	17,868
6 Merrill Lynch & Co.	29	11,469	103	15,713
7 National Bank Financial Inc.	73	3,907	307	9,790
8 Barclays Bank PLC	8	5,832	11	5,976
9 HSBC Securities (Canada) Inc.	21	2,385	175	5,856
10 Deutsche Bank Aktiengesellschaft	15	4,390	26	5,027

Source: **FPinfomart.ca**, *National Post*, January 31, 2008, DM10, retrieved January 31, 2008. Material reprinted with the express permission of The National Post Company, a Canwest Partnership.

TABLE 14.2

Top 10 IPO issues in 2007

Rank 2007	Gross Proceeds Raised \$000s	Lead Underwriter(s)
1 Franco-Nevada Corp.	1,258,560	BMO Capital Markets, UBS Securities Canada Inc.
2 Mecachrome International Inc.	205,625	RBC Capital Markets, Merrill Lynch Canada Inc.
3 Northstar Healthcare Inc.	170,285	BMO Capital Markets
4 Lockerbie & Hole Inc.	150,880	GMP Securities LP, Raymond James Ltd.
5 EarthFirst Canada Inc.	116,962	GMP Securities LP, Scotia Capital Inc.
6 Innergex Renewable Energy Inc.	115,005	BMO Capital Markets, CIBC World Markets Inc.
7 OceanaGold Corp.	100,713	BMO Capital Markets
8 Day4 Energy Inc.	100,050	GMP Securities LP
9 B2Gold Corp.	85,000	Genuity Capital markets
10 Centenario Copper Corp.	83,496	Canaccord Capital Corp., BMO Capital Markets

Source: *National Post Business*, June 2008 (FP500), p. 157, retrieved June 28, 2008. Material reprinted with the express permission of The National Post Company, a Canwest Partnership.

TABLE 14.3

Top ten underwriters of debt, equity, and equity-related issues in 2007 (US\$ millions)

Global		
Underwriter	Proceeds	No. of Issues
Citigroup	617,602.9	1740
JP Morgan	554,141.2	1606
Deutsche Bank AG	481,909.9	1411
Merrill Lynch	431,472.7	1429
Morgan Stanley	425,935.0	1326
Lehman Brothers	395,040.3	1008
Goldman Sachs & Co	357,146.0	905
Barclays Capital	352,845.8	960
UBS	325,982.9	1270
Credit Suisse	319,494.9	1065
Top Ten Total	4,261,571.6	12,720
Industry Total	7,510,018.3	22,256

Source: Thomson Reuters, "Equity Capital Market Review," Fourth Quarter 2007, p. 3, www.thomsonreuters.com/league, retrieved January 26, 2008.

TABLE 14.4

Trading activity on Canadian stock exchanges

Stock Exchange	Trading Activity, September 2008	
	Value of Shares (Millions of Dollars)	Volume of Shares (Millions of Shares)
Toronto Stock Exchange	194,572	10,701
TSX Venture Exchange	1,152	2,889

Source: www.tsx.com, News and Events, News Archives, Market Information and Statistics, retrieved October 7, 2008. © 2008 TSX Inc. All rights reserved.

14.4

LISTING ON THE STOCK MARKET

When a firm decides on an initial public offering of its stocks, it has to decide where its newly issued shares should be traded. As we have discussed in Chapters 2 and 6, stock markets can be either organized exchanges with centralized physical locations or over-the-counter markets consisting of a network of security dealers who trade with each other over the phone and increasingly over electronic networks. Most trading in the shares of large Canadian corporations takes place on the Toronto Stock Exchange (TSX), while shares of smaller and emerging companies are traded through the TSX Venture Exchange (TSXV). Electronic trading in shares can also be done through Nasdaq Canada, which has operations in Montreal for the purpose of trading in shares listed on the Nasdaq stock market. Table 14.4 provides details regarding the trading activity for September 2008 of the Toronto Stock Exchange and the TSX Venture Exchange.

In order to list its stock issue on a stock exchange, the firm will have to meet the exchange's listing requirements and pay the requisite listing fee. These tend to vary; generally, the larger and more prestigious stock exchanges also tend to have stricter listing requirements and higher listing fees. Table 14.5 summarizes major listing requirements of the TSX for profitable industrial companies.

14.5

RIGHTS ISSUES AND GENERAL CASH OFFERS BY PUBLIC COMPANIES

After the initial public offering, a successful firm will continue to grow and from time to time it will need to raise more money by issuing stock or bonds. An issue of additional stock by a company whose stock already is publicly traded is called a **seasoned offering**. Any issue of securities needs to be formally approved by the firm's board of directors. If a stock issue requires an increase in the company's authorized capital, it also needs the consent of the shareholders.

seasoned offering Sale of securities by a firm that is already publicly traded.

TABLE 14.5

Toronto Stock Exchange:
Major listing requirements for
profitable industrial
companies^a

- | | |
|-------|---|
| (i) | <i>Assets:</i> Net tangible assets of \$2,000,000. |
| (ii) | <i>Earnings:</i> Earnings from ongoing operations of at least \$200,000 before taxes and extraordinary items in the fiscal year immediately preceding the filing of the listing application. |
| (iii) | <i>Cash Flow:</i> Pre-tax cash flow of \$500,000 in the immediately preceding fiscal year. |
| (iv) | <i>Working Capital and Capital Structure:</i> Adequate working capital to carry on the business and an appropriate capital structure. |
| (v) | <i>Public Distribution:</i> At least 1,000,000 freely tradeable shares having an aggregate market value of \$4,000,000 must be held by at least 300 public holders, each holding one board lot or more shares. ^b |
| (vi) | <i>Management:</i> Management (including the company's board of directors) should have adequate experience and technical expertise relevant to the company's business and industry and adequate public company experience. Companies will be required to have at least two independent directors. |

^a The requirements vary with the type of industrial companies, that is profitable companies, companies forecasting profitability, technology companies, or research and development companies. Different requirements also exist for mining, and oil and gas companies. Requirements may also change from time to time. Complete details regarding all listing requirements are provided on the TSX Web site at www.tsx.com.

^b A board lot comprises 100 shares for securities selling at \$1 and more. See www.tsx.com.

Source: www.tsx.com. © 2008 TSX Inc. All rights reserved.

rights issue Issue of securities offered only to current shareholders.

Public companies can issue securities either by making a general cash offer to investors at large or by making a **rights issue**, which is limited to existing shareholders. Let us first concentrate on the mechanics of the rights issue.

RIGHTS ISSUES

In a rights issue, the company offers the shareholders the opportunity, or *right*, to buy more shares at an “attractive” subscription price. For example, if the current stock price is \$100, the company might offer investors an additional share at \$50 for each share they hold. Suppose that before the issue an investor has one share worth \$100 and \$50 in the bank. If the investor takes up the offer of a new share, that \$50 of cash is transferred from the investor's bank account to the company's. The investor now has two shares that are a claim on the original assets worth \$100 and on the \$50 cash that the company has raised. So the two shares are worth a total of \$150, or \$75 each.

By directly offering a new share issue to existing shareholders, a company could hope to save on issuing and underwriting expenses. Also, shareholders do not run a risk of dilution of their proportional shareholding and are able to retain their voting position on the company's major business decisions. Of course, shareholders will have an incentive to exercise their rights only if the subscription price stays below the market price of the shares. Otherwise, if the share price falls, the full issue of new shares may not be taken up. To protect against this possibility, the firm may enter into a **standby underwriting agreement** with an investment dealer. Under this arrangement, the underwriter stands ready to purchase any unsold shares and receives a *standby fee* and possible additional amounts depending on the extent of unsold shares. Also, the company may give its shareholders an **oversubscription privilege** under which they will be able to purchase any unsold shares at the subscription price. Of course, a small proportion of shareholders may not exercise their rights, perhaps because they are away on vacation or for other personal reasons.

In some countries, rights issues are the most common or only method for issuing common stock. In Canada, they are less common. Sometimes, a preemptive right is contained in the firm's articles of incorporation, in which case, the firm has to offer any new issue of common stock to its existing shareholders.

In a rights offering, existing shareholders receive one right for each share of stock held. To take advantage of the rights offering, shareholders will have to exercise the right within a specified period of time by submitting a completed subscription form to the company's subscription agent. If rights are not exercised within the period stipulated, they will expire.

standby underwriting agreement The underwriter stands ready to purchase any unsold shares.

oversubscription privilege Given to shareholders in a rights issue, enabling them to purchase any unsold shares at the subscription price.

Example 14.4

RIGHTS ISSUES

Easy Writer Word Processing Company has one million shares outstanding, selling at \$20 a share. To finance the development of a new software package, it plans a rights issue, allowing one new share to be purchased for each 10 shares currently held. The purchase price will be \$10 a share. How many shares will be issued? How much money will be raised? What will be the stock price after the rights issue?

