

Accounting for the interaction between investment banks and lenders in IPO underpricing in Canada

By

Yu Du

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Approved: **Dr. Colin Dodds**

Faculty Advisor

Approved: **Dr. Francis Boabang**

MFIN Director

Date: September 4, 2013

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Abstract

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This paper investigates the effects of pre-IPO banking relationships on a firm's IPO. Using the data set, which compares the firm's pre-IPO banking relationships to the underwriters managing the firm's new issue, I test whether banking relationships established before the firm's IPO ameliorate asymmetric information problems behind high IPO underpricing. The results show that firms with a pre-IPO banking relationship with a prospective underwriter face about 45.7% lower underpricing than firms without such banking relationships.

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Chapter 1 Introduction

1.1 Purpose of study

Capital is a critical factor for all firms. They use it to finance new projects, expand operations, or in many cases, just to start up their business. Making the firm go public is one of the best ways that companies have found to raise additional capital. Historically, Initial public offerings (IPOs) had very large first day gains compared to the performance of the rest of the market. To explain the IPO underpricing, numerous studies have been conducted and most of these theories attribute the first-day IPO underpricing to the existence of information asymmetry between certain parties in the IPO process. In this IPO arena of discussing an initial public offering, each player has its own rational adjustments and acts toward its own financial purpose, thus the asymmetric information problem cannot be avoided.

According to past research on this topic, obtaining accurate information about the issuing firm is the key part of the pricing of a company's stock in the IPO. Unfortunately, the underwriting bank is uninformed about the firm's value in most cases. However, if the investment bank can generate more accurate information of the firm, a question to pose is, can this reduce the asymmetric information problem?

According to my research, when a bank lends to a firm, it obtains more precise, firm-specific information that cannot be easily and credibly conveyed to others. Thus, lending relationships may reduce asymmetric information problems between a firm and its bank.

Even the lender cannot directly participate in the firm's IPO, but the lender's subsidiary-investment bank can.

This paper focuses on the interaction of investment bank and firm's lenders. The purpose of this paper is to investigate whether lending relationships established prior to the firm's IPO with a bank that can manage the IPO by itself or has subsidiary investment bank to take the firm go to public can moderate the asymmetric information problem that the issuing firm faces, and reduce IPO underpricing consequently.

1.2 Background

Starting from 1926, studies of Canadian IPOs' underpricing have been carried out over the past 30 years (Shaw, 1971), and the techniques used in such studies have become relatively standardized, which permits us to see the historical trend of Canadian's IPO underpricing. Between 1971 and 1983, Jog and Riding (1987) reported that the average short-term return of the IPO is 11.5%. During the period 1979 to 1985 in the Toronto Stock Exchange, Suret, and Lemay (1990) reported that for the average initial returns of 86 IPOs, it was 12%, but with no underpricing for 63 IPOs issued under the Quebec Stock Saving Plan (QSSP). Jog and Srivastava (1994) extended the empirical analysis of Jog and Riding (1987) and reported average initial returns of 5.67% between 1984 and 1992. Considering all the Canadian IPOs made from 1993 to 1994, Jog (1997) again extended the analysis of Jog and Srivastava (1994) and reported average initial returns of 7.89%. He (1997) pointed out that the degree of underpricing in Canada was much lower in the 1980s and the early 1990s than had been reported for previous periods. Table 1.1 summarizes the findings of these and other studies.

Table 1.1 Historical Underpricing in Canadian IPOs

Study Authors (Date of study)	Period Studies	Average Underpricing(per cent)
Krinsky and Rotenberg(1989)	1971-83	11.6
Jog and Riding(1989)	1971-83	9.96
Jog and Srivastava(1994)	1971-92	7.87
Jog (1997)	1971-94	8.43
Clarkson and Merkley (1994)	1984-87	6.44
Kryzanowski and Rakita (1996)	1984-93	4.18
Ursel and Ljucovic (1998)	1987-94	3.64

From the studies associated with the IPO underpricing in Canada we can see that this abnormal phenomenon is consistently existed, which means there is still a motivation to study the reasons behind this phenomenon. Considering the specific area this paper focuses on, it is important to provide a background of the banking structure of Canada.

In Canada, there are nearly 30 dealers that actively participate in the IPO market. Since the beginning of 2000, each of the dealers listed below was involved in a minimum 10 IPOs as the lead underwriter. They have been grouped into the following three categories: full-service bank owned firms, full-service independent firms and specialized institutional boutiques.

- Full Service Bank Owned: Scotia Capital Inc., National Bank Financial Inc., BMO Nesbitt Burns Inc., RBC Dominion Securities Inc., CIBC World Markets Inc., and TD Securities Inc.

- Full Service Independent Firms: Raymond James Ltd., Canaccord Financial Limited, Dundee Securities Corporation.
- Specialized Institutional Boutiques: Global Securities Corporation, Blackmont Capital Inc., Bolder Investment Partners, Ltd., Macquarie Capital Markets Canada Ltd., GMP Securities Ltd., Integral Wealth Securities Limited, Investpro Securities Inc., Jones Gable & Company Limited, Jennings Capital Inc., , Leede Financial Markets Inc., Northern Securities Inc., Merrill Lynch Canada Inc., Union Securities Ltd., Octagon Capital Corporation, PI Financial Corp, Research Capital Corporation, Desjardins Securities Inc. Wellington West Capital Inc., Wolverton Securities Ltd.

Between the years from 2005 to 2009, there were over 800 IPOs on the TSX Venture Exchange (TSXV), raising nearly \$1.5 billion in capital for these companies. There were \$3 billion capital was raised through a further 230 public offerings. For companies listed on the TSXV, the most popular financing vehicle is private placements. In the past five years, 10,000 private placements were conducted by small companies to help them generate over \$30 billion.

There have been approximately 2,400 IPOs completed in Canada over the last ten years. An estimated \$90 billion was raised through these IPOs for these firms. However, in Canada, 85% of total dollar value underwritten was concentrated with the 500 largest IPOs. In the past ten years, there were active players among large and small dealers in the Canadian IPO marketplace.

1.3 Need for the study

There are two basic things needed to be studied in this paper. The first one is the degree of underpricing of the firm's IPO. The second is the bank relationships between the firm and the underwriter.

