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# The Problems Confronting Small Utah Companies Seeking the First Increment of Public Equity Capital

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# THE PROBLEMS CONFRONTING SMALL UTAH COMPANIES SEEKING THE FIRST INCREMENT OF PUBLIC EQUITY CAPITAL

by

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ABSTRACT

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Seeking the First Increment

Of Public Equity Capital

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The objective of this research is to isolate and analyze those areas which represent the greatest difficulty in expense, administrative burden and confusion. Information was gathered by survey and interviews to determine what services are offered by underwriting firms and what services small businesses have found most beneficial in planning and executing their offering. The information gathered in Utah is compared with that gathered in California to determine the differences in the public equity markets of the two regions. These differences are the basis for the recommended changes in the underwriting procedures in Utah.

(78 pages)

# INTRODUCTION

## Purpose

This is a study of the very costly and complicated problem faced by the small Utah business needing its first increment of public (equity) venture capital. This problem stifles the growth and development of many businesses that have services or products that in many cases have realistic potential.

## Objectives

To isolate and identify the areas where the problems lie, specifically: 1) the requirements businesses must meet; 2) the costs involved in raising this capital; 3) what firms are handling Regulation A (under $300, 000 offerings at the time of the survey but recently changed to $500, 000); 4) what type of underwriting firm can affect the best distribution while meeting the needs of the new corporation; and 5) if a public offering is the most advantageous means of financing desired growth for all companies, is the purpose of this study.

# METHOD OF PROCEDURE

## Collection

Underwriters: Data was collected by interviews with the Salt Lake and San Francisco firms providing regional underwriting services. Firms which focus their attention on serving companies with nationwide appeal were excluded because of their size and price limits, $15 million minimum issue and $15 per share. These limits could not be met by the type of company considered by this study.

The interviews followed the general format contained in the questionnaire shown at Appendix 1.

New Corporations: Questionnaires were sent with a cover letter attached as shown at Appendix 2 to companies which had recently undergone an initial underwriting.

Regulations: The requirements for new underwriting as practiced by the State Securities Commission of Utah were obtained by interview with the Commissioner, William Sergeant and from the Utah Uniform Securities Act.

## Analysis

The data obtained from the various sources were studied for obvious incongruities and areas where the goals of the three groups were not compatible. Data collected in Utah was compared with that gathered in San Francisco, California to determine the correlation. San Francisco was selected for comparison because of its position as a financial center of the United States located closest to Utah.

## A REVIEW OF LITERATURE

"More small and medium companies can find more advantage in selling stock to the public than they or anyone else realizes. And the difficulties are not great if they are approached realistically."[1]

If this statement is true, why are not more Utahans seeking to benefit from this method of raising capital? Many answers have been given to this question and not all apply to all companies. But in general, small businessmen have avoided public financing for the following reasons:

"--They do not have a clear picture of the specific advantages.

--They do not know how to go about getting such financing.

--They fear they will lose control of their business.

--They do not want to account to outsiders.

--They are reluctant to give up a "good thing" and allow others to share.

--They think that now is not the time, if they wait longer they can get more.

--They believe they are too small.

--They do not know where their appeal to the investor lies.

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[1] Robert A. Weaver, Jr., Initial Public Financing for the Small and Medium Sized Business (Washington, D.C.: Investment Bankers Association, 1969), p. 7.

--They misunderstand the role of the underwriter and are discouraged by the seemingly high fee.

--They are unfamiliar with and unduly afraid of security laws and SEC regulation."[2]

As is indicated by the many reasons given, many small businesses appear to have an inferiority complex when considering public financing. Furthermore, these companies are not likely to change their attitude unless they become more familiar with the fundamentals of equity financing.[3]

## Availability of Credit

If the small business is to continue to grow beyond its current capacity, it will probably need to acquire additional capital to finance its development. In most situations it will be necessary to obtain this capital from outside the existing organization. Small businesses do not have a particular problem in obtaining financial assistance in the form of short-term and intermediate-term loans. But in many cases when the funds are to be used for expansion, a long-term loan is the only type of debt financing that will suffice. Unfortunately the sources of long-term capital to the small firm are extremely limited.

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[2] Ibid., p. 11

[3] Ibid., p. 12

## Short-Term Loans

Of the three types of loans mentioned, the short-term loan is the easiest for the small business to obtain. This is due to the low risk and the ability of the small firm to forecast revenue for the period in question.