The firm will issue one new share for every 10 old ones, or 100,000 shares. So shares outstanding will rise to 1.1 million. The firm will raise $\$10 \times 100,000 = \1 million. Therefore, the total value of the firm will increase from \$20 million to \$21 million, and the stock price will fall to $\$21 \text{ million} / 1.1 \text{ million shares} = \19.09 per share.

The standard procedure for issuing rights involves the firm announcing the issue and setting a **holder-of-record date**. This is the date on which existing shareholders, as listed in the company's records, are entitled to the stock rights. Actually, to comply with stock exchange rules, the stock will usually go *ex-rights* four trading days before the holder-of-record date. If the stock is sold before this date, the new owner will receive the rights, and so, its value will be with *rights*, *rights-on*, or *cum-rights*. If the stock is sold after the **ex-rights date**, the buyer will no longer be entitled to the rights.

Since rights offerings enable shareholders to buy shares at a favourable price, they clearly have value. How would you arrive at the value of a right? Notice that to buy one new share, the existing shareholder will have to use 10 rights and pay the purchase price of \$10. However, the market price of the share after the rights issue, that is the ex-rights price, is \$19.09. We can, therefore, formulate an equation that will give the theoretical value of a right.

$$\begin{aligned} \text{Value of one right} &= \frac{\text{Market value of share, ex-rights} - \text{subscription price}}{\text{Number of rights required to purchase a share}} \\ &= \frac{\$19.09 - \$10}{10} = \frac{\$9.09}{10} = \$0.91 \end{aligned}$$

You can also arrive at the theoretical value of a right by using the price of the stock during the cum-rights period.

$$\begin{aligned} \text{Value of one right} &= \frac{\text{Market value of share, rights on} - \text{subscription price}}{\text{Number of rights required to purchase a share} + 1} \\ &= \frac{\$20 - \$10}{10 + 1} = \frac{\$10}{11} = \$0.91 \end{aligned}$$

Suppose Easy Writer Word Processing Company announces the terms of its rights offering on May 31, stating that the rights would be mailed to shareholders of record as of July 15. In this case, the ex-rights date is July 11, and so shareholders who own the stock until July 10 are entitled to receive the rights. The rights-on price of the shares is \$20 and it drops to the ex-rights price of \$19.09. Notice that the share price drops by \$.91, that is, to the extent of the value of a right.

holder-of-record date The date on which shareholders appearing on company records are entitled to receive the stock rights.

ex-rights date This date is usually four business days before the holder-of-record date.

general cash offer Sale of securities open to all investors by an already-public company.

GENERAL CASH OFFERS

When a public company makes a **general cash offer** of debt or equity, it essentially follows the same procedure used when it first went public. This means that it must first register the issue in compliance with the regulations of relevant provincial commissions. The issue is then sold to an underwriter under a firm-commitment arrangement or on a best-effort basis.¹⁰ The underwriter (or syndicate of underwriters), in turn, offers the securities to the public.

Many underwriting agreements, including those involving firm commitments, may contain a *market-out clause* or *disaster-out clause*, which limits the underwriters' risk. Such a clause can enable the underwriter to terminate the underwriting agreement without penalty under

¹⁰ A large issue will typically be handled by a syndicate of underwriters.

bought deal The underwriter buys securities from the issuing company and sells them to investors.

prompt offering prospectus (POP) system Allows qualified firms quicker access to capital markets by enabling them to use a short-form filing process rather than a full prospectus.



shelf registration A procedure followed in the United States that allows firms to file one registration statement for several issues of the same security.



extraordinary circumstances or even if the underwriter judges that the state of the financial market is not good for the security issue. Another well-known practice is for underwriting contracts to have an *overallotment* or *green-shoe* option. This option allows the underwriter to buy more shares from the issuer if the need arises because of strong investor demand.¹¹

In Canada, competition for lucrative underwriting deals and a dislike of the market-out clause among investors has created an environment for **bought deals**, which are often used by large, well-known companies for their seasoned equity issues. Here, the investment dealer buys the entire offering from the issuing company and then decides how to sell it to investors. This is advantageous to the company because it is able to obtain a relatively quick and firm commitment on its securities. Bought deals are not commonly used in the United States.

Usually the large issuers in Canada who go for bought deals can also take advantage of the **prompt offering prospectus (POP) system**, which allows short-form filing since much of the information contained in the regular prospectus is already expected to have been filed annually. Thus under the POP system, only material changes and financial statements have to be provided to regulators who are able to give their clearance within about five days—instead of several weeks required for a full prospectus. The investing public must still be provided with a regular prospectus. In the United States, companies can take advantage of **shelf registration**, which allows them to file a single registration statement covering financing plans for up to two years into the future. Within this time period, companies do not need to prepare a separate registration statement every time they issue new securities.

COSTS OF THE GENERAL CASH OFFER

Whenever a firm makes a cash offer, it incurs substantial administrative costs. Also, the firm needs to compensate the underwriters by selling them securities below the price that they expect to receive from investors. Figure 14.3 shows the average underwriting spread and administrative costs for several types of security issues in the United States.¹²

The figure clearly shows the economies of scale in issuing securities. Costs may absorb 15 percent of a small IPO or seasoned equity issue of no more than US\$10 million. This occurs because a large part of the issue cost is fixed. The costs are similar in Canada.¹³

Figure 14.3 shows that issue costs are higher for equity than for debt securities—the costs for both types of securities, however, show the same economies of scale. Issue costs are higher for equity than for debt because administrative costs are somewhat higher, and also because underwriting stock is riskier than underwriting bonds. The underwriters demand additional compensation for the greater risk they take in buying and reselling equity.



Check Point 14.4

Use Figure 14.3 to compare the costs of 10 issues of US\$15 million of stock in a seasoned offering versus one issue of US\$150 million.

MARKET REACTION TO STOCK ISSUES

Because stock issues usually throw a sizable number of new shares onto the market, it is widely believed that they must temporarily depress the stock price. If the proposed issue is very large, this price pressure may, it is thought, be so severe as to make it almost impossible to raise money.

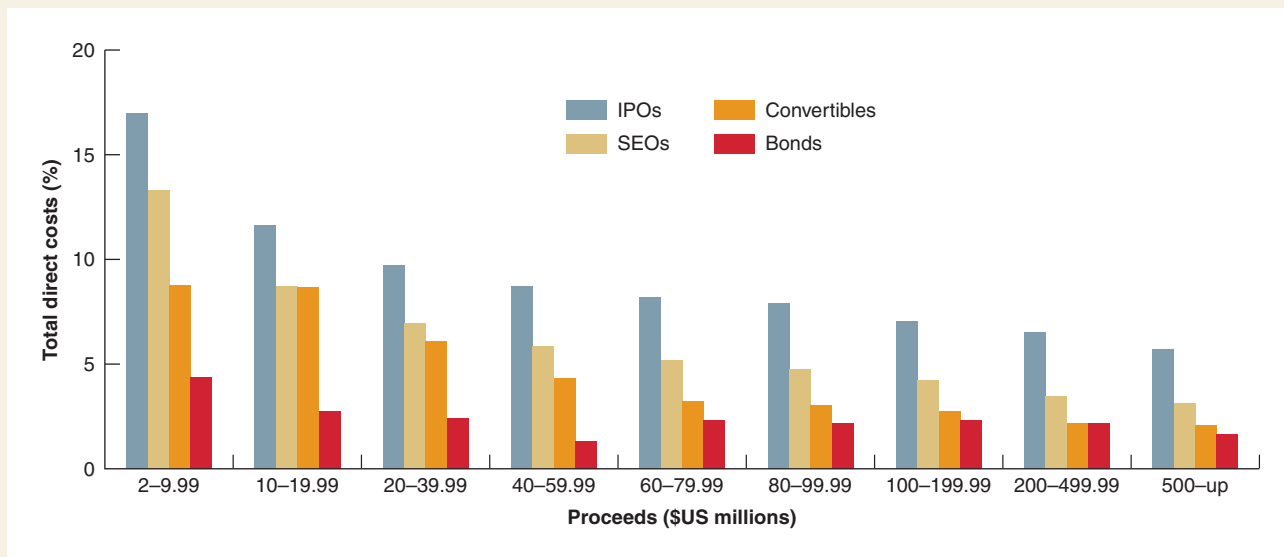
¹¹ Typically, the overallotment option allows the underwriter to buy up to 15 percent more shares.

¹² These figures do not capture all administrative costs. For example, they do not include management time spent on the issue.

¹³ A study finds that average Canadian underwriter fees for medium-sized IPOs (\$10 to 50 million) average 6 percent, compared with a US average of 7 percent. See L. Kryzanowski and I. Rakita “Is the US 7 percent Solution Equivalent to the Canadian 6 percent Solution?” *Canadian Investment Review* (Fall 1999), Volume 2, pp. 27–34.

FIGURE 14.3

Total direct costs as a percentage of gross proceeds. The total direct costs for initial public offerings (IPOs), seasoned equity offerings (SEOs), convertible bonds, and straight bonds are composed of underwriter spreads and other direct expenses.



