- Report on Business

INVESTING

The incredible shrinking stock market

A stock ticker display outside the TSX in Toronto.

FRED LUM/THE GLOBE AND MAIL

An investor's hunt for the hot new stocks is getting harder every year. Amid mass delistings and a wilting market for IPOs, the options are vanishing. Where have all the public companies gone?

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2 Comments

Starting up a software company catering to the oil patch seemed like a good fit for Glen Gray and his brother back in the early 1990s.

Between them, they had engineering and computer-science expertise. Microsoft had recently introduced a version of Windows that represented a major advancement in operating systems. And the brothers were from Calgary.

So it was that Peloton Computer Enterprises was born.

They landed a demo of their data-management product for oil wells with Exxon – then the largest publicly traded company in the world. The brothers would soon get Exxon's business, and the company remains a client to this day.

Over almost three decades, that two-man software startup became the global front-runner in oil-well data management, and now employs about 100 people in 11 countries. About 70 per cent of the world's oil wells are in Peloton's system. And the most important figure: The company has a $1-billion valuation.

Now Mr. Gray needs to unlock some of that value. The company has been entirely self-funded through its history, but some of Peloton's earliest shareholders – all current and former employees – want to cash in on the company's success. The need for liquidity is just the kind of issue traditionally solved by an initial public offering.

But while the idea of going public is a natural next step, for Mr. Gray, it's more like a last resort. "I really don't want to if I don't have to," he said. "With the public market, you get a lot more pressure for short-term results. And it would be tough for me to keep explaining things to investors."

Instead, he will probably either sell to a foreign acquirer or take a big cheque from a private-equity firm. Big numbers have already been discussed with American PE investors, he said. An IPO is a distant third choice.

Many other Canadian entrepreneurs needing liquidity or capital to support the next phase of growth are also turning their backs on the public markets. What was once a rite of passage for the best private companies is increasingly being displaced by alternatives that don't carry the extraordinary burden of leading a public enterprise.

This kind of retreat from the public route is apparent in the wilting IPO market, which has squeezed the pipeline for new listings. IPOs on the Toronto Stock Exchange have declined steadily over the past decade, with last year seeing a grand total of three new issues.

The roster of existing listings on major exchanges is also in long-term decline, as hundreds of stocks vanish from North American exchanges year after year. The two trends – fewer IPOs and mass delistings – have combined into what researchers have called the "systematic decline" of public equities. And it seems to be part of a financial megatrend fundamentally

reshaping North American markets.

Just since the end of 2008, the number of corporate listings on the Toronto Stock Exchange (TSX) has declined 30 per cent to 861 from 1,232. U.S. listings have fallen by nearly half over the past 20 years, and are now at a level on par with the early 1970s, when the U.S. economy was one-third of today's size.

Three new corporate listings were added to the TSX in 2016, a far cry from the 79 IPOs that joined the market in 2005.

MARK BLINCH/REUTERS

Publicly listed companies have to disclose a great deal of information on how they operate and how they perform, but every company like Peloton that chooses to stay private will remain out of public scrutiny. And it will remain off limits to average Canadians saving up for retirement, who have an ever-shrinking roster of stocks to choose from.

What is to blame for the exodus from public financial markets? The rise of private capital and excessive regulation are often named as the primary culprits. Another is that younger companies seem inclined to sell out sooner. Most likely there is no single cause, said Bryce Tingle, who holds the Murray Edwards chair of business law at the University of Calgary. For him, it all boils down to this: "We have made the public markets a very unpleasant place to be."

Keeping private

Canadian investors are by now terribly familiar with the distortions in the domestic stock market: big-bank dominance, heavy resource concentration, few consumer stocks and minimal health care and technology representation. The country's main stock index – the S&P/TSX composite index – has just 11 tech companies with valuations of at least $1-billion. Only six of them are software stocks. None are doing quite what Peloton does.

Peloton is "precisely the kind of company that Canada needs in its public markets," Mr. Tingle said.