The degree of underpricing is defined as:

$$\text{Underpricing} = (\text{First closing price} - \text{offering price}) * 100 / \text{offering price}$$

To identify the bank relationships, we examine the lending relationship between the investment bank and the firm. As we know, the investment bank has no lending power, but it may have a relationship with the firm's lenders-commercial bank. For instance, the underwriter may be TD Securities Inc, which is part of the TD bank group, and the TD bank group may be the lender of the IPO's issuer firm. In this case, the interaction between the TD bank group and TD securities Inc may have influence in the IPO pricing process. Since the lender generates more accurate information about the issuing firm's true value it can have a direct influence on its subsidiary.

Chapter 2 Literature review

Over the last 30 years, many researchers have conducted studies about the underpricing of IPOs and there are three main perspectives of these theories including allocation of shares, underwriter reputation and asymmetric information. The next section will give a review of these theories.

2.1 Theories that focus on the allocation of shares

In recent years, how IPOs are allocated and how their shares trade have become more attractive for researchers' attention. Many analysts argue that there is unfairness in how shares are allocated given the large amount of money left on the table. Particularly, the allocation of shares among institutional investors and individuals has been a topic of interest.

The model focusing on the allocation of shares was put forward by Benveniste and Spindt (1989). They reported that underwriters use their discretion to abstract information from investors, which reduces average underpricing and increases proceeds to the issuers. As Sherman (2000) has pointed out, the ability to allocate shares in future IPOs to investors of the underwriters can reduce the average level of underpricing required inducing information exposure. Sherman and Titman (2002) also argue that there is an equilibrium degree of underpricing which compensates investors for acquiring costly information.

Loughran and Ritter (2002) explore the conflict of interest between underwriters and issuers. Given discretion in share allocations, underwriters will not use this in the best

interests of the issuing firm. Conversely, underwriters might purposefully leave more money on the table than necessary, and then assign these shares to favoured buy-side clients. Loughran and Ritter also argue that if the managers learn about a post-market valuation that is higher than what they expected, they are more tolerant of excessive underpricing. In other words, the greater the recent increase in their wealth, the less is the bargaining effort of issuers in their negotiations over the offer price with underwriters.

2.2 Theories that focus on the underwriter reputation

When a company make a decision to go public, choosing an investment banking partner with the capability to successfully execute an IPO becomes a very important issue to the company. Because of the bargaining process that occurs in the secondary market with investors, there is a significant influence on a company's stock price through the right choice of underwriter. The investors' opinions about the quality of an issuer and its long-term prospects may be significantly affected by the underwriter's reputation.

Logue et al, (2002) claimed that because a firm typically goes public only once, issuers may not rely on their own reputation and aftermarket performance to sell shares efficiently.

They typically rely on the underwriting services of an investment bank to execute their IPOs. Therefore the underwriter's reputation becomes a crucial issue in the IPO process.

The ability and knowledge possessed by an underwriter is assumed to be a proven guarantee for the company. A reputable underwriter will increase the issuer's confidence that their public bidding process is being handled properly. Furthermore, investors also expect issuers to use an experienced underwriter who acts as a assurance for them in making their investments in the new shares.

Numerous studies have explained that the underwriter bank with higher reputation tends to underprice less. They conclude that the expected level of informed investors' activity is affected by the level of the banker's reputation. As a result, the incentive of an investor to acquire information becomes less with lower risk as agency costs are perceived to be lower. Hence a smaller number of informed investors are invested in the IPO with prestigious bankers.

Betty and Ritter (1986) report that the bankers with high reputation are associated with lower risk issues than the non-prestigious bankers. Carter and Manaster (1990) state that with the execution of high quality underwriters, less money has been left on the table for the investors. Kooli and Suret (2001) proved that firms go public with a prestigious underwriter in Canada's IPO market generate 9.37% level of underpricing compared with the firm's IPO handled by a less reputable underwriter reaches 31.13%. They concluded that the level of underpricing of IPOs is correlated with the reputation of the underwriter.

2.3 Theories that focus on asymmetric information

Many theorists blame the asymmetric information problem regarding the issuing firm's value as the cause of the underpricing of firm's IPO. Allen and Faulhaber (1989), Grinblatt and Hwang (1989), and Welch (1989, 1992) assume that the only informed party in the IPO is the issuing firm. To separate high-quality firms from low-quality firms, underpricing is the costly signal that the high-quality firms have to choose. In the research of Rock (1986), it assumes that none of the firms or their underwriters or the remaining investors know the

firm's true value. Only a random group of investors can achieve the information about the firm's value. In this case, these uninformed investors can get compensation for their biased purchases of lower value firms through the IPO's underpricing. Benveniste and Spindt (1989) and Benveniste and Wilhelm (1990) also assume that both the underwriting bank and the firm are unaware of the firm's true value, but they further assume that there are some investors who are informed about the firm's prospects through repeated interaction with the investment bank. In this scenario, underpricing compensates informed investors for revealing their private information to the investment bank. Muscarella and Vetsuypens (1989) find that in some situations where asymmetric information is low like self-marketed IPOs and IPOs of reverse leveraged buyouts, underpricing is also lower.

Michaely and Shaw (1994) test Rock's model and find that in markets where uninformed investors with a priori knowledge that they do not have to compete with informed investors, IPOs are not highly underpriced. Cornelli and Goldreich (2002, 2003), and Aggarwal, Prabhala, and Puri (2002) find evidence that investment banks implement book-building theories to allocate more underpriced shares to institutional investors in order to compensate them for revealing information about the issuer.

James and Wier (1990) point out that issuing private debt claims before issuing stock of a high-value firm is a signal that reduces asymmetric information since only high-value firms apply for, and are granted, inside debt. The authors investigate whether the firm had a bank loan and show that firms with inside debt at the time of the IPO, display lower IPO underpricing. In the period that James and Wier wrote their paper, commercial banks were restricted from managing equity issues by the Glass-Steagall Act. After its effective repeal,

the bank from which the firm borrowed prior to the IPO generates the ability of managing the firm's issue. This allows me to test whether the IPO underpricing can be reduced by having an established banking relationship with a potential underwriter.