Source: I. Lee, S. Lochhead, J. Ritter, and Q. Zhao, "The Costs of Raising Capital," *Journal of Financial Research* 19 (Spring 1996), pp. 59-74.

This belief in price pressure implies that a new issue depresses the stock price temporarily below its true value. However, that view doesn't appear to fit very well with the notion of market efficiency. If the stock price falls solely because of increased supply, then that stock would offer a higher return than comparable stocks, and investors would be attracted to it like ants to a picnic.

Economists who have studied new issues of common stock have generally found that the announcement of the issue *does* result in a decline in the stock price. For industrial issues in the United States, this decline amounts to about 3 percent.¹⁴ While this may not sound overwhelming, such a price drop can be a large fraction of the money raised. Suppose that a company with a market value of equity of \$5 billion announces its intention to issue \$500 million of additional equity and thereby causes the stock price to drop by 3 percent. The loss in value is $.03 \times \$5$ billion, or \$150 million. That's 30 percent of the amount of money raised ($.30 \times \$500$ million = \$150 million).

What's going on here? Is the price of the stock simply depressed by the prospect of the additional supply? Possibly, but here is an alternative explanation.

Suppose managers (who have better information about the firm than outside investors) know that their stock is undervalued. If the company sells new stock at this low price, it will give the new shareholders a good deal at the expense of the old shareholders. In these circumstances managers might be prepared to forgo the new investment rather than sell shares at too low a price.

If managers know that the stock is overvalued, the position is reversed. If the company sells new shares at the high price, it will help its existing shareholders at the expense of the new ones. Managers might be prepared to issue stock even if the new cash were just put in the bank.

¹⁴ See, for example, P. Asquith and D. W. Mullins, "Equity Issues and Offering Dilution," *Journal of Financial Economics* 15 (January-February 1986), pp. 61-90; R. W. Masulis and A. N. Korwar, "Seasoned Equity Offerings: An Empirical Investigation," *Journal of Financial Economics* 15 (January-February 1986), pp. 91-118; W. H. Mikkelsen and M. M. Partch, "Valuation Effects of Security Offerings and the Issuance Process," *Journal of Financial Economics* 15 (January-February 1986), pp. 31-60. There appears to be a smaller price decline for utility issues. Also Marsh observed a smaller decline for rights issues in the United Kingdom; see P. R. Marsh, "Equity Rights Issues and the Efficiency of the UK Stock Market," *Journal of Finance* 34 (September 1979), pp. 839-862.

Of course, investors are not stupid. They can predict that managers are more likely to issue stock when they think it is overvalued, and therefore, they mark the price of the stock down accordingly.



The tendency for stock prices to decline at the time of an issue may have nothing to do with increased supply. Instead, the stock issue may simply be a signal that well-informed managers believe the market has overpriced the stock.¹⁵

14.6

THE PRIVATE PLACEMENT

private placement Sale of securities to a limited number of investors without a public offering.

Whenever a company makes a public offering, it must register the issue with the relevant provincial commission. It could avoid this costly process by selling the issue privately. There are no hard and fast definitions of a **private placement**. Most private sales of debt and equity are to exempt institutions such as large pension funds or insurance companies, which are considered to be knowledgeable buyers and will not require all the information provided in a regular prospectus. Currently, the minimum investment requirement for a private placement is \$150,000, which effectively shuts out average investors, although some wealthy individuals do participate as buyers.

One disadvantage of a private placement is that the investor cannot easily resell the security. This is less important to institutions such as insurance companies, which invest huge sums of money in corporate debt for the long haul.

As you would expect, it costs less to arrange a private placement than to make a public issue. That might not be so important for the very large issues where costs are less significant, but it is a particular advantage for companies making smaller issues.

Another advantage of the private placement is that the debt contract can be custom-tailored for firms with special problems or opportunities. Also, if the firm wishes later to change the terms of the debt, it is much simpler to do this with a private placement where only a few investors are involved.

Therefore, it is not surprising that private placements occupy a particular niche in the corporate debt market, namely, loans to small- and medium-sized firms. These are the firms that face the highest costs in public issues, that require the most detailed investigation, and that may require specialized, flexible loan arrangements.

We do not mean that large, safe, and conventional firms should rule out private placements. Enormous amounts of capital are sometimes raised by this method. For example, Air Canada borrowed \$400 million through a private placement of senior unsecured debt. Norske Skog Canada Ltd., a large pulp and paper company based in Western Canada, had a US\$250 million private placement offering targeted at investors in the United States and some Canadian provinces. Nevertheless, the advantages of private placement—avoiding registration costs and establishing a direct relationship with the lender—are generally more important to smaller firms.

Of course, these advantages are not free. Lenders in private placements have to be compensated for the risks they face and for the costs of research and negotiation. They also have to be compensated for holding an asset that is not easily resold. All these factors are rolled into the interest rate paid by the firm. It is difficult to generalize about the differences in interest rates between private placements and public issues, but a typical yield differential could be on the order of half a percentage point.

¹⁵ This explanation was developed in S. C. Myers and N. S. Majluf's "Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have," *Journal of Financial Economics* 13 (1984), pp. 187–222.

14.7

SUMMARY

1. How do venture capital firms design successful deals?

Infant companies raise **venture capital** to carry them through to the point where they can make their first public issue of stock. More established publicly traded companies can issue additional securities in a **general cash offer**.

Financing choices should be designed to avoid conflicts of interest. This is especially important in the case of a young company that is raising venture capital. If both managers and investors have an important equity stake in the company, they are likely to pull in the same direction. The willingness to take that stake also signals management's confidence in the new company's future. Therefore, most deals require that the entrepreneur maintain large stakes in the firm. In addition, most venture financing is done in stages that keep the firm on a short leash and force it to prove, at several crucial points, that it is worthy of additional investment.

2. How do firms make initial public offerings and what are the costs of such offerings?

The **initial public offering** is the first sale of shares in a general offering to investors. The sale of the securities is usually managed by an underwriting firm that buys the shares from the company and resells them to the public. The **underwriter** helps to prepare a **prospectus**, which describes the company and its prospects. The costs of an IPO include direct costs such as legal and administrative fees as well as the underwriting spread—the difference between the price the underwriter pays to acquire the shares from the firm and the price the public pays the underwriter for those shares. Another major implicit cost is the **underpricing** of the issue—that is, shares are typically sold to the public somewhat below the true value of the security. This discount is reflected in abnormally high average returns to new issues on the first day of trading.

3. What are some of the significant issues that arise when established firms make a rights issue, a

general cash offer, or a private placement of securities?

There are always economies of scale in issuing securities. It is cheaper to go to the market once for \$100 million than to make two trips for \$50 million each. Consequently, firms “bunch” security issues. This may mean relying on short-term financing until a large issue is justified. Or it may mean issuing more than is needed at the moment to avoid another issue later.

A **seasoned offering** may depress the stock price. The extent of this price decline varies, but for issues of common stocks by industrial firms, the fall in the value of the existing stock may amount to a significant proportion of the money raised. The likely explanation for this pressure is the information the market reads into the company's decision to issue stock.

The **prompt offering prospectus (POP) system** often makes sense for equity or debt issues by well-established companies. It allows short-form filing to regulators and, thereby, reduces the time taken to arrange a new issue.

Private placements are well suited for small, risky, or unusual firms. Of course, established and conventional firms also often raise large sums of capital by this method. The special advantages of private placement stem from avoiding registration expenses and getting a more direct relationship with the lender.

4. What is the role of the underwriter in an issue of securities?

The underwriter manages the sale of the securities for the issuing company. The underwriting firms have expertise in such sales because they are in the business all the time, whereas the company raises capital only occasionally. Moreover, the underwriters may give an implicit seal of approval to the offering. Because the underwriters will not want to squander their reputation by misrepresenting facts to the public, the implied endorsement may be quite important to a firm coming to the market for the first time.



Related Web Links

www.ipohome.com/default.asp News and statistics on the IPO market

www.cbs.marketwatch.com Information on new IPOs in the United States

www.tfibcm.com Information on underwriting activity

www.FreeEDGAR.com Information on registration of new securities offerings in the United States

www.cob.ohio-state.edu/~fin/resources_education/credit.htm The changing mix of corporate financing

www.vnpartners.com/ Venture capital as a source of project financing

www.strategis.ic.gc.ca Industry Canada

www.bdc.ca Business Development Bank of Canada

www.rim.com Research In Motion

www.osc.gov.on.ca Ontario Securities Commission

www.sedar.com Information on document filings by Canadian companies including for new securities

www.724.com 724 Solutions

www.cvca.ca Canadian Venture Capital Association (CVCA)

www.canadavc.com Venture capital information; Web site of Thomson Financial (acquired from Macdonald and Associates Ltd.).

www.iclub.com Products and services targeted at investment clubs

www.canadait.com Venture capital and angel investor information

<http://bear.cba.ufl.edu/ritter> Web page of Jay Ritter, the well-known finance professor; includes some great data on IPOs

www.aboutus.org/VentureEconomics.com News and statistics on the U.S. venture capital industry

www.nvca.org Home page of the National Venture Capital Association, based in the United States.