But the rigours of being a public company these days have little appeal, Mr. Gray said. He is deeply involved in the day-to-day operations of his business, and being a public CEO would add a new set of responsibilities, whether attending to regulatory requirements, financial reporting, or investor relations. "Other parts of the business would suffer because of that," he said.

Mr. Tingle said he's encountering that kind of aversion to public markets a lot these days. "You now find people who've run three or four public companies in the past, who are bending over backward to not go public this time around," he said. "They say they just don't want to put up with the grief."

Today's public companies face enormous pressure to deliver smooth quarterly earnings or risk incurring the market's wrath if analyst forecasts are not met. "You have two bad quarters, and 40 per cent of your stock gets sopped up by hedge funds, and they're changing the board on you," said Tom Liston, managing partner at Difference Capital Financial.

Two Canadian companies that struggled under the market's system of quarterly performance reviews were construction firm Canam Group and LED lighting company Lumenpulse. Both saw their stocks punished for failing to meet the Street's earnings expectations. And both ultimately opted out of the public space altogether with deals to go private in late April. "I think there's a disconnect between the pace at which we see our business going and what the markets were expecting," Canam CEO Marc Dutil, said in an interview with The Globe and Mail.

For managers repelled by intense public attention, an alternative has arisen in the form of private funding. "Today the dollar amount available for investment in private companies is staggeringly higher," said Tom Kennedy, the founder of Kensington Capital Partners, a Toronto-based venture capital (VC) investor.

Although the Canadian private markets have evolved in recent years, most of the firepower is concentrated in U.S. private capital. U.S. private-equity and VC firms controlled $1.2-trillion (U.S.) in assets under management by the end of 2016 – a tenfold increase over the past 20

years, according to a Credit Suisse report. And the big U.S. players are finding the Canadian market to be a bountiful hunting ground.

Traders work on the floor of the New York Stock Exchange. U.S. listings have fallen by nearly half over the past 20 years.

JIN LEE/BLOOMBERG

Canadian health-care software firm PointClickCare Technologies looked all set to go public on the Nasdaq and TSX when it received a better offer – $85-million (U.S.) in a private financing led by San Francisco fund Dragoneer Investment Group announced in February. "We found that there were private alternatives that looked as good as public ones," PointClickCare founder and chief executive officer Mike Wessinger said. "They had roughly the same terms, but without the obligations of quarterly reporting, earnings calls, and that sort of thing.

"On a near tie, you're going to go private every time."

Not only has private capital become abundant at attractive valuations, allowing younger companies to incubate longer, but general attitudes regarding public versus private seem to have shifted. It used to be that going public was seen as "far sexier" than being private, said Ungad Chadda, the president of capital formation for equities at exchange operator TMX Group Ltd. "The other folks on the private equity side have done a good job branding it as, 'Why would you go into the throes of being public?'" Going public needs a rebranding of its own, to bring back "the appropriate balance," Mr. Chadda said.

Once a private investor is involved, that company might never IPO. The preferred exit is generally through being acquired by another public company. Over the past four years, venture capital investors have exited positions in Canadian companies through mergers and acquisitions in 125 deals, while just 14 exits took place through IPOs, according to data from the Canadian Venture Capital and Private Equity Association. "They pay cash, and by and large you get your money out the day you close," Kensington's Mr. Kennedy said.

The finality of a takeover was a big selling point for Cambridge Global Payments, which just this week, sold to U.S. work-force payment company FleetCor Technologies for $900-million (Canadian). Over 25 years, the Toronto-based company, which processes payments between businesses and their clients or employees, has grown from a two-person startup, to the second-biggest non-bank company of its kind in the world behind Western Union. It now has 470 employees, is growing at more than 25 per cent a year and, in a previous era, would probably be looking at an IPO.

"Just getting to market is an unbelievably tedious task. I would be using half of my leadership team working on that," said Gary McDonald, Cambridge's CEO. The pressures don't exactly ease up once a company has gone public. "You look at the disclosure, the legal requirements, the scrutiny you go through," Mr. McDonald said. "I've seen a lot of companies get listed and it really drags them down."

Gary McDonald, CEO of Cambridge Global Payments, at the company's Toronto offices.