Considering the effect of lending relationships, Rajan (1992) generates valuable information, including soft data such as a firm's prior projections, the reliability and competence of the firm's managers, and its ability to meet established targets to test the underpricing of IPO. There are also some other studies that examine the effect of the banking relationship that can reduce the asymmetric information problem associated with the underpricing of the IPO. For instance, the study conducted by Stein (2002) claims that the distinctive characteristic of small-business lending is that it relies on this soft data generated by the lending institution, such as the loan officer learning that the borrowing-firm's manager is honest and hardworking. Petersen and Rajan (1994) argue that the firm's credit availability is positively improved since the lending relationship reduces the asymmetric information problem between the firm and the lending bank. Chemmanur and Fulghieri (1994) show that banks have an incentive to spend many resources to monitor their borrowing-firm's activities, since doing so enables them to build a reputation for making the right decision on whether to liquidate the firm or renegotiate its loan when firms suffer financial distress.

Chapter 3 Methodology

3.1 Introduction of research design

The purpose of this paper is to investigate whether the banking relationship with the issuing firm can reduce the level of the underpricing of IPO. First thing is to decide how to define the IPO's underpricing. There are lots of models measures the underpricing of IPO.

The most commonly used method is the non-adjusted initial return which defined as follows:

$$\text{Initial return} = \frac{P_1 - P_0}{P_1} * 100\% \text{ ----- } 3.1$$

Where P_0 stand for the offering price and P_1 represents the first trading day closing price.

However, the return measured by the Equation 3.1 would be invalid when the market has a significant time gap between the application closing day and the first trading day. In this case we can improve the first method by adjusting the initial return for the market index return.

$$\text{Initial return} = \left(\frac{P_1 - P_0}{P_1} - \frac{M_1 - M_0}{M_1} \right) * 100\% \text{ ----- } 3.2$$

Where P_0 stands for the offering price and P_1 represents the first trading day closing price, M_1 is the market index on the first day of trading; M_0 is the market index on the application closing day.

The third method used by researchers is to adjust for the systematic risk of the firm. The initial return would be given by:

$$\text{Initial return} = \left(\frac{P_1 - P_0}{P_1} - \beta \frac{M_1 - M_0}{M_1} \right) * 100\% \quad \text{-----} \quad 3.3$$

Where P_0 stands for the offering price and P_1 represents the first trading day closing price, M_1 is the market index on the first day of trading; M_0 is the market index on the application closing day and β is the systematic risk of the firm.

In this paper, we only use the non-adjusted initial return which is the Equation 3.1 to measure the level of IPO underpricing. Because our focus is to investigate whether having a prior established bank relationship can reduce the asymmetric information problem, this reduces the level of underpricing and the time lag issue in the Canadian market is not significant. Therefore we do not need to adjust the initial return for the market index.

Once we determine the method of underpricing, the next step is to analyse the main factors that affect the level of the underpricing. In my research, I divided this section into two parts. The first part is to determine the banking relationship of the issuing firm and the underwriter bank. The second is a multivariate analysis by introducing factors that may have affected the IPO's underpricing, including the issuing size and firm's market capitalization. However, the focus is still on the examination of whether the effect of the banking relationship is significantly positive or negative.

In the first part, I classify the banking relationship into two categories and I use two dummy variables D_1 and D_2 to represent each category. If at least one of the banks that served the firm prior to the IPO could become the underwriter of the firm or the bank's subsidiary could underwrite the firm's new issuing, I define the $D_1=1$, if none of the banks can manage the firm's IPO, then the $D_1=0$. However, sometimes the firm has a loan with a prior

relationship that could help the firm go public and the potential underwriter actually did it. In this case $D_2=1$. On the contrary, if the firm does not choose the potential underwriter, but chooses to switch to another bank without a prior relationship to manage it go public then $D_2=0$. After identifying like this, we may generate three results:

The first is $D_1=1$ and $D_2=1$, which means the firm has a prior relationship with the bank and the bank actually did the firm's IPO.

The second is $D_1=1$ and $D_2=0$, which means the firm has a prior relationship with the bank, but moves to another bank to go public.

Third, $D_1=0$ and $D_2=0$, which means the firm has no potential bankers with a prior relationship so issues new shares with other bankers.

In the second part, I perform a multivariate analysis about the firm's IPO underpricing, it introduce two more main factors which are issuing size and company market capitalization.

The regression model is defined as (Equation 3.4)

$$\text{Underpricing} = \beta_0 + \beta_1 D_1 + \beta_2 D_2 + \beta_3 \ln(\text{FC}) + \beta_4 \ln(\text{IS}) + \varepsilon_i \text{ ----- } 3.4$$

D_1 and D_2 are the dummy variables which are already defined above. FC is the firm market capitalization and IS is the issuing size of the IPO.

The reason I introduce these two factors is that they are obvious signals to the investors.

The investor will likely be more confident with the firm's new issue with a higher market capitalization and issuing size. Thus these two factors have more influence on the trading of the new shares and therefore affect the IPO's underpricing. However, whether the effect is positive or negative is uncertain and I need to perform the regression analysis to obtain a statistical explanation of this phenomenon.

During the analysis process, the focus is still on the coefficient of the two dummy variables. I need to investigate whether these two coefficients are significantly positive or negative or there is no influence on the firm's IPO underpricing. In Sections 3.2 and 3.3, I will introduce data collection and hypothesis development.

3.2 Sample selection and Date collection

The sample period in this paper commences from 2009 to the first half year of 2013. I chose this period because I want to avoid the market performance abnormality associated with the financial crisis in 2008. As we know after the financial crisis, there has been a significant change regarding the financial services sector. By using 2009-2013, this will permit me to investigate whether the asymmetric information problem associated with the firm's IPO is still consistent in the post-period of the financial crisis.

The exchange I chose was the Toronto Stock Exchange (TSE) which is the biggest exchange in Canada. Most of the big IPOs are executed through the TSE, accounting for approximately 95% of all equity trading in Canada. Nevertheless, the TSX Venture Exchange has more IPOs executed than TSE in the last five years. However, its focus is more to help small companies raise capital and the issuing price of each share is very small. Therefore the underpricing level may be biased.