Key Terms

angel	436	oversubscription privilege	447	shelf registration	449
bought deal	449	private placement	451	spread	438
ex-rights date	448	prompt offering prospectus		standby underwriting	
flotation costs	441	(POP) system	449	agreement	447
general cash offer	448	prospectus	438	underpricing	439
holder-of-record date	448	rights issue	447	underwriter	438
initial public offering (IPO)	437	seasoned offering	446	venture capital	435

Questions and Problems

*Answers in Appendix B

BASIC

- *1. **Underwriting.**
 - a. Is a rights issue more likely to be used for an initial public offering or for subsequent issues of stock?
 - b. Is a private placement more likely to be used for issues of seasoned stock or seasoned bonds by an industrial company?
 - c. Is the Prompt Offering Prospectus (POP) system more likely to be used for issues of unseasoned stocks or bonds by a large industrial company?
2. **Underwriting.** Each of the following terms is associated with one of the events beneath. Can you match them up?
 - a. Red herring
 - b. Firm commitment
 - c. Rights issue
 - A. The underwriter agrees to buy the issue from the company at a fixed price.
 - B. The company offers to sell stock to existing stockholders.
 - C. The company issues a preliminary prospectus for distribution to the public.
- *3. **Underwriting Costs.** For each of the following pairs of issues state which of the two you would expect to involve the lower proportionate underwriting and administrative costs, other things being equal:
 - a. a large issue/a small issue
 - b. a bond issue/a common stock issue
 - c. a small private placement of bonds/a small general cash offer of bonds

- *4. **IPO Costs.** Why are the issue costs for debt issues generally less than those for equity issues?
- 5. **Venture Capital.** Why do venture capital companies prefer to advance money in stages?
- 6. **IPOs.** Your broker calls and says that you can get 500 shares of an imminent IPO at the offering price. Should you buy? Are you worried about the fact that your broker called you?

INTERMEDIATE

- *7. **IPO Underpricing.** Having heard about IPO underpricing, I put in an order to my broker for 1,000 shares of every IPO he can get for me. After three months, my investment record is as follows:

IPO	Shares Allocated to Me	Price per Share	Initial Return
A	500	\$10	7%
B	200	20	12
C	1,000	8	-2
D	0	12	23

- a. What is the average underpricing of this sample of IPOs?
 - b. What is the average initial return on my “portfolio” of shares purchased from the four IPOs I bid on? Calculate the average initial return, weighting by the amount of money invested in each issue.
 - c. Why have I performed so poorly relative to the average initial return on the full sample of IPOs? What lessons do you draw from my experience?
8. **IPO Costs.** Moonscape has just completed an initial public offering. The firm sold three million shares at an offer price of \$8 per share. The underwriting spread was \$.50 a share. The price of the stock closed at \$11 per share at the end of the first day of trading. The firm incurred \$100,000 in legal, administrative, and other costs. What were flotation costs as a fraction of funds raised?
9. **IPO Costs.** Look at the illustrative new-issue prospectus in Appendix 14B.
- a. Is this issue a primary offering, a secondary offering, or both?
 - b. What are the direct costs of the issue as a percentage of the total proceeds? Are these more than the average for an issue of this size?
 - c. Suppose that on the first day of trading the price of Hotch Pot’s stock is \$15 a share. What are the *total* costs of the issue as a percentage of the market price?
 - d. After paying her share of the expenses, how much will the firm’s president, Emma Lucullus, receive from the sale? What will be the value of the shares that she retains in the company?
- *10. **Flotation Costs.** “For small issues of common stock, the costs of flotation amount to about 15 percent of the proceeds. This means that the opportunity cost of external equity capital is about 15 percentage points higher than that of retained earnings.” Does this make sense?
11. **Flotation Costs.** When Microsoft went public, the company sold two million new shares (the primary issue). In addition, existing shareholders sold .8 million shares (the secondary issue) and kept 21.1 million shares. The new shares were offered to the public at \$21 and the underwriters received a spread of \$1.31 a share. At the end of the first day’s trading, the market price was \$35 a share.
- a. How much money did the company receive before paying its portion of the direct costs?
 - b. How much did the existing shareholders receive from the sale before paying their portion of the direct costs?
 - c. If the issue had been sold to the underwriters for \$30 a share, how many shares would the company have needed to sell to raise the same amount of cash?
 - d. How much better off would the existing shareholders have been?
- *12. **Flotation Costs.** The market value of the marketing research firm Fax Facts is \$600 million. The firm issues an additional \$100 million of stock, but as a result the stock price falls by 2 percent. What is the cost of the price drop to existing shareholders as a fraction of the funds raised?
13. **Flotation Costs.** Young Corporation stock currently sells for \$30 per share. There are one million shares currently outstanding. The company announces plans to raise \$3 million by offering shares to the public at a price of \$30 per share.



EXCEL

- a. If the underwriting spread is 8 percent, how many shares will the company need to issue in order to be left with net proceeds of \$3 million?
 - b. If other administrative costs are \$60,000, what is the dollar value of the total direct costs of the issue?
 - c. If the share price falls by 3 percent at the announcement of the plans to proceed with a seasoned offering, what is the dollar cost of the announcement effect?
14. **Private Placements.** You need to choose between the following types of issues:
- A public issue of \$10 million face value of 10-year debt.* The interest rate on the debt would be 8.5 percent and the debt would be issued at face value. The underwriting spread would be 1.5 percent and other expenses would be \$80,000.
- A private placement of \$10 million face value of 10-year debt.* The interest rate on the private placement would be 9 percent, but the total issuing expenses would be only \$30,000.
- a. What is the difference in the proceeds to the company net of expenses?
 - b. Other things being equal, which is the better deal?
 - c. What other factors beyond the interest rate and issue costs would you wish to consider before deciding between the two offers?
- *15. **Rights.** In 2001, Pandora, Inc., makes a rights issue at a subscription price of \$5 a share. One new share can be purchased for every four shares held. Before the issue there were 10 million shares outstanding, and the share price was \$6.
- a. What is the total amount of new money raised?
 - b. What is the expected stock price after the rights are issued?
16. **Rights.** Problem 15 contains details of a rights offering by Pandora. Suppose that the company had decided to issue the new stock at \$4 instead of \$5 a share. How many new shares would it have needed to raise the same sum of money? Recalculate the answers to problem 15. Show that Pandora's shareholders are just as well off if it issues the shares at \$4 a share rather than \$5.
17. **Rights.** Consolidated Jewels needs to raise \$2 million to pay for its Diamonds in the Rough campaign. It will raise the funds by offering 200,000 rights, each of which entitles the owner to buy one new share. The company currently has one million shares outstanding priced at \$20 each.
- *a. What must be the subscription price on the rights the company plans to offer?
 - *b. What will be the share price after the rights issue?
 - *c. What is the value of a right to buy one share?
 - *d. How many rights would be issued to an investor who currently owns 1,000 shares?
 - e. Show that the investor who currently holds 1,000 shares is unaffected by the rights issue. Specifically, show that the value of the rights plus the value of the 1,000 shares after the rights issue equals the value of the 1,000 shares before the rights issue.
18. **Rights.** Associated Breweries is planning to market unleaded beer. To finance the venture it proposes to make a rights issue with a subscription price of \$10. One new share can be purchased for each two shares held. The company currently has 100,000 shares outstanding priced at \$40 a share. Assuming that the new money is invested to earn a fair return, give values for the
- a. number of new shares
 - b. amount of new investment
 - c. total value of company after issue
 - d. total number of shares after issue
 - e. share price after the issue



EXCEL

CHALLENGE

19. **Standard & Poor's.** Go to Market Insight (www.mcgrawhill.ca/edumarketinsight). Click on the "Excel Analytics" icon and review the Monthly Valuation Data Report for Telus Corp. (TU) and Shaw Communications Inc. (SJR). Which company has the higher price-earnings ratio? What variables (for example, financial ratios or growth rates) might explain the P/E differential?



20. **Internet.** Jay Ritter’s home page (<http://bear.cba.ufl.edu/ritter>) is a mine of information on IPOs. Look up the number of IPOs during the 1999–2000 period and compare this with the number of IPOs during the 2006–2007 period. What is the average first day return on IPOs and money left on the table for the two periods? From his table of “money-left-on-the-table,” which company provided the greatest one-day dollar gains to investors?



EXCEL

21. **Venture Capital.** Here is a difficult question. Pickwick Electronics is a new high-tech company financed entirely by one million ordinary shares, all of which are owned by George Pickwick. The firm needs to raise \$1 million now for stage one and, assuming all goes well, a further \$1 million at the end of 5 years for stage two.

First Cookham Venture Partners is considering two possible financing schemes:

1. Buying two million shares now at their current valuation of \$1.
2. Buying one million shares at the current valuation and investing a further \$1 million at the end of 5 years at whatever the shares are worth.