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The regulatory environment for listed companies isn't exactly welcoming either, particularly in the United States. There, the cost and risk of being an officer in the public company increased dramatically with reforms enacted in response to accounting scandals such as Enron, and again in the aftermath of the global financial crisis. While elements of the governance reform movement made their way north, regulatory changes here were largely discretionary and watered down, Mr. Tingle said in a co-authored study. "We have nevertheless succeeded in dramatically increasing the exposure of managers to shareholder pressure."

Canadian managers today have their compensation and personal details made available for virtually anyone to access. CEOs report that investor relations and satisfying the many gatekeepers – securities regulators, stock exchanges, proxy advisers and auditors – take up most of their time, Mr. Tingle said. The average tenure of a Canadian CEO has declined to 6.3 years from 8.1 years between 2000 and 2009. In 2013, Encana Corp.'s then-CEO Randy Eresman stepped down, reportedly "fatigued" with the public marketplace.

"Presumably they originally got into business because they wanted to do business, but that isn't what they get in the public markets," Mr. Tingle said.

IP-no

Public companies come and go. Some get bought. Others go belly up. A few break the rules and are forced to delist. That's why new listings are the lifeblood of the capital markets. The problem is that businesses aren't going public like they used to.

"Every situation is unique," said Kirby Gavelin, the head of equity capital markets at RBC Dominion Securities Inc. "People are making decisions based on how they evaluate their own best interests and what the other alternatives are. People are making choices." And more companies are making the choice not to go public.

Last year was the worst on record for IPOs in Canada since PricewaterhouseCoopers began surveying the market in 1998. The three new corporate listings on the TSX in 2016 were a far cry from the 79 IPOs that joined the country's senior market in 2005. It's even fewer than the five that listed in 2009, in the midst of the financial crisis.

Bankers have said some IPO candidates never made it to the public market because they were able to fetch higher valuations by selling their companies outright. Others choose to shelve their listing plans in turbulent markets, find money elsewhere and wait for brighter days.

Aritzia Inc. snapped a months-long IPO drought last October, in between the summer Brexit vote and the fall U.S. election. Bankers have said the clothing retailer's success out of the gate amid choppy global markets emboldened the likes of Freshii Inc. and Canada Goose Holdings Inc. to pursue stock offerings of their own. When their dual-class shares made it to market during the first quarter of this year, investors lined up to get a slice of the offering, gobbling up the deal in the hopes of either diversifying their portfolios or hastily flipping their positions for a pretty penny.

A new year has brought some life back into the new-listings space, with several companies hitting the market, headlined by Canada Goose.

FRED THORNHILL/REUTERS

But, in the equity market, sentiment can turn on a dime. Any stock, especially a newcomer, can be hot today and cold tomorrow – and some entrepreneurs who have poured their life savings

into their businesses would rather avoid this daily roller coaster if they could.

By January, Aritzia's early backers pressed their luck and sold more stock to the public, this time at $17.50. The company's share price took a hit and has never recovered, closing Friday at $14.95. Freshii has seen the momentum around its stock wane. After pricing its IPO at $11.50 and trading above $15 in March, the shares have retreated to $13.50.

Despite the dearth of IPOs, investors still aren't clamouring to own everything that's being sold to them. Last month, Source Energy Services Ltd. became the first Canadian energy firm to complete an IPO in 2 1/2 years. The energy services firm sold its shares for $10.50, a price well below what the company and its private-equity owners had initially hoped to raise. STEP Energy Services Ltd. ran into the same conundrum this week with its IPO.

After an optimistic start to 2017 in the energy patch, tumbling oil prices have put a dent in valuations, which will likely keep energy companies considering an IPO from the sidelines.

Making matters worse for many of these businesses is the regulatory burden they face as they prepare to IPO, then become and stay public. It's a regime that some describe as costly, cumbersome and time-consuming.

"It's a bit of a shock to the system when [companies] recognize the true extent of all their obligations," said John Sabetti, a lawyer at Fasken Martineau DuMoulin LLP who advises clients on IPOs and other money-raising transactions. "The cost of regulatory compliance, it's expensive for issuers."