Once the two main conditions of the sample design were decided, I used the Fpinfomart.ca which is a reliable university data base that features current and historical corporate and financial information about the selected Canadian publicly traded companies to generate

the IPOs that occurred during the last 5 years on the Toronto Stock Exchange. The original sample size was 222 IPOs. However, this database does not give the first trading day closing price, so I used the Disnat IPO center to check the first trading date of each IPO. It is a reliable internet resource which is owned by Canada's leading financial service company, Desjardins Group. Once I obtained the first trading date of each IPO, then I go to the Toronto Stock Exchange website to get the historical price of each IPO. In the process of doing this, I dropped some IPOs as I can't find the first trading day closing price in the TSE website. This left me with 156 IPOs in my sample. Appendix A will give the details of these data. However, as there were only 30 IPOs that experienced underpricing out of these, then the final sample size was 30 IPOs. These samples are shown in Appendix B.

As the main purpose of my research is to identify the banking relationship prior to the firm's IPOs therefore I needed to find the history of the firm's borrowing information. To solve this problem, I used Dealscan which is the world's number one source for comprehensive, reliable historical deal information on the global loan markets. By comparing the loan information and the underwriter information of the firm, I could determine the dummy variable value in my regression model.

3.3 Development of the hypothesis

As developed in Section 3.2, if the firm has a banking relationship with the underwriter, the asymmetric information justification for IPO underpricing is no longer tenable and then we can expect the underpricing level would be lower.

However there are three different cases we should consider; (i) did the firm have a lending relationship with the bank, and go public with this bank; (ii) did the firm have a lending relationship with the bank, but switch to another bank without this relationship and; (iii) the bank had no relationship with the underwriters.

Intuitively the level of IPO underpricing would be expected to be low if the firm had a prior bank relationship and could manage its IPO, but it switched banks and went public with another bank. The reason behind this is the issuing firm had the option of going public with the bank that had private information about its value. If the firm went public with one that did not know the firm instead of the bank that knows the firm well, then the firm's type would be revealed to the market. At this point, asymmetric information would be lower and hence so would underpricing.

To illustrate this, consider a simple context. Let there be two types of firms, low-value firms valued at V_L and high-value firms valued at V_H , and two types of banks, the relationship bank (informed about the firm's 'true' value) and the non-relationship bank (the uninformed bank). These two banks compete for underwriting the firm's IPO. Take the case of the low-value firm which goes public with its relationship bank. This bank knows the firm is worth V_L , so it will offer to take the firm public and sell it for its worth V_L . Suppose this low-value firm did not choose the relationship bank, but the uninformed bank. This bank does not know the 'true' value of the firm but still takes it public. If this bank were to offer the issuing firm anything above V_L , as a result the bank would lose its reputation. If the loss of reputation for selling the firm's new shares above its true value is large enough, the uninformed bank will never execute the new issues at anything above V_L .

Thus, V_L will be the equilibrium value that the uninformed bank offers firms approaching it, and hence we can see only the low-value firms will switch underwriters. In general, only the uninformed bank will offer a low price to all firms that approach it. High-value firms will keep their relationship bank to help them go public. Thus when the firm switches banks it is observed by the market, and investors will immediately understand it to be a low-value firm. Hence the asymmetric information associated with the firms that switch banks is low, and the underpricing consequently should be lower for these firms.

In summary, the prediction that firms with an established relationship with a bank that can take them public but switch banks are expected to exhibit lower underpricing. The case of the relationship bank cannot take the firm public will have a high asymmetric information problem, and thus high underpricing.

Based on the above analysis, our hypotheses can be developed as follows:

Hypothesis 1: The coefficient of the dummy variable is negative (which means that the effect of the relationship between the lender and investment bank regarding the underpricing of IPO is negative).

Hypothesis 2: The coefficient of market capitalization is negative (which means that the market capitalization is negatively affecting the level of the underpricing).

Hypothesis 3: The coefficient of issuing size is negative (so issuing size is negatively affecting the level of the underpricing).

Chapter 4 Analysis of the results

4.1 The lending relationship

The share of the firms in my sample that have a lending relationship with a bank and actually go public with the bank, $D_1=1$ and $D_2=1$, is 40%. The share of firms in my sample that has lending relationship with the bank, but switches to another bank to go public, $D_1=1$ and $D_2=0$, is 30%. The share of firms in my sample that had no available relationship to a bank to execute its IPO, $D_1=0$ and $D_2=0$, is 30%. Table 4.1 will give a comparison of the level of these firms' underpricing.

Table 4.1 Comparable results of firms' underpricing

Underpricing	D1=1		D1=0
	D2=0	D2=1	
Mean	3.973	3.263	6.02
Standard division	2.61	4.60	6.52
Max	18	12.09	9
Min	0.1	0.028	0.7
Number of observations	9	12	9
Sample (%)	40	30	30

These results show that:

1. the mean of the underpricing level of the firms that have lending relationship with the bank but switch to another bank to go public, $D_1=1$ and $D_2=0$, is 34% than the underpricing level of the firms that have no choice to go public with its relationship bank, $D_1=0$ and $D_2=0$.
2. the mean of the underpricing level of the firms that lending relationship with the bank and actually goes public with the bank, $D_1=1$ and $D_2=1$, is 45.7% lower than

the underpricing level of the firms that have no choice to go public with its relationship bank, $D_1=0$ and $D_2=0$.

- the mean of the underpricing level of the firms that have lending relationship with the bank but switch to another bank to go public, $D_1=1$ and $D_2=0$, is 12.5% higher than the underpricing level of the firms that lending relationship with the bank and actually goes public with the bank, $D_1=1$ and $D_2=1$.

Recall that in our hypothesis analysis, the pre-IPO relationship with potential underwriter can reduce the asymmetric information problem; in this case the underpricing level should be much smaller than the firm without potential underwriter that has relationship with it. However whether the firm go public with this relationship bank or not does not have significant influence on the underpricing of the IPO. The results above actually prove these predictions.

4.2 The issuing factors (size and capitalization)

I classify the result of these two factors into three categories as $D_1=1$ and $D_2=1$, $D_1=1$ and $D_2=0$ and $D_1=0$ and $D_2=0$. The purpose of doing this is trying to connect the effect of these two factors with the banking relationship. Table 4.2 and 4.3 summarise the results.