The outlook for Pickwick is uncertain, but as long as the company can secure the additional financing for stage two, it will be worth either \$2 million or \$12 million after completing stage two. (The company will be valueless if it cannot raise the funds for stage two.) Show the possible payoffs for Mr. Pickwick and First Cookham and explain why one scheme might be preferred. Assume an interest rate of zero.



22. **Internet.** In Appendix 14B we provide a flavour of an IPO prospectus, but you can see what an actual prospectus or registration statement looks like by using the System for Electronic Document Analysis and Retrieval (Sedar) Web site at www.sedar.com for Canadian companies or the SEC’s huge database on www.freeedgar.com for US companies. You can also log in to www.nasdaq.com, click on “IPOs” to find a company, and then click on “Filings,” which will take you to the correct SEC form. Pick a recent prospectus filing of a Canadian company from www.sedar.com. On the basis of this prospectus, do you think the stock looks like an attractive investment? Which parts of the statement appear most useful? Which seem the least useful?



Solutions to Check Points

- 14.1 Unless the firm can secure second-stage financing, it is unlikely to succeed. If the entrepreneur will reap any reward on his own investment, he needs to put in enough effort to get further financing. By accepting only part of the necessary venture capital, management increases its own risk and reduces that of the venture capitalist. This decision would be costly and foolish if management lacked confidence that the project would be successful enough to get past the first stage. A credible signal by management is one that only managers who are truly confident can afford to provide. However, words are cheap and there is little to be lost by *saying* that you are confident (although if you are proved wrong, you may find it difficult to raise money a second time).
- 14.2 If an investor can distinguish between overpriced and underpriced issues, she will bid only on the underpriced ones. In this case she will purchase only issues that provide a 10 percent gain. However, the ability to distinguish these issues requires considerable insight and research. The return to the informed IPO participant may be viewed as a return on the resources expended to become informed.

14.3	Direct expenses	(\$ millions)
	Underwriting spread = 69 million × \$4	276.0
	Other expenses	9.2
	Total direct expenses	285.2
	Underpricing = 69 million × (\$70 – \$64)	414.0
	Total expenses	699.2
	Market value of issue = 69 million × \$70	4,830.0

Expenses as proportion of market value = $699.2/4,830 = .145 = 14.5\%$.

- 14.4 Ten issues of \$15 million each will cost about 9 percent of proceeds, or $.09 \times \$150 \text{ million} = \13.5 million . One issue of \$150 million will cost only 4 percent of \$150 million, or \$6 million.

Mutt.Com was founded in 2000 by two graduates of the University of Wisconsin with help from Georgina Sloberg, who had built up an enviable reputation for backing new start-up businesses. Mutt.Com's user-friendly system was designed to find buyers for unwanted pets. Within 3 years the company was generating revenues of \$3.4 million a year, and despite racking up sizable losses, was regarded by investors as one of the hottest new e-commerce businesses. The news that the company was preparing to go public therefore generated considerable excitement.

The company's entire equity capital of 1.5 million shares was owned by the two founders and Ms Sloberg. The initial public offering involved the sale of 500,000 shares by the three existing shareholders, together with the sale of a further 750,000 shares by the company in order to provide funds for expansion.

The company estimated that the issue would involve legal fees, auditing, printing, and other expenses of \$1.3 million, which would be shared proportionately between the selling shareholders and the company. In addition, the company agreed to pay the underwriters a spread of \$1.25 per share.

The roadshow had confirmed the high level of interest in the issue, and indications from investors suggested that the entire issue could be sold at a price of \$24 a share. The

underwriters, however, cautioned about being too greedy on price. They pointed out that indications from investors were not the same as firm orders. Also, they argued, it was much more important to have a successful issue than to have a group of disgruntled shareholders. They therefore suggested an issue price of \$18 a share.

That evening Mutt.Com's financial manager decided to run through some calculations. First she worked out the net receipts to the company and the existing shareholders, assuming that the stock was sold for \$18 a share. Next she looked at the various costs of the IPO and tried to judge how they stacked up against the typical costs for similar IPOs. That brought her up against the question of underpricing. When she had raised the matter with the underwriters that morning, they had dismissed the notion that the initial day's return on an IPO should be considered part of the issue costs. One of the members of the underwriting team had asked: "The underwriters want to see a high return and a high stock price. Would Mutt.Com prefer a low stock price? Would that make the issue less costly?" Mutt.Com's financial manager was not convinced but felt that she should have a good answer. She wondered whether underpricing was a problem only because the existing shareholders were selling part of their holdings. Perhaps the issue price would not matter if they had not planned to sell.

APPENDIX 14A: THE FINANCING OF NEW AND SMALL ENTERPRISES

VENTURE CAPITAL IN CANADA

We saw in Section 14.1 that venture capital is an important source of equity for start-up companies that have the potential to develop into significant economic contributors. Venture capitalists make risky investments with the expectation of earning high rewards if the young ventures become successful. Often, their investments pay off handsomely, as in the case of companies such as Microsoft, Intel, or Research In Motion, which are today established leaders in their respective industries. Of course, venture capitalists may seek to lessen the risk of venture investing in a number of ways. For instance, before making investment decisions, they try to screen the technical and business merits of the proposed company carefully and usually end up investing in only a small percentage of the businesses they review. They also like to work actively with managements of companies they invest in by contributing their business knowledge and experience, gained from helping other companies with similar growth challenges. Often, they diversify their investments by developing a portfolio of young companies in a single venture fund. Many times they will co-invest with other professional venture capital firms in syndicated investment arrangements. In addition, many venture capitalists manage multiple funds together. Table 14A.1 lists some of the important attributes of classic venture capital investing.

TABLE 14A.1

Attributes of classic venture capital investing

1. Create new businesses or expand or revitalize existing ones.
2. The investor, usually the venture capital (VC) fund's general manager and associates, are involved in the management of their portfolio companies, providing a great deal of "value added" to their companies.
3. The *potential* return from the investment is quite large due to investing in high-risk/high-reward situations.
4. Only a few investments are made each year after many candidates have been screened and a handful have been fully analyzed.
5. Negotiate appropriate financial structures using individualized investment instruments.
6. Take a long-term orientation toward their portfolio companies because of the illiquidity of their investments.
7. Try to maximize the growth of their funds since the VC receives, as incentive, compensation as a percentage of the capital gains after return of capital.
8. Venture capitalists often diversify their risk by syndicating their investment with other VC funds.

Based on information in K. W. Rind, "The Role of Venture Capital in Corporate Development," *Strategic Management Journal* (April–June 1981), pp. 169–180.

Source: A. Best and D. Mitra, "The Venture Capital Industry in Canada," *Journal of Small Business Management* (April 1997), Vol. 35, No. 2, pp. 105–110.

TYPES OF VENTURE CAPITAL FUNDS

In Canada, venture capital activity has grown significantly since 1990. For instance, in 1990 there were 34 venture funds with \$3.3 billion worth of capital under management. By 2006, the number of venture capital investment firms had grown to 1,200. Together, these funds had over \$50 billion worth of capital under management.

Canada's venture capital funds can be grouped into one of five categories: private independent, labour-sponsored, corporate, government and hybrid.¹⁶ *Private independent firms* typically have no affiliations with any other financial institution. Some large private independent funds have been very active although in recent years the level of activity of this category of funds has slowed somewhat. For instance, in 2006, about \$1.6 billion of new capital flowed into the industry across all fund types, with private independent funds attracting \$666 million of new capital, slightly less than \$672 million raised by such funds in 2005. Fund raising was generally quite sluggish in 2006, down by 25 percent from the \$2.2 billion of 2005.

Labour-sponsored funds, or retail funds, are venture capital pools formed with the help of provincial and federal governments. These funds were mostly introduced in the late 1980s to facilitate business and economic growth. By 2000, these had about 50 percent of the money invested in the venture capital industry, mainly because of generous tax incentives given to investors in such funds. Despite a decline in investment activity in recent years, these funds were the largest investors when compared with all other categories until 2003. However, in 2006, their share of the total investment activity of venture capital firms dropped to second place at 22 percent. Currently, investors receive a 15 percent tax credit from both the federal government and participating provincial governments. Moreover, the investment is Registered Retirement Savings Plan (RRSP) eligible, and, therefore, provides the investor an additional tax benefit in the form of a tax deferral depending on her income level. Labour-sponsored funds are structured in a similar fashion to mutual funds. Individuals are able to buy shares in the fund, allowing investment by those who are not wealthy. The fund pools the money with the objective of investing in enterprises that have yet to go public instead of purchasing stocks and bonds. Three large and active labour-sponsored funds are GrowthWorks, Fonds de Solidarité du Travailleurs du Québec, and Triax Growth Fund. A number of *corporate*

¹⁶ These classifications are used by Canada's Venture Capital and Private Equity Association (CVCA) to provide periodic reports on venture capital activity. The reports are available on its Web site at www.cvca.ca. Data for these reports is often compiled by Macdonald and Associates Ltd., which is the best-known data source on Canadian venture capital activity.

venture capital funds also exist in Canada. These could include financial corporation funds, which tend to be venture capital affiliates or subsidiaries set up by large Canadian banks. For instance, RBC Capital Partners is a subsidiary of the RBC Financial Group. The financial institution can provide a range of financial services to entrepreneurs and enhance their credibility with suppliers and customers. You could also have subsidiaries of large manufacturing companies such as Dow Chemical Corporate Venture Capital, or subsidiaries of utility and power corporations such as Hydro-Québec Capitech Inc. Goals of corporate venture capital funds tend to be strategically tied to the parent organization; they often prefer to invest in ventures that will give them access to new technologies or provide a competitive advantage. For instance, Chrysalix Energy LP is an early to mid-stage venture capital firm focusing on fuel cell and related fuelling technology companies and was formed jointly by Ballard Power Systems and several large multinational companies such as Boeing, Mitsubishi Corporation, and Shell Hydrogen.