Canadian securities regulators have taken notice. This year, they kicked off a review aimed at reducing the regulatory burden on reporting issuers. It comes as the administration of U.S. President Donald Trump promises to roll back a raft of financial rules, which could make the process of raising money in the United States cheaper, faster and easier.

"If you could ease the regulation that would facilitate more public market financings," said Ian Russell, who heads up the Investment Industry Association of Canada. "The regulators have put that down as a priority. They need to move on and achieve some results."

A new year has brought some life back into the new-listings space. So far in 2017, several companies have hit the market, headlined by Toronto-based parka maker Canada Goose, and others are working with their bankers to test the waters for an IPO. And these bankers say that there's more to come – as long as the market stays receptive.

"Many very good companies are currently considering an IPO," said Benoit Lauzé, head of equity capital markets at CIBC World Markets. "Our pipeline for the rest of 2017 is healthy."

But whether these companies make it to market, or get sold to the highest bidder before then,

remains to be seen.

The big get bigger

When a listed company disappears from the public market, more often than not it has been acquired by a larger public entity. At least in the U.S. market, research suggests that the recent wave of mergers and acquisitions has been the cause of most delistings.

As a result, the listings that remain have gotten bigger and bigger. Over the past 20 years, the size of the average publicly traded firm has tripled in real terms, according to a study co-written by Yelena Larkin, assistant professor at York University's Schulich School of Business. "This phenomenon has been fuelled by consolidation of public firms into mega firms," the paper said.

The biggest corporations have become planet-sized, sucking in an incredible concentration of value and profits into their orbits. As of 2015, 35 firms accounted for half the assets of all U.S. public companies, while 30 accounted for half the profit, according to a National Bureau of Economic Research (NBER) working paper. Similar patterns seem to be at play in the Canadian market. Since 2008, the market capitalization of the average TSX stock has more than tripled. "Industries are more concentrated and the average company that has a listed stock is bigger, older, more profitable, and has a higher propensity to disburse cash to shareholders," Michael Mauboussin, head of global financial strategies at Credit Suisse, wrote in a recent report.

More than three-quarters of U.S. industries have become more concentrated over the past 20 years, as companies have bought up rivals at an unprecedented pace. "A small number of firms account for most of the market capitalization, most of the net income, most of the cash, and most of the payouts of public firms," according to an NBER paper titled Is the American Public Corporation in Trouble?

Many factors seem to be contributing to the frenzy of deal making, which has seen U.S. deal volume hit a record high of $2.8-trillion (U.S.) in 2015, while the $2-trillion-mark has been topped in each of the past three calendar years. Lax enforcement of antitrust laws has been an important driver in facilitating consolidation, Ms. Larkin's paper said. But perhaps the best explanation is that larger companies are able to extract higher profit margins through weakened competition. "Mergers have become more profitable over time," the authors wrote. "Excess profits may be driven by higher market power, thus emphasizing the importance of industry consolidation."

With incentives to become ever larger, U.S. corporate acquirers have become eager suitors of Canadian small-cap companies, particularly in the tech sector.

Delistings in Canada: small-cap carnage

When Vancouver-based consumer payments processing firm TIO Networks announced in February it had been sold to PayPal Holdings Inc. for more than $300-million (Canadian), Beacon Securities analyst Gabriel Leung lamented the loss. "The universe of Canadian small-cap technology stocks continues to shrink," Mr. Leung wrote in a note titled: "Desperately Seeking New Stocks To Cover."

The wave of delistings in Canada has carved a swath through the market for smaller stocks in particular. And now that the small-cap space has rebounded in price in recent months, few are paying attention. One-quarter of the boutique brokerages have disappeared, fewer sell-side analysts track that segment of the market, and the number of funds focusing on smaller stocks has dwindled.