Table 4.2 Results of the effect of the issuing size

Issuing size	D1=1		D1=0
	D2=0	D2=1	
Mean	1487737362	423162973	286356995
Standard division	2135350554	469689402	195175492
Max	6620600105	1496000000	663520008
Min	109445226	58151235	30073020
Number of observations	9	12	9
Sample (%)	30	40	30

Table 4.3 Results of the effect of the firm market capitalization

Firm market capitalization	D1=1		D1=0
	D2=0	D2=1	
Mean	29132206	16651435	19002444
Standard division	20979298	10520411	16337752
Max	63327000	34200000	58000000
Min	4850000	2500000	2800000
Number of observations	9	12	9
Sample (%)	30	40	30

4.3 The result of the multivariable regression model

The multivariable regression model we can recall from Chapter 3 is:

$$\text{Underpricing} = \beta_0 + \beta_1 D_1 + \beta_2 D_2 + \beta_3 \ln(\text{FC}) + \beta_4 \ln(\text{IS}) + \varepsilon_i \text{-----} 3.4$$

By introducing issuing size and firm market capitalization into this model, the result of the regression model are summarised in the Table 4.4.

Table 4.4 Results of the multivariable regression model

variables	coefficient	Standard division	t-statistic	P value
D1	-0.5452388	2.453255	3.21	0.026
D2	-1.791652	2.271027	2.79	0.038
Ln(FC)	1.288009	0.9575232	1.35	0.191
Ln(IS)	-2.752463	1.309143	-2.10	0.046

The empirical evidence indicates as follows:

1. β_1, β_2 are both negative and significant at the 95% confidence level, which proves our first hypothesis. Therefore, it indicates that the firms that go public with the bank that had a prior banking relationship reduce the asymmetric information problem and thus reduces the degree of underpricing.
2. β_3 is positive but it's not significant at the 95% confidence level, which leads us to reject our second hypothesis. However the coefficient is not statistically significant so there is not enough explanatory power of this factor for the IPO's underpricing.
3. β_4 is negative and significant at the 95% confidence level, which supports our third hypothesis. Therefore, it shows that the firms with a higher issuing size have less degree of underpricing of the new issues.

Chapter 5 Conclusion

In this paper, we tried to answer two questions. The first one is whether having a pre-relationship with a potential banker can reduce the asymmetric information problem facing firms issuing equity for the first time. The second is whether the capitalization and issuing size have effect on the firm's IPO underpricing.

Given the prior empirical evidence reporting a negative correlation between asymmetric information and underpricing, if asymmetric information is in fact reduced following banking relationships with potential underwriters, then IPO underpricing should be lower for firms with these relationships. I test my hypothesis by using the dataset which compares the identity of the firm's pre-IPO bank to the underwriters managing the firm's new issue. The evidence reported here reveals that firms go public with an established relationship with a prospective underwriter and face a 45.7% lower underpricing than firms without a pre-IPO relation with an underwriter. In addition, I find that the main two factors, market capitalization and issuing size, have opposite effects on the firm's IPO underpricing. Capitalization has a positive effect on the level of underpricing of the firm's IPO, but issuing size has a negative effect.

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Appendix A

Legal Name	Market Capitalization	Amount Offered	Issue Price	First trading day closing price
Advantaged Canadian High Yield Bond Fund	43,456,200	4,045,620	10	9.95
Argent Energy Trust	250,345,000	21,222,000	10	10.07
Athabasca Oil Sands Corp.	6,992,678,592	75,000,000	18	16.9
Australian Banc Capital Securities Trust	153,715,860	14,581,576	10	9.75
Australian Banc Income Fund	85,798,020	8,160,300	10	9.9
Avigilon Corporation	139,595,791.50	5,554,446	4.5	4.5
Bauer Performance Sports Ltd.	225,345,862.50	10,000,000	7.5	7.45
Black Iron Inc.	192,290,642.60	25,000,000	1.4	1.43
Bloom Select Income Fund	54,748,130	5,000,000	10	9.86
Braeval Mining Corporation	56,260,671.60	16,667,000	0.6	0.5
Brand Leaders Income Fund	31,216,536	2,500,000	12	11.85
Brookfield High Yield Strategic Income Fund	129,250,000	12,500,000	10	9.9
Build America Investment Grade Bond Fund	33,613,000	1,270,700	25	24.85
Can-Financials Income Corp.	93,790,000	9,000,000	10	9.94
Can-60 Income Corp.	259,500,000	25,000,000	10	9.9
Canadian Advantaged Convertibles Fund	97,500,000	9,000,000	10	9.95

Canadian Convertibles Income Plus Fund	102,800,000	9,000,000	10	9.93
Canadian 50 Advantaged Preferred Share Fund	62,365,575	2,400,000	25	24.88
Canadian High Income Equity Fund	121,833,324	10,000,000	12	11.5
Canadian High Yield Focus Fund	41,444,316	3,400,000	12	11.75
Canadian REIT Income Fund	47,500,000	4,750,000	10	9.9
Canadian Utilities & Telecom Income Fund	60,720,000	4,900,000	12	11.5
CanBanc 8 Income Corp.	41,900,000	4,000,000	10	9.85
CanBanc Income Corp.	240,270,000	23,000,000	10	9.9
Canso Credit Income Fund	146,400,000	14,000,000	10	10
Chieftain Metals Inc.	58,151,235	2,500,000	5	5.9
Condor Petroleum Inc.	484,294,708.80	57,142,857	1.4	1.55
Coxe Global Agribusiness Income Fund	39,000,000	3,900,000	10	9.95
Crius Energy Trust	100,000,000	10,000,000	10	9.99
Diversified Alpha Fund II	50,690,000	4,800,000	10	9.95
Dividend Select 15 Corp.	97,800,000	9,000,000	10	9.85
Dundee Industrial Real Estate Investment Trust	407,846,310	15,500,000	10	10.9
Dundee International Real Estate Investment Trust	438,500,000	27,000,000	10	10.2
ENERGY INDEXPLUS Dividend Fund	64,800,000	5,400,000	12	11.8
Eagle Energy Trust	180,115,810	13,000,000	10	10.01
East Coast Investment Grade Income Fund	139,020,000	11,250,000	12	11.9