Federal or provincial governments run government funds by employing professional venture capital fund managers. For instance, the federal Business Development Corporation (BDC) has an active venture capital division that, for the end of fiscal year March 2007, had a total commitment of venture capital investments of \$748 million. The BDC has focused on using venture capital to generate growth in new economy industries such as biotechnology, medical/health-related, information technology, and electronics. Much of the financing goes to companies in early stages of development and considered to be high risk. Some crown corporations such as Export Development Canada have venture capital operations as well. Provincial governments have also sponsored their own funds with goals of nurturing small businesses and also providing financing to high-technology firms, for instance, Crown Investments Corporation of Saskatchewan.

Pension funds, insurance companies or large endowments also may form venture capital funds. Teachers' Private Capital which is the venture capital arm of Ontario Teachers' Pension Plan is an example of one such *institutional fund*. Government and institutional funds have profit-maximizing objectives similar to private and labour-sponsored funds. Table 14A.2 lists some Canadian venture capital funds and describes their investment preferences.

TABLE 14A.2

Some representative Canadian venture capital firms

Firm	Type of Firm	Capital under Management (\$ millions)	Geographic Preference	Industry Preference
GrowthWorks ^a	Labour-Sponsored Venture Capital Fund	\$ 900	Canada	Information technology, life sciences, and advanced manufacturing
Société Innovatech Québec ^b	Corporate Investor	\$ 125	Canada	Information technology and telecommunications, biotechnology, and advanced applied technologies
TD Capital Private Equity Investors ^c	Bank (Independent private equity arm of TD Bank Financial Group)	\$2,500	Canada, United States, Europe	Information technology, life sciences, and other technologies
Clairvest Group Inc. ^d	Private Equity Investor	\$ 600	Canada, United States	All Industries
Ventures West Capital LTD. ^e	Private Venture Capital Fund	\$ 700	Canada	Biotechnology, Cleantech, and communications

Source: CVCA—Canada Venture Capital & Private Equity Association, <http://www.cvca.ca/membership/directory/>, retrieved September 23, 2008

^a GrowthWorks website, <http://www.growthworks.ca/aboutus/>, retrieved September 23, 2008

^b Société Innovatech Québec website, <http://www.innovatechquebec.com/www/home.html>, retrieved September 23, 2008

^c TD Capital Private Equity Investors website, <http://www.tdcapital.com/tdcapital/pei/home.html>, retrieved September 23, 2008

^d Clairvest Group Inc. website, <http://www.clairvest.com/index.php/about/>, retrieved September 23, 2008

^e Ventures West Capital LTD. website, <http://www.ventureswest.com/>, retrieved September 23, 2008

STAGES OF DEVELOPMENT FINANCED BY CANADIAN VENTURE CAPITAL FIRMS

New enterprises can be at different stages of development. Described below are some of the stages firms may go through after they are started.

- *Seed Stage*: the very early stage when the new enterprise may seek to test a concept or build a product prototype and develop a product.
- *Start-Up Stage*: the enterprise may have a product being developed, but not yet marketed and sold commercially.
- *Expansion Stage*: the firm requires significant capital for plant expansion, marketing, and initiation of full commercial production and sales.
- *Acquisition/Buyout Stage*: the management of the firm acquires a product line, a division, or a company.
- *Turnaround Stage*: the firm was once profitable but is now earning less than its cost of capital.

Generally the seed and start-up stages are considered to be the early stages of development. During their life cycle, all firms will go through the seed, start-up, and expansion stages, but not all will experience the buyout or turnaround stages. From Table 14A.3, we see that Canadian venture capital firms tend to finance enterprises across different stages of development. Over \$721 million, or roughly 43 percent of all investments, went to financing 236 early-stage enterprises including seed, start-up, and other early-stage firms in 2006. In 2006, emphasis on early stage ventures declined somewhat compared with past years. For instance, in 2004 early stage firms obtained about 50 percent of all disbursements, whereas in 2006 early stage firms received only 43 percent of all disbursements. Some recent examples of big early-stage deals include Meriton Networks, Zelos Therapeutics, and Celator Technologies. Follow-on and expansion-stage investments amounted to about \$935 million, or 55 percent of all disbursements. This was higher than 2004, where expansion stage firms received 43 percent of the total disbursement. Clearly expansion and later-stage transactions have been gaining momentum in recent years in Canada.

RECENT VENTURE CAPITAL INVESTMENT ACTIVITY

Just a few years ago, Canada's venture capital firms had been very active, with record investments of \$5.8 billion in 2000 disbursed to 1,006 companies.¹⁷ Since then, investment activity has considerably declined and, in 2006, \$1.693 billion was disbursed to 459 firms. Table 14A.4 provides sector-wise details regarding where the venture capital firms invested in 2006. We see that 90.7 percent of the investing has focussed on large deals involving technology companies, particularly in life sciences, computer and Internet-related sectors, communications, and electronics.

TABLE 14A.3

Venture capital investment activity by stage of development in 2005 and 2006

Stage	2006		2005	
	Amount (\$ million)	Percentage of Total	Amount (\$ million)	Percentage of Total
Early Stage	\$ 721	43%	\$ 893	53%
Expansion	\$ 935	55%	\$ 762	45%
Acquisition/Buyout	\$ 12	1%	\$ 10	1%
Turnaround	\$ 8	0%	\$ 4	0%
Other	\$ 17	1%	\$ 8	0%
Total	\$1,693	100%	\$1,677	100%

Source: Canada's Venture Capital & Private Equity Association and Macdonald & Associates Ltd., www.cvca.ca.

¹⁷ In contrast, the American venture capital industry reported a 10 percent increase in investment activity in 2006 from the previous year, with investments totalling US\$25.5 billion disbursed to 3,416 company deals. For more information on venture capital activity in the United States, go the National Venture Capital Association Web site at www.nvca.org.

TABLE 14A.4
Venture capital investment
activity by sector

Industry	2006		2005	
	Amount (\$ million)	Percentage of Total	Amount (\$ million)	Percentage of Total
Technology				
Biopharmaceuticals	431	25.5	332	19.8
Medical/Health Related	62	3.7	106	6.3
Communications and Networking	238	14.1	333	19.9
Electronics and Computer Hardware	110	6.5	110	6.6
Internet Focus	81	4.8	101	6.0
Semiconductors and Software	406	24.0	351	20.9
Energy and Environmental Technologies	119	7.0	65	3.9
Other IT Services	89	5.3	61	3.6
Total	1,536	90.7	1,459	87.0
Traditional				
Consumer Related	73	4.3	98	5.8
Manufacturing	58	3.4	65	3.9
Miscellaneous	26	1.5	55	3.3
Total	157	9.3	218	13.0
TOTAL	1,693	100.0	1,677	100.0

Source: Canada's Venture Capital & Private Equity Association and Macdonald & Associates Ltd., www.cvca.ca.

Topping the list were firms in the information technology sector, accounting for 219 companies that absorbed about \$835 million or 49.4 percent of total disbursement. In this sector, firms in software and semiconductor-related sectors received \$406 million, followed by those in the communications industry with \$238 million, while firms in the electronics and computer hardware industry received \$110 million. Biotechnology and health science firms received 29.2 percent representing 89 firms. Companies in traditional industries such as manufacturing or consumer-related received only 9.3 percent of venture capital investments.

Table 14A.5 provides details on the top 10 venture capital deals for 2006. Notice the very large amounts invested in some life science firms. However, there were only a few such mega deals in 2006. On average, the size of financing was much less, at \$4.2 million in 2006. In general, however, the average amount invested per company was 40 percent higher than the \$3 million average of 2005. About \$686 million, or 40 percent of the total invested, went to 118 Ontario-based firms, particularly to technology-intensive enterprises in the Greater Toronto and Ottawa Valley regions. Quebec-based companies captured the second largest portion of total spending—about 36 percent at \$603 million.