The carnage in the small-cap space was made considerably worse by the commodity downturn. As the global resource complex tipped into a long-term decline in 2011, it pulled the market for smaller Canadian stocks into a brutal selloff. Resource concentration is a pervasive Canadian vulnerability, but the smaller segments of the Canadian market are even more heavily weighted in commodities. Prior to the downturn, the S&P/TSX Venture composite index had a combined energy and materials weighting of about 75 per cent. As a result, that index fell by 80 per cent between 2011 and early 2016, with the lows hitting depths not even visited through the worst of the global financial crisis. The S&P/TSX SmallCap Index, which tracks lesser-known names on the main exchange, dropped by nearly 50 per cent over the same time.

For years, the bread and butter for many Canadian boutique dealers has been in advising, investing in and promoting fledgling energy and mining companies. But those stories became much harder to sell to the Street after the latest rout in commodity prices. Since 2012, 46 boutique dealers have shut their doors, either by going out of business, merging with other firms or relocating to another corner of the financial services sector.

But commodity prices are not solely to blame for the attrition in Canadian small caps. That trend seems to have been in place long before the most recent commodity sell-off, according to Mr. Tingle. Smaller companies are not going public at the pace they once did. And acquisitive U.S. companies have proven to have an appetite for promising Canadian small caps. "That's particularly true in areas like technology. Apple, Google, and Cisco are coming up here to buy promising startups," Mr. Tingle said.

The remaining small Canadian tech stocks that might be next targets of U.S. takeovers include Montreal-based supply chain software company Tecsys Inc., Toronto-based fleet management company BSM Technologies, and Quebec City-based H2O Innovation, which designs water treatment systems, according to Mr. Leung. "While it's disappointing to see good companies

go, this has been an ongoing theme in the Canadian marketplace and will continue to remain so," he wrote.

Implications for investors

PointClickCare, the Canadian software firm that backed off a planned IPO in February, remains open to going public at some point. But until the calculus shifts back in favour of the IPO, ordinary Canadian investors find themselves shut out of yet one more promising IT play. Since Shopify went public in 2015, there have been zero tech IPOs in Canada, though mortgage services firm Real Matters is set to end that particular drought. As long as entrepreneurs can receive good valuations elsewhere, they will be inclined to stay private for longer. "This means that investors who do not have access to venture capital are missing substantial gains," Michael Mauboussin, head of global financial strategies at Credit Suisse, said in a recent report. That would include virtually every ordinary Canadian retail investor.

Mr. Mauboussin cited Uber and Airbnb as examples of American companies building a great deal of value privately, with their latest valuations together totalling about $100-billion (U.S.). By contrast, Amazon.com went public in 1997 – three years after its founding, at a market cap of $625-million. Investors in the IPO would have made 565 times their money, he wrote.

As the investible arena for average Canadians has thinned out, what remains available to retail investors is a public market increasingly dominated by the biggest companies, commanding an increasing share of profits, market value and investor attention.

Investor preferences in general have also homed in on the largest stocks. The preference for size has been fuelled by the hunt for yield in an era of paltry interest rates, while growing awareness around fees and the rise of passive investing strategies funnel investor money into the biggest names. "There is just not as much small-cap money as there used to be," Mr. Liston said. Aging demographics in Canada have exacerbated a demand for yield from stock portfolios, and larger, stable companies are in the best position to oblige in the form of dividends.

Growing awareness of fees, meanwhile, has given rise to passive, low-cost equity exposure, facilitated by the spread of exchange-traded funds. "Everybody just wants extremely passive money at low cost," Mr. Liston said. Vanguard Group, which helped popularize the index fund, is currently taking in as much as $2-billion a day in new investor money. On average, the larger names are the biggest beneficiaries of the passive investing phenomenon.

As the number of public listings declines, it gets harder for active managers to differentiate themselves. Funds start to look more and more alike. "When your universe shrinks, it's harder for active strategies," said Craig Doidge, a finance professor at the University of Toronto's

Rotman School of Management. “Everyone is looking under the same lamppost.”

Last year, just 17 per cent of active Canadian fund managers focusing on domestic stocks beat the S&P/TSX composite index, according to numbers released by S&P Dow Jones Indices.

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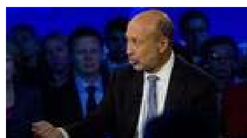

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