EcoSynthetix Inc.	496,671,480	11,150,000	9	9
Excel Latin America Bond Fund	30,073,020	2,800,000	10	10.35
FAM Real Estate Investment Trust	58,800,000	5,880,000	10	9.9
First Asset Canadian Dividend Opportunity Fund II	61,500,000	6,000,000	10	9.82
First National Mortgage Investment Fund	48,900,000	4,600,000	10	10
First Trust Advantaged Short Duration High Yield Bond Fund	83,208,360	6,709,030	12	11.8
Floating Rate Income Fund	66,720,000	5,400,000	12	11.82
Front Street Strategic Yield Fund Ltd.	71,200,000	7,000,000	10	9.7
GWR Global Water Resources Corp.	65,659,582.50	8,185,000	7.5	7.5
Gibson Energy Inc.	1,496,000,000	31,250,000	16	16.06
Global Advantaged Telecom & Utilities Income Fund	32,683,944	2,600,000	12	12
HBanc Capital Securities Trust		6,200,000	25	24.9
HealthLease Properties Real Estate Investment Trust	121,000,000	11,000,000	10	10.1
ING Floating Rate Senior Loan Fund	328,153,900	24,500,000	10	9.8
Ivanplats Limited	2,313,097,985.75	63,327,000	4.75	5.05
JFT Strategies Fund	91,000,000	9,100,000	10	9.88
KP Tissue Inc.	153,125,017.50	8,000,000	17.5	17.35
Karnalyte Resources Inc.	173,385,460	6,975,000	8.6	7.75
Legg Mason BW Investment Grade Focus Fund	34,750,000	3,200,000	10	10
Legumex Walker Inc.	124,973,442	7,225,000	9	8.85

Leisureworld Senior Care Corporation	191,500,000	19,020,000	10	9.99
Lithium Americas Corp.	136,020,140	24,324,400	1.85	1.84
Longview Oil Corp.	489,500,100	15,000,000	10	10.45
Low Volatility Canadian Equities Income Fund	30,865,050	3,000,000	10	9.82
Lupaka Gold Corp.	59,149,750.50	13,333,334	1.5	0.19
MEG Energy Corp.	6,620,600,105	20,000,000	35	35.01
Macquarie Emerging Markets Infrastructure Income Fund	56,400,000	4,200,000	12	11.74
Man GLG Emerging Markets Income Fund	106,289,210	10,049,921	10	9.8
Marquest Canadian Equity Income Fund	23,155,550	2,250,000	10	9.7
Marret Multi-Strategy Income Fund	196,680,000	15,835,000	12	11.8
Metals Plus Income Corp.	38,044,400	3,600,000	10	9.95
Midas Gold Corp.	342,036,292	12,307,700	3.25	3.26
Middlefield Can-Global REIT Income Fund	75,000,000	7,500,000	10	11.65
Middlefield Income Plus II Corp.	61,200,000	5,000,000	12	11.65
Moneda Latam Corporate Bond Fund	50,007,140	4,559,824	10	9.85
Moneda Latam Fixed Income Fund	46,300,000	4,350,000	10	9.75
Morguard North American Residential Real Estate Investment Trust	287,230,900	7,500,000	10	10.52
Namibia Rare Earths Inc.	62,262,800	31,250,000	0.8	0.81
NexJ Systems Inc.	185,008,995	4,850,000	9	9.13

North American Advantaged Convertibles Fund	102,840,000	10,000,000	10	9.8
North American REIT Income Fund	42,800,000	4,200,000	10	9.8
NorthWest Healthcare Properties Real Estate Investment Trust	264,997,720	17,500,000	10	10.18
OCP Senior Credit Fund	341,000,000	30,000,000	10	9.99
O'Leary Canadian Diversified Income Fund	25,800,000	2,000,000	12	11.7
O'Leary U.S. Strategic Yield Advantaged Fund	50,064,000	4,000,000	12	11.8
Parallel Energy Trust	393,300,000	34,200,000	10	10.28
Picton Mahoney Tactical Income Fund	132,300,000	13,000,000	10	9.85
Potash Ridge Corporation	81,263,778	14,944,746	1	0.65
Pretium Resources Inc.	491,067,516	44,170,000	6	6.05
Propel Multi-Strategy Fund	74,473,600	7,000,000	10	9.56
REIT INDEXPLUS Income Fund	179,100,000	14,600,000	12	11.7
Raven Rock Strategic Income Fund	61,000,000	6,000,000	10	9.9
Regal Lifestyle Communities Inc.	153,798,000	13,879,700	10	9.97
Royal Canadian Mint	600,000,000	30,000,000	20	19.36
Royal Nickel Corporation	194,970,831.75	14,500,000	2.25	1.85
Secure Energy Services Inc.	191,020,974	19,166,667	3	3.1
Sprott Physical Gold Trust	442,500,000	40,000,000	10	9.69

Sprott Strategic Fixed Income Fund	210,000,000	21,000,000	10	9.88
Star Hedge Managers Corp. II	64,877,710	6,000,000	10	9.75
Star Portfolio Corp.	92,108,184	7,250,000	12	11
Stonegate Agricom Ltd.	127,411,992	33,000,000	1	0.97
Strad Energy Services Ltd.	148,760,456	10,000,000	4	3.74
Strategic Income Allocation Fund	70,280,000	6,600,000	10	9.65
Symphony Floating Rate Senior Loan Fund	54,500,000	4,548,200	10	9.8
Tahoe Resources Inc.	663,520,008	58,000,000	6	6.25
Taylor North American Equity Opportunities Fund	32,850,000	3,100,000	10	9.85
Tech Leaders Income Fund	81,500,000	8,000,000	10	9.85
Teranga Gold Corporation	736,854,000	32,000,000	3	2.74
Timbercreek Global Real Estate Fund	55,969,140	4,425,903	12	11.7
Timbercreek Senior Mortgage Investment Corporation	152,200,000	10,000,000	10	9.95
Top 20 Dividend Trust	79,600,000	7,600,000	10	9.88
Top 20 Europe Dividend Trust	31,000,000	3,000,000	10	10
Tourmaline Oil Corp.	2,860,012,260	10,000,000	21	20.65
Trez Capital Mortgage Investment Corporation	115,000,000	10,000,000	10	9.95
Trez Capital Senior Mortgage Investment Corporation	89,150,000	8,500,000	10	9.86
Tricon Capital Group Inc.	109,445,226	10,500,000	6	6.1

U.S. Agency Mortgage-Backed REIT Advantaged Fund	32,421,850	3,100,000	10	9.97
U.S. Housing Recovery Fund	26,314,300	2,500,000	10	9.9
Whistler Blackcomb Holdings Inc.	454,110,000	25,000,000	12	12.06
Yield Advantaged Convertible Debentures Fund	191,220,000	15,500,000	12	11.97
Canadian Banc Capital Securities Trust	98,989,000	3,851,560	25	24.89
Capital Power Corporation	1,803,200,000	21,750,000	23	22.64
Deans Knight Income Corporation	100,368,900	10,036,890	10	10
Dollarama Inc.	1,272,108,862.50	17,142,857	17.5	19.49
Genworth MI Canada Inc.	2,320,547,900	44,740,000	19	18.28
Gold Participation and Income Fund	28,200,000	2,300,000	12	11.65
Marret High Yield Strategies Fund	215,000,000	21,500,000	10	9.9
Marret Investment Grade Bond Fund	337,800,000	26,700,000	12	11.89
North American Financials Capital Securities Trust	54,795,000	2,032,860	25	24.9
OCP Credit Strategy Fund	207,800,000	20,000,000	10	9.85
Pathfinder Convertible Debenture Fund	74,676,000	5,900,000	12	12
Precious Metals Bullion Trust	29,872,596	2,300,000	12	11.5
Preferred Share Investment Trust	55,000,000	5,500,000	10	9.94
Ridgewood Canadian Investment Grade Bond Fund	52,404,000	4,200,000	12	12
Silver Bullion Trust	26,000,000	2,600,000	10	10.45

Trident Performance Corp. II	45,100,000	4,400,000	10	9.75
Agellan Commercial Real Estate Investment Trust	207,474,970	13,461,943	10	10
American Hotel Income Properties REIT LP	100,050,000	8,700,000	10	10.18
BRP Inc.	2,539,721,083	12,200,000	21.5	24.1
Bloom U.S. Advantaged Income & Growth Fund	4,766,560	476,656	10	9.8
Brookfield Global Infrastructure Securities Income Fund	344,000,000	32,500,000	10	9.8
Choice Properties Real Estate Investment Trust	3,782,228,710	40,000,000	10	10
Eclipse Residential Mortgage Investment Corporation	40,700,000	3,900,000	10	9.7
Excel Latin America Bond Fund II	52,179,230	3,600,000	10	9.96
First Asset Morningstar U.S. Consumer Defensive Index Fund	44,340,000	4,000,000	10	9.88
Global Dividend Growers Income Fund	65,000,000	6,500,000	10	9.85
Halogen Software Inc.	248,409,602.50	4,800,000	11.5	13.21
ING Diversified Floating Rate Senior Loan Fund	184,753,910	16,000,000	10	9.8
Information Services Corporation	245,000,000	10,500,000	14	15.9
Inovalis Real Estate Investment Trust	113,700,000	10,500,000	10	10.2
Limited Duration Investment Grade Preferred Securities Fund	83,495,800	3,339,832	25	24.35
Low Volatility U.S. Equity Income Fund	21,350,000	2,050,000	10	9.75
Manulife Floating Rate Senior Loan Fund	263,989,490	23,063,949	10	9.8

Melcor Real Estate Investment Trust	194,907,980	8,300,000	10	9.99
Moneda LatAm Growth Fund	34,500,000	3,200,000	10	9.85
NexC Partners Corp.	30,928,800	3,092,880	10	10
North American Preferred Share Fund	74,000,000	2,960,000	25	24.75
Oryx Petroleum Corporation Limited	1,477,500,000	15,366,667	15	14.66
WPT Industrial Real Estate Investment Trust	114,300,000	10,000,000	10	9.95

Appendix B

Legal Name	Underwriters
Argent Energy Trust	BMO Capital Markets (10.000%); TD Securities Inc. (10.000%); Canaccord Genuity Corp. (5.000%); National Bank Financial Inc. (5.000%); Acumen Capital Finance Partners Limited (1.000%); AltaCorp Capital Inc. (1.000%); Cormark Securities Inc. (1.000%); Desja
Black Iron Inc.	Canaccord Genuity Corp. (17.500%); CIBC World Markets Inc. (17.500%); BMO Capital Markets (15.000%); Dundee Securities Ltd. (5.000%); Macquarie Capital Markets Canada Ltd. (5.000%)
Chieftain Metals Inc.	Raymond James Ltd. (22.500%); Haywood Securities Inc. (15.000%)
Condor Petroleum Inc.	UBS Securities Canada Inc. (17.500%); Raymond James Ltd. (12.500%); Dundee Securities Ltd. (5.000%); Haywood Securities Inc. (5.000%); Jennings Capital Inc. (5.000%)
Dundee Industrial Real Estate Investment Trust	Scotia Capital Inc. (19.000%); CIBC World Markets Inc. (12.000%); RBC Capital Markets (12.000%); BMO Capital Markets (8.000%); Canaccord Genuity Corp. (6.000%); Dundee Securities Ltd. (6.000%); Brookfield Financial Corporation (2.000%); Desjardins Securit
Dundee International Real Estate Investment Trust	Scotia Capital Inc. (19.000%); CIBC World Markets Inc. (12.000%); RBC Capital Markets (10.000%); BMO Capital Markets (9.000%); Canaccord Genuity Corp. (6.000%); Dundee Securities Ltd. (6.000%); HSBC Securities (Canada) Inc. (3.000%); Brookfield Financial
Eagle Energy Trust	BMO Capital Markets (16.000%); CIBC World Markets Inc. (16.000%); TD Securities Inc. (13.000%); National Bank Financial Inc. (10.000%); Dundee Securities Ltd. (7.000%); Canaccord Genuity Corp. (3.000%); FirstEnergy Capital Corp. (2.500%); GMP Securities L
Excel Latin America Bond Fund	TD Securities Inc. (n/a); GMP Securities L.P. (n/a); Raymond James Ltd. (n/a); Desjardins Securities Inc. (n/a); Macquarie Capital Markets Canada Ltd. (n/a); Dundee Securities Ltd. (n/a); Mackie Research Capital Corporation (n/a); Manulife Securities Inco
Gibson Energy Inc.	TD Securities Inc. (15.000%); RBC Capital Markets (10.000%); Citigroup Global Markets Canada Inc. (5.000%); FirstEnergy Capital Corp. (5.000%); UBS Securities Canada Inc. (5.000%)
HealthLease Properties Real Estate Investment	BMO Capital Markets (12.500%); CIBC World Markets Inc. (12.500%); Dundee Securities Ltd. (5.000%); GMP Securities L.P. (5.000%); Raymond James Ltd. (5.000%)