VENTURE CAPITAL EXITS

Venture capitalists provide a combination of unique services to companies in which they invest. In addition to financial capital they also help with a variety of advisory services. The investee firm also benefits indirectly when a reputed venture capital organization invests in it. By making the investment, the venture capitalist is, in a sense, signalling its approval of the firm's business plan, growth and profit potential, and future prospects. Once information gets out about the venture capitalist's interest in the firm, other service providers such as advertisement agencies or accounting firms also become eager to do business with the firm and are, often, willing to provide significant discounts on fees and other charges during its early-growth phase. As the investee firm matures and becomes more established, the value of services provided to it by the venture capitalist diminishes. It becomes important, therefore, for the venture capitalist to exit from the firm and to recycle its investment into another young venture.¹⁸

¹⁸ For further discussion, see B.S. Black and R. J. Gilson (1998), "Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets," *Journal of Financial Economics*, Vol. 47, 243–277.

TABLE 14A.5

Top 10 venture capital deals in 2006

Rank 2006		Invested \$000s	Business Description	Investors
1	Variation Biotechnologies Inc., Que.	41,400	Intelligent vaccine designs that mimic the immune system	5AM Ventures, ARCH Venture Partners, Clarus Ventures, and others
2	OZ Communications Inc., Montreal	38,700	Mobile instant messaging solutions	CDP Capital—Amerique, Fonds de Solidarité (FTQ), VantagePoint Venture Partners and others
3	Xenon Pharmaceuticals Inc., B.C.	35,600	Drug discovery and development	Invesco Private Capital, LipoteRx, MX Associates
4	Liquid Computing Inc., Ottawa	31,500	Development of computer and server solutions	ATA Ventures, Axis Investment Fund, BDC Venture Capital Group, EDC Equity Fund, Newbury Ventures, VenGrowth Investment Fund II and III, VenGrowth VLP
5	Iogen Corp., Ottawa	30,000	Renewable energy technology	Goldman Sachs Group
6	Airwide Solutions, Ont.	28,900	Mobile infrastructure software	Advent International, Artiman Ventures, Axiom Venture Partners, Key Venture Partners, Kodiak Venture Partners
7	Neuromed Pharmaceuticals, Vancouver	28,900	Drug discovery	BDC Venture Capital Group, Canadian Medical Discoveries Fund I, Cogene Biotech Ventures, James Richardson & Sons, MPM Capital, and others
8	Xanthus Pharmaceuticals Inc., Montreal	28,500	Development of anti-cancer medicines	CDIB BioScience Ventures, GeneChem, GIMV NV, Hambrecht & Quist Capital Management, Healthcare Ventures, Kestrel Management, and others
9	MethylGene Inc., Montreal	22,400	Development of therapeutics for cancer	BDC Venture Capital Group, CIBC Capital Partners, Domain Associates, Pappas Ventures, ProQuest Investment, and others
10	Viron Therapeutics Inc., Ont.	22,000	Treatment of inflammatory disorders	Arngen Ventures, BDC Venture Capital Group, Canadian Medical Discoveries Fund I, GrowthWorks Canadian Fund Inc., Novartis Pharma AG, and others

Source: *National Post Business*, June 2007 (FP500), p. 142, retrieved January 26, 2008. Material reprinted with the express permission of The National Post Company, a Canwest Partnership.

The venture capitalist can exit from an investment through a variety of means including (a) acquisition by a third party, (b) company buyback by the entrepreneur, (c) initial public offering, (d) merger with another entity and, in the event that all other options fail, (e) write-off. According to a recent study, company buybacks by entrepreneur/managers from venture capitalists appear to be the predominant mode of venture capital exits in Canada followed by initial public offerings.¹⁹ Acquisition by a third party is also a popular exit route. Unfortunately, a sizeable number of exits occur through write-offs as well. The average duration of successful venture capital investments before exiting through a company buyback or an initial public offering is close to six years. Venture capitalists appear to be able to spot failures earlier on; the average duration of investments that are written off is a little over four years.

ANGEL INVESTING

Although the organized venture capital industry plays an important role in the creation of new ventures, those seeking very early-stage financing for small and new enterprises often have to resort to informal financing sources. In this context, wealthy individual investors, known as

¹⁹ See D.J. Cummings and J.G. MacIntosh "A Cross-Country Comparison of Full and Partial Venture Capital Exits," *Journal of Banking and Finance* 27 (2003), pp. 511–548.

angels, can play a critical role by making small-scale investments in local start-ups and early-stage ventures, and by bringing a significant hands-on contribution to such business ventures.

The angel investor, typically a millionaire or a multimillionaire, may invest on average between \$100,000 and \$250,000 in a start-up, and prefers to be involved with the project. According to some estimates, there are about 200,000 angel investors in Canada.²⁰ Angels can play either *active* or *passive* roles in the investee firms. “Active” angels are often highly motivated ex-entrepreneurs who are skilled at picking good management teams and good ideas. They help companies arrange additional financing, hire top management, and recruit knowledgeable board members. “Passive” angels provide only money and rarely monitor the firm closely; they are often part of an informal network led by one or more active angels who find deals and manage the investments. A number of organized services exist that are designed to match angel investors with entrepreneurs looking to fund their new ventures. These angel-network services include Ottawa Capital Network, VentureDrive.com, the Montreal-based InvestAngel Network, the Ottawa-based eValhalla.com, and Angel Investors Canada, which is the Toronto chapter of the International Angel Investors Group.

OTHER SOURCES OF SMALL BUSINESS FINANCING

FINANCING UNDER THE CANADA SMALL BUSINESS FINANCING ACT²¹

These are term loans and capital leases of up to 10 years available through all chartered banks, most credit unions and caisses populaires, and many trust and insurance companies, and are guaranteed by the federal government if taken for specific purposes and limits. The loans or leases are available under the federal government’s Canada Small Business Financing Act (CSBFA) to small businesses in Canada that have gross revenues of \$5 million or less in the year of application for the loan. The loans can be used to finance up to 90 percent of the purchase or improvement of eligible assets such as land, premises, and equipment. The loans cannot be used to buy shares or provide working capital. Capital leases (with an option to purchase) can be used to finance the cost of a variety of new and used equipment including vehicles, hotel and restaurant equipment, medical and health services equipment, computer hardware and software, telecommunications, and manufacturing equipment. CSBFA loans and leases are made to small businesses in a variety of industries such as communication, construction, manufacturing, transportation, and wholesale trade. The loans and leases are not available to farming, charitable, or religious enterprises.

BUSINESS DEVELOPMENT BANK OF CANADA

The Business Development Bank of Canada (BDC) is a Crown financial institution that specializes in providing financial and other support services to small- and medium-sized businesses in Canada. BDC’s major activities include term lending, giving loan guarantees, and providing venture capital financing. It is also involved in lease financing and providing consultancy services. As of the fiscal year ending March 2007, BDC had over 26,643 customers to whom the total financing committed exceeded \$10.1 billion. During the fiscal year March 2007, total financing authorized had reached a record \$2.6 billion. In recent years, BDC supports new ventures in fields such as medical technologies, telecommunications, information technology etc. BDC continued to provide financing in support of new ventures with direct investment of \$106 million as of the fiscal year ending March 2007. It also plays an active role in the First Peoples’ market and in supporting female entrepreneurs.

²⁰ See, for instance, “Startups Angle for Angels,” *The Globe and Mail* (June 29, 2000), p. T1.

²¹ Details are available at the Industry Canada Web site, <http://strategis.ic.gc.ca>.

REGIONAL AND PROVINCIAL LENDING PROGRAMS

There are a number of regional agencies across Canada that have lending and other assistance programs, designed to nurture and grow small businesses. Some of the important regional agencies and initiatives include Atlantic Canada Opportunities Agency (ACOA), Federal Economic Development Initiative in Northern Ontario (FedNor), Canada Economic Development for Québec Regions: Financing, and Western Economic Diversification Canada: Financing. For descriptions of such agencies and details regarding the services provided by them, go to the Industry Canada Web site at <http://strategis.ic.gc.ca>.

Practice Problems



1. **Internet.** This chapter has provided Web site information for several venture capital sources and angel investing networks. Use the Internet to explore these Web sites. Also, see whether you can identify other interesting Web sites that will provide useful information on venture capital and angel investing activity.
2. **Venture Capital.** Based on your Internet research in question 1, can you answer the following?
 - a. We described different types of venture capital funds that exist in Canada. What are the main differences in investment goals and characteristics between these funds? Do some types of funds appear to participate more in earlier stage financing than others?
 - b. Do some venture capitalists appear to specialize by investing in only a few selected industries, while others are more diversified in their investment activity? Can you think of some good reasons for firms pursuing either of the two strategies?
 - c. Venture capitalists have geographical preferences for their investment activity. Can you discern some common motivations for such preferences?
3. **Venture Capital and Angel Investing.** Venture capitalists and many angel investors are often actively involved with the ventures in which they invest. How does this benefit the entrepreneur? Does this benefit the venture capitalist and angel investor as well?
4. **Internet.** To find out what is happening in the venture capital industry in the United States, look at the National Venture Capital Association website (www.NVCA.org). Now find the NVCA Yearbook 2008 in the Resources, Publications section of the Web site and look at the recent U.S. national data. How does the level of deals compare with the boom year of 2000? Which industries are attracting the most venture capital? Is the money going into new start-ups or expansion of existing businesses?