Short-term loans normally run from 30 days to as long as a year. Loans of this type are often given in the form of trade credit, particularly when the period is for 90 days or less. For periods longer than this a commercial lending institution is usually the source of the loan.

## Intermediate-Term Loans

Although short-term loans are readily available to the small business, the repayment period is too short to meet the needs of the firm. When the loan is to be used to develop new business territory, improvement of plant, inventory expansion or other purposes of this nature, the firm must seek a loan with a repayment period which is more lenient. Loans of this type normally run from one to five years.

Loans of this type are obtained from commercial banks also, but other institutions often make funds available. Sales finance companies and insurance companies are two examples of businesses who make it a practice of extending loans to small firms. A problem which often must be faced, though, is finding an institution willing to loan funds of this type in a small enough increment. Because of the costs involved in making a loan and conducting a credit investigation many institutions prefer to make loans on a scale larger than most small businesses are in a position to accept.[4]

Long-Term Loans

When the small business is in need of capital to finance growth and expansion, it faces the most difficulty in obtaining outside help. This type of loan normally runs from five to twenty years and the money involved is often referred to as venture capital because of the risks involved. Although it is possible to predict fairly accurately what revenues can be expected in the short and intermediate-term, it is impossible to forecast much beyond the five year mark. This inability to predict the future increases the risk of this type of loan. Therefore, it is almost impossible for a small business to obtain financing for growth in this way. But if the firm is to grow at an optimal rate, the funds must be found.[5]

Public equity financing offers five significant advantages to this type of firm. Financing through the sale of stock to the public

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[4] Financing Small Business, Economic Policy Division Series No. 35 (New York: National Association of Manufacturers, 1960), p. 26.

[5] James F. Mahar and Dean C. Coddington, The Financial Gap--Real or Imaginary (Denver, Colorado: Denver Research Institute, University of Denver, 1962).

provides working capital, enhances credit, improves marketability of stock, and can be done without the loss of control that many fear.[6]

Many small firms are caught in a cash squeeze brought on by inflation and higher taxes. The need for greater amounts of working capital is expanding to meet rising operating costs and to implement plans for physical growth.

To get the needed working capital by securing a loan or bond issue would result in an obligation to pay interest charges regardless of the financial position of the company. A company that is struggling to grow will have very little margin after taxes. If this margin is reduced by a fixed debt obligation, little could remain to be plowed back into the company. And should an economic slow-down occur the company could conceivably be forced into bankruptcy.

Often the large amounts of capital required for physical growth or product development are not available from commercial banks, factors, or private individuals on favorable terms. And even if the desired funds are available privately, it is possible that the additional loans would put the company's capital structure out of balance. Equity financing frequently is the answer.

Public equity financing of small firms with growth potential has an appeal to investors who are willing to forgo the immediate returns

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[6] Weaver, p. 13.

in the expectation of ample rewards in the form of capital growth and/or later dividends. Therefore, working capital is available in amounts and at terms which provide the small, but growing company with much more financial freedom than possible through debt financing.[7]

## Enhanced Credit

It should be emphasized that a reasonable amount of borrowing is often in order. Flexibility can be added to the company's short term financial operations by the use of funds borrowed for a short period of time. This source of funds is particularly beneficial during emergencies or at other times when there is an unusual but temporary drain on resources. Equity financing will not fill this temporary need any more than borrowing is suited for long term growth situations.

The two kinds of financing work well together. While debt funds can be used to ease fluctuations in financial operations, equity financing from the public can contribute to the strength of the company's borrowing position. This added strength enables the company to either borrow more money or to borrow the same amount of money at more favorable terms. Such evidence of a

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[7] Ibid., p. 14-15

sound financial structure commands respect from suppliers, customers, and also bankers.[8]

## Market Status

Marketability of the stock of a small corporation can be of value to the owners. The market value of stock in growing public companies often exceeds the book value of the outstanding shares. The original owner's efforts in developing the company can be immediately rewarded by the improvement of the market position of their shares. They can increase their net worth while being free to diversify their personal holdings.

In contrast, the stock of a closed corporation has no marketability and therefore no immediate cash value. Any sale of stock would be time consuming and result in either the sale of the entire business or at a price no more than the book value of the stock.[9]

## Retaining Control

One real fear expressed by many company owners concerning the sale of stock to the public was their concern for the control of the company. They want to keep the flexibility of decision to which they are accustomed.

In fact, there is no need for the owners to divest themselves of a majority or controlling interest. Few companies would need

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[8] Ibid., p. 15

[9] Ibid., p. 16

to sell more than 49 percent interest. Even if the actual percentage exceeded that figure, effective control would be maintained because of the dispersion of non-management shares among many small stockholders.

On the other hand, if a large debt were incurred, or distribution of stock was made to a small group of investors, it is likely that the representatives of the money would take an active interest in management decisions. Therefore, control can be maintained better through the public offering of stock than either private placement or by securing a loan of the desired size.[10]

Disadvantages

Not everything is good about going public. There exist many disadvantages.

--Subject to more government regulation.

--Subject to additional legal restrictions which protect the rights of the minority stockholder.

--Loss of corporate secrecy.

--Loss of opportunity to operate company with a view toward personal benefit.

However, the imposition caused by these disadvantages often result in better business practices which make the company that much

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[10] Ibid, p. 17

stronger.[11] There appears to be no disadvantage which is not outweighed by the advantages and the stimulus provided by public ownership.[12]

## Needed Qualifications

A company seeking equity capital from the public must be acceptable in one or more of the following areas: (a) a satisfactory record of earnings; (b) a product which is cheaper and/or better in a known market; (c) good management; and (d) strong growth potential. Of these four, growth potential is indispensable.

Earnings Record. A record of earnings is advantageous but not necessary to get financing. A firm which can show its past success through earnings is likely to follow the same pattern.

Product Development. On the other hand, a firm which has spent years and great sums developing the product, with no earnings, could be an excellent candidate for public financing.

Management Potential. A company with a new management which demonstrates progressive ideas and ability could be a good candidate for public financing in spite of the past earnings record.

Growth Potential. Real potential for growth must be exhibited before seeking public financing. Without an existing plant and

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[11] Ibid., p. 18

[12] Robert Levy, "The Perils of Going Public," Duns Review, XCIV (September, 1969), p. 46-47.

organization, potential customers and a real or potential demand for the product, a firm is in no position to seek public capital. Another source of funds must be found.[13]

## Private Placement

The process of placing an issue of securities with individuals or institutions within a legally specified number is known as private placement. This process can give the privately owned company the necessary financial muscle to meet the above conditions necessary to go public. And it can be done at a comparatively cheap rate as far as the actual placement costs are concerned.[14]

Advantages. The advantages of this type of financing over borrowing are basically the same as with a public offering. An additional advantage is the less stringent requirements to show an earnings record, an existing base for growth, a fully developed product, or a complete management organization. The most important factors necessary are a capable management coupled with a product with sound potential.[15]

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[13] Weaver, p. 21-22.

[14] Arlene Hershman, "Private Placement, the 'New' Money Game," Duns Review, XCIII (February, 1969), p. 23-25.

[15] J. Glade Dursteler, An Evaluation of the Small Business Investment Company Program (1966), p. 76.

Disadvantages. There can be a greater loss of control resulting from this type of financing because of the small number of people involved.[16] Also, the return demanded from this type of investor will exceed that of other types of financing.

Market Psychology

Students of the stock market look upon the activity of some investors as a game--a game where money is the way the score is kept. The real object of the game is not the money but the playing of the game itself.[17] It is an exercise in mass psychology, trying to guess better than the crowd what the crowd will do. Why is this so? Market values are only partly determined by income statements and balance sheets. The factors which have a much greater effect are the hopes and fears of humanity, greed, ambition, acts of God, invention, financial stress and strain, weather, discovery, fashion and numberless others.[18]

Many individual investors are not seeking to increase their income but invest to satisfy some other need such as common ground with friends, self fulfillment, tradition, or just something to do. They want to be a part of what's going on; and if given a choice

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[16] Ibid., p. 77

[17] Adam Smith, The Money Game (New York: Random House, 1967), p. 13.

[18] Gerald Loeb, The Battle for Investment Survival (New York: Simon and Schuster, 1957).

between making money, guaranteed, or staying in the game, they would pick the game.[19]

## Registration Requirements for Issuers in Utah

### Risk Capital

Substantial risked capital by the incorporators and promoters is required before registration can be approved. This risk capital must be in cash in addition to any properties or organizational expenses, and should be at least 5 percent of the aggregate offering price.

### Selling Expenses

Issuers are not allowed to spend more than 20 percent of the proceeds from the offering as selling expenses. Commissions agreed upon in the underwriting agreement are usually limited to 15 to 17 1/2 at the discretion of the Commission.

### Prospectus

Prospectus must be prepared for the approval of the Commission. It should contain a full disclosure of applicant, history, description and valuation of properties, use of funds, etc. The prospectus must disclose the plain and simple truth, and must spell out the dilution

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[19] Smith, p. 57-75.

factor concisely on a per share basis. A list of all current stockholders must also be provided, showing the number of shares owned, the amount paid per share and whether paid with services, property or cash.

Assets

The values of properties, real or personal, listed as assets must be justified by a competent disinterested authority. Mining claims cannot be valued in excess of $500.

Dilution

Any securities sold or issued to underwriters, promoters, or insiders for a consideration lower than the proposed net offering price shall not result in a dilution of more than 33 1/3 of the value of the shares outstanding in the hands of the public at any time.

Insider Stock

Stock received by the promoters at a consideration lower than the net offering price to the public must remain in escow for a period of not less than 13 months.

Private Placement

No issue can be sold to more than ten individuals or institutions without completing the registration process.

Financial Statement

A financial statement dated with the four month period prior to the registration date must be prepared by an independent public accountant.[20]

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[20] Department of Business Regulation, Utah Securities Commission, <u>Utah Uniform Securities Act</u>, Title 61, Chapter 1, Session of Laws of Utah, 1963.

# RESULTS

## Responses to Questionnaire for Underwriters

Thirteen firms actively engaged in underwriting were interviewed. Seven of these firms (g through m) were located in San Francisco and are to be used as a comparison in evaluating the responses of the six (a through f) Utah underwriters from which data were received. Not all those interviewed chose to answer all of the questions and in many cases gave more than one appropriate response; therefore, tallies may not equal thirteen.

### Minimum Issue Size

It was noted that with one exception the California firms practice higher minimums than in Utah (1--no minimum; 1--$500,000; 2--$1,500,000; 2--$2,000,000) for public issues (Figure 1). The Utah firms operate with minimums which comply with the provisions of a Regulation A offering (1--no minimum; 1--$200,000; 4--$300,000). On the surface this would indicate a void in the California market for smaller issues but these are handled by a different type of offering, as will be shown later. No minimum limit in the case of companies "D" and "L" does not seem economically realistic. A point must exist

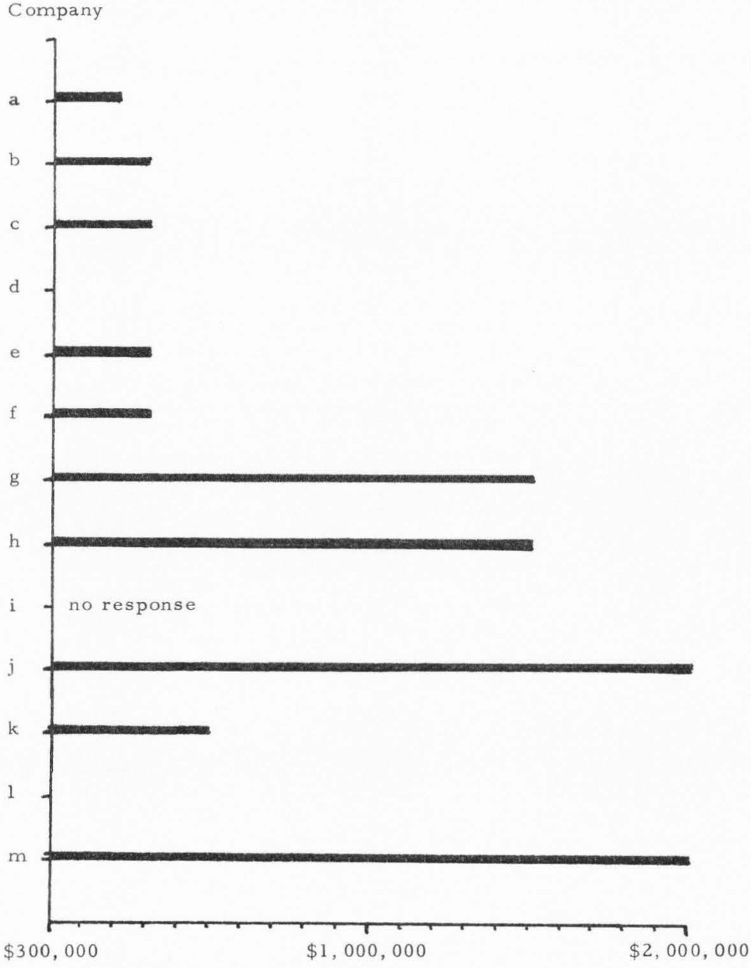


Figure 1. Minimum Issue. Size of issue below which the underwriter feels it is uneconomical to handle an issue.

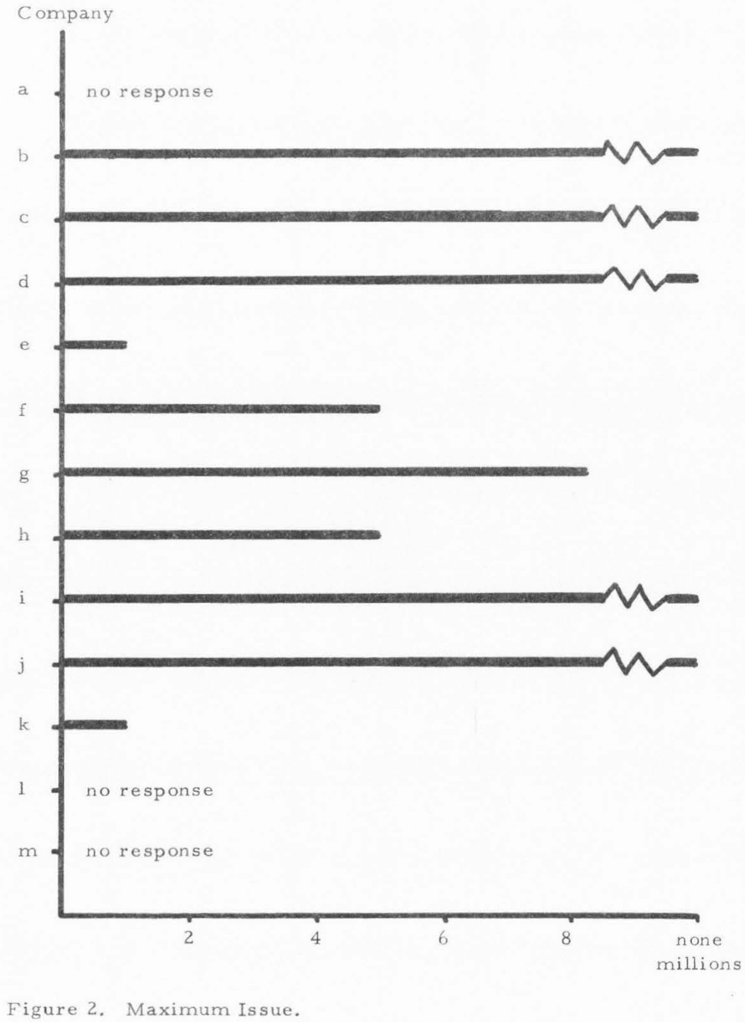


Figure 2. Maximum Issue.

whether formally established or not, below which the costs of underwriting an issue would exceed a reasonable spread.

## Maximum Issue Size

There is no apparent difference between regions with regard to maximums (Figure 2). In every instance that a "no limit" was given it was qualified to mean that a syndicate with other underwriters would be formed if the amount to be raised exceeded individual capabilities. Among those indicating a maximum limit were firms which had had limited experience in underwriting.

## Underwriting Costs

With the exception of two firms all Utah firms indicated that the underwriting spread charged by them was 15 percent, the maximum usually allowed by the Utah Securities Commission. The California firms operated with spreads no larger than 15 percent and in two cases were as low as 8 percent. This could be due to the economies of a larger operation. Many companies indicated that larger issues could be handled at lower percentage rates. This would appear to be the case for company "M" (see Figures 1 and 3). Company "L's" response of 8 percent does not seem realistic when considered in connection with the response to the first question (see Figure 1). Obviously, a preposed issue could be small enough such that an 8 percent spread would not cover the cost incurred by the underwriter.