Trust

Ivanplats Limited	CIBC World Markets Inc. (5.000%); Citigroup Global Markets Canada Inc. (3.000%); Renaissance Securities Inc. (3.000%); UBS Securities Canada Inc. (3.000%)
Longview Oil Corp.	Scotia Capital Inc. (16.000%); BMO Capital Markets (13.000%); National Bank Financial Inc. (13.000%); CIBC World Markets Inc. (10.000%); Macquarie Capital Markets Canada Ltd. (3.000%)
MEG Energy Corp.	TD Securities Inc. (5.130%); Goldman Sachs Canada Inc. (5.130%); Scotia Capital Inc. (2.560%); FirstEnergy Capital Corp. (2.560%); Peters & Co. Limited (2.560%)
Midas Gold Corp.	Canaccord Genuity Corp. (15.000%); Macquarie Capital Markets Canada Ltd. (5.000%)
Morguard North American Residential Real Estate Investment Trust	CIBC World Markets Inc. (12.000%); BMO Capital Markets (10.000%); Scotia Capital Inc. (10.000%); HSBC Securities (Canada) Inc. (5.000%); National Bank Financial Inc. (3.000%); Canaccord Genuity Corp. (2.500%); Dundee Securities Ltd. (2.500%)
Namibia Rare Earths Inc.	CIBC World Markets Inc. (20.000%)
NexJ Systems Inc.	Raymond James Ltd. (10.000%); RBC Capital Markets (10.000%); Scotia Capital Inc. (10.000%); TD Securities Inc. (10.000%); NCP Northland Capital Partners Inc. (2.000%)
NorthWest Healthcare Properties Real Estate Investment Trust	BMO Capital Markets (19.500%); CIBC World Markets Inc. (15.000%); National Bank Financial Inc. (7.500%); Scotia Capital Inc. (7.500%); TD Securities Inc. (7.500%); Canaccord Genuity Corp. (3.000%); Macquarie Capital Markets Canada Ltd. (3.000%); Versant P
Parallel Energy Trust	BMO Capital Markets (10.000%); TD Securities Inc. (10.000%); Canaccord Genuity Corp. (4.000%); National Bank Financial Inc. (4.000%); Desjardins Securities Inc. (2.000%); HSBC Securities (Canada) Inc. (2.000%); FirstEnergy Capital Corp. (1.000%); Peters &
Pretium Resources Inc.	BMO Capital Markets (8.000%); Credit Suisse Securities (Canada), Inc. (5.000%); Cowen Securities LLC (5.000%); GMP Securities L.P. (5.000%); Salman Partners Inc. (2.000%)
Secure Energy	Raymond James Ltd. (30.000%); Peters & Co. Limited (15.000%)

Services Inc.	
Tahoe Resources Inc.	BMO Capital Markets (8.000%); CIBC World Markets Inc. (8.000%); Macquarie Capital Markets Canada Ltd. (8.000%); RBC Capital Markets (8.000%); Dundee Securities Ltd. (1.500%); Paradigm Capital Inc. (1.500%)
Tricon Capital Group Inc.	Canaccord Genuity Corp. (17.500%); CIBC World Markets Inc. (17.500%); National Bank Financial Inc. (10.000%); TD Securities Inc. (10.000%)
Whistler Blackcomb Holdings Inc.	Scotia Capital Inc. (12.000%); BMO Capital Markets (11.000%); TD Securities Inc. (11.000%); Goldman Sachs Canada Inc. (8.000%); Canaccord Genuity Corp. (5.000%); Desjardins Securities Inc. (3.500%); HSBC Securities (Canada) Inc. (3.500%); Raymond James Lt
Dollarama Inc.	Scotia Capital Inc. (10.000%); Barclays Capital Canada Inc. (7.000%); National Bank Financial Inc. (7.000%); Desjardins Securities Inc. (2.000%); HSBC Securities (Canada) Inc. (2.000%); Merrill Lynch Canada Inc. (2.000%); Raymond James Ltd. (2.000%)
American Hotel Income Properties REIT LP	TD Securities Inc. (11.500%); BMO Capital Markets (9.500%); CIBC World Markets Inc. (9.500%); Scotia Capital Inc. (9.500%); Dundee Securities Ltd. (4.200%); GMP Securities L.P. (4.200%); Macquarie Capital Markets Canada Ltd. (4.200%); Burgeonvest Bick Sec
BRP Inc.	Wells Fargo Securities, LLC (6.000%); CIBC World Markets Inc. (4.333%); Desjardins Securities Inc. (4.333%); Scotia Capital Inc. (4.333%); National Bank Financial Inc. (3.000%); Robert W. Baird & Co. Incorporated (2.000%)
Halogen Software Inc.	Raymond James Ltd. (20.000%); Cantor Fitzgerald Canada Corporation (6.000%); National Bank Financial Inc. (6.000%)
Information Services Corporation	BMO Capital Markets (10.000%); Scotia Capital Inc. (10.000%); TD Securities Inc. (10.000%); GMP Securities L.P. (5.000%); National Bank Financial Inc. (5.000%); Canaccord Genuity Corp. (2.000%); Dundee Securities Ltd. (1.000%); Mackie Research Capital Cor
Inovalis Real Estate Investment Trust	GMP Securities L.P. (20.000%); Macquarie Capital Markets Canada Ltd. (20.000%); Laurentian Bank Securities Inc. (10.000%); UBS Securities Canada Inc. (10.000%); Manulife Securities Incorporated (4.000%); Burgeonvest Bick Securities Limited (2.000%); Indus