APPENDIX 14B: HOTCH POT'S NEW ISSUE PROSPECTUS²²

PROSPECTUS

800,000 Shares
Hotch Pot, Inc.
Common Stock

Of the 800,000 shares of Common Stock offered hereby, 500,000 shares are being sold by the Company and 300,000 shares are being sold by the Selling Shareholders. See "Principal and Selling Shareholders." The Company will not receive any of the proceeds from the sale of shares by the Selling Shareholders.

²² Most prospectuses have content similar to that of the Hotch Pot prospectus but go into considerably more detail. Also, we have omitted from the Hotch Pot prospectus the company's financial statements. You can get a better impression of the contents of a prospectus by looking at some real ones. These are available at the system for Electronic Document Analysis and Retrieval (SEDAR) Web site at www.sedar.com. For instance, you can read the preliminary prospectus of Ripple Lake Diamonds Inc., which was filed on August 26, 2004.

Before this offering there has been no public market for the Common Stock. **These securities involve a high degree of risk. See “Certain Factors.”**

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY A SECURITIES COMMISSION NOR HAS ANY COMMISSION PASSED ON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public	Underwriting Discount	Proceeds to Company*	Proceeds to Selling Shareholders
Per share	\$12.00	\$1.30	\$10.70	\$10.70
Total	\$9,600,000	\$1,040,000	\$5,350,000	\$3,210,000

* Before deducting expenses payable by the Company estimated at \$400,000, of which \$250,000 will be paid by the Company and \$150,000 by the Selling Stockholders.

The Common Shares are offered, subject to prior sale, when, as, and if delivered to and accepted by the Underwriters and subject to approval of certain legal matters by their counsel and by counsel for the Company and the Selling Shareholders. The Underwriters reserve the right to withdraw, cancel, or modify such offers and reject orders in whole or in part.

Silverman Pinch Inc.

April 1, 2008

No person has been authorized to give any information or to make any representations, other than as contained therein, in connection with the offer contained in this Prospectus, and, if given or made, such information or representations must not be relied upon. This Prospectus does not constitute an offer of any securities other than the registered securities to which it relates or an offer to any person in any jurisdiction where such an offer would be unlawful. The delivery of this Prospectus at any time does not imply that information herein is correct as of any time subsequent to its date.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITER MAY OVER ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE COMMON SHARES OF THE COMPANY AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

PROSPECTUS SUMMARY

The following summary information is qualified in its entirety by the detailed information and financial statements appearing elsewhere in this Prospectus.

The Company: Hotch Pot, Inc. operates a chain of 140 fast food outlets in Canada, offering unusual combinations of dishes.

The Offering: Common Shares offered by the Company 500,000 shares;
Common Shares offered by the Selling Shareholders 300,000 shares;
Common Shares to be outstanding after this offering 3,500,000 shares.

Use of Proceeds: For the construction of new restaurants and to provide working capital.

THE COMPANY

Hotch Pot, Inc. operates a chain of 140 fast food outlets in Ontario, Québec, and British Columbia. These restaurants specialize in offering an unusual combination of foreign dishes.

The Company was organized in Ontario in 1994.

USE OF PROCEEDS

The Company intends to use the net proceeds from the sale of 500,000 shares of Common Stock offered hereby, estimated at approximately \$5 million, to open new outlets in the Atlantic provinces and to provide additional working capital. It has no immediate plans to use any of the net proceeds of the offering for any other specific investment.

DIVIDEND POLICY

The company has not paid cash dividends on its Common Stock and does not anticipate that dividends will be paid on the Common Stock in the foreseeable future.

CERTAIN FACTORS

Investment in the Common Stock involves a high degree of risk. The following factors should be carefully considered in evaluating the Company:

Substantial Capital Needs. The Company will require additional financing to continue its expansion policy. The Company believes that its relations with its lenders are good, but there can be no assurance that additional financing will be available in the future.

Competition. The Company is in competition with a number of restaurant chains supplying fast food. Many of these companies are substantially larger and better capitalized than the Company.

CAPITALIZATION

The following table sets forth the capitalization of the Company as of December 31, 2007, and is adjusted to reflect the sale of 500,000 shares of Common Stock by the Company.

	<u>Actual</u>	<u>As Adjusted</u>
	(\$ 000s)	
Long-term debt	\$ —	\$ —
Stockholders' equity		
Common shares: 3,000,000 shares outstanding, 3,500,000 shares outstanding, as adjusted	2,000	7,350
Retained earnings	<u>3,200</u>	<u>3,200</u>
Total shareholders' equity	<u>5,200</u>	<u>10,550</u>
Total capitalization	<u>\$5,200</u>	<u>\$10,550</u>

SELECTED FINANCIAL DATA

[The Prospectus typically includes a summary income statement and balance sheet.]

MANAGEMENT'S ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

Revenue growth for the year ended December 31, 2007, resulted from the opening of 10 new restaurants in the Company's existing geographic area and from sales of a new range of desserts, notably crêpe suzette with custard. Sales per customer increased by 20% and this contributed to the improvement in margins.

During the year the Company borrowed \$600,000 from its banks at an interest rate of 2% above the prime rate.

BUSINESS

Hotch Pot, Inc. operates a chain of 140 fast food outlets in Ontario, Québec, and British Columbia. These restaurants specialize in offering an unusual combination of international dishes. Fifty percent of the company's revenues were derived from the sale of two dishes, sushi and sauerkraut, and curry bolognese. All dishes are prepared in three regional centres and then frozen and distributed to the individual restaurants.

MANAGEMENT

The following table sets forth information regarding the Company's directors, executive officers, and key employees:

Name	Age	Position
Emma Lucullus	38	President, Chief Executive Officer, and Director
Ed Lucullus	43	Treasurer & Director

Emma Lucullus Emma Lucullus established the Company in 1994 and has been its Chief Executive Officer since that date.

Ed Lucullus Ed Lucullus has been employed by the Company since 1994.

EXECUTIVE COMPENSATION

The following table sets forth the cash compensation paid for services rendered for the year 2007 by the executive officers:

Name	Capacity	Cash Compensation
Emma Lucullus	President and Chief Executive Officer	\$130,000
Ed Lucullus	Treasurer	\$ 95,000

CERTAIN TRANSACTIONS

At various times between 1994 and 2007, First Cookham Venture Partners invested a total of \$1.5 million in the Company. In connection with this investment, First Cookham Venture Partners was granted certain rights to registration under the Ontario Securities Act, including the right to have their shares of Common Stock registered at the Company's expense with the Ontario Securities Commission.

PRINCIPAL AND SELLING STOCKHOLDERS

The following table sets forth certain information regarding the beneficial ownership of the Company's voting Common Stock as of the date of this prospectus by (i) each person known by the Company to be the beneficial owner of more than 5% of its voting Common Stock, and (ii) each director of the Company who beneficially owns voting Common Stock. Unless otherwise indicated, each owner has sole voting and dispositive power over his or her shares.

Name of Beneficial Owner	Shares Beneficially Owned prior to Offering		Shares to Be Sold	Shares Beneficially Owned after Offering	
	Number	Percent		Number	Percent
Emma Lucullus	400,000	13.3	25,000	375,000	10.7
Ed Lucullus	400,000	13.3	25,000	375,000	10.7
First Cookham Venture Partners	1,700,000	56.7	250,000	1,450,000	41.4
Hermione Kraft	200,000	6.7	—	200,000	5.7

DESCRIPTION OF CAPITAL STOCK

The Company's authorized capital stock consists of 10,000,000 shares of voting Common Stock.

As of the date of this Prospectus, there are four holders of record of the Common Stock.

Under the terms of one of the Company's loan agreements, the Company may not pay cash dividends on Common Stock except from net profits without the written consent of the lender.

UNDERWRITING

Subject to the terms and conditions set forth in the Underwriting Agreement, the Underwriter, Silverman Pinch, Inc., has agreed to purchase from the Company and the Selling Stockholders 800,000 shares of Common Stock.

There is no public market for the Common Stock. The price to the public for the Common Stock was determined by negotiation between the Company and the Underwriter, and was based on, among other things, the Company's financial and operating history and condition, its prospects, and the prospects for its industry in general, the management of the Company, and the market prices of securities for companies in businesses similar to that of the Company.

LEGAL MATTERS

The validity of the shares of Common Stock offered by the Prospectus is being passed on for the Company by Blair, Kohl, and Chirac, and for the Underwriter by Chretien Howard.

LEGAL PROCEEDINGS

Hotch Pot was served in January 2008 with a summons and complaint in an action commenced by a customer who alleged that consumption of the Company's products caused severe nausea and loss of feeling in both feet. The Company believes that the complaint is without foundation.

EXPERTS

The consolidated financial statements of the Company have been so included in reliance on the reports of Hooper Firebrand, independent accountants, given on the authority of that firm as experts in auditing and accounting.

FINANCIAL STATEMENTS

[Text and tables omitted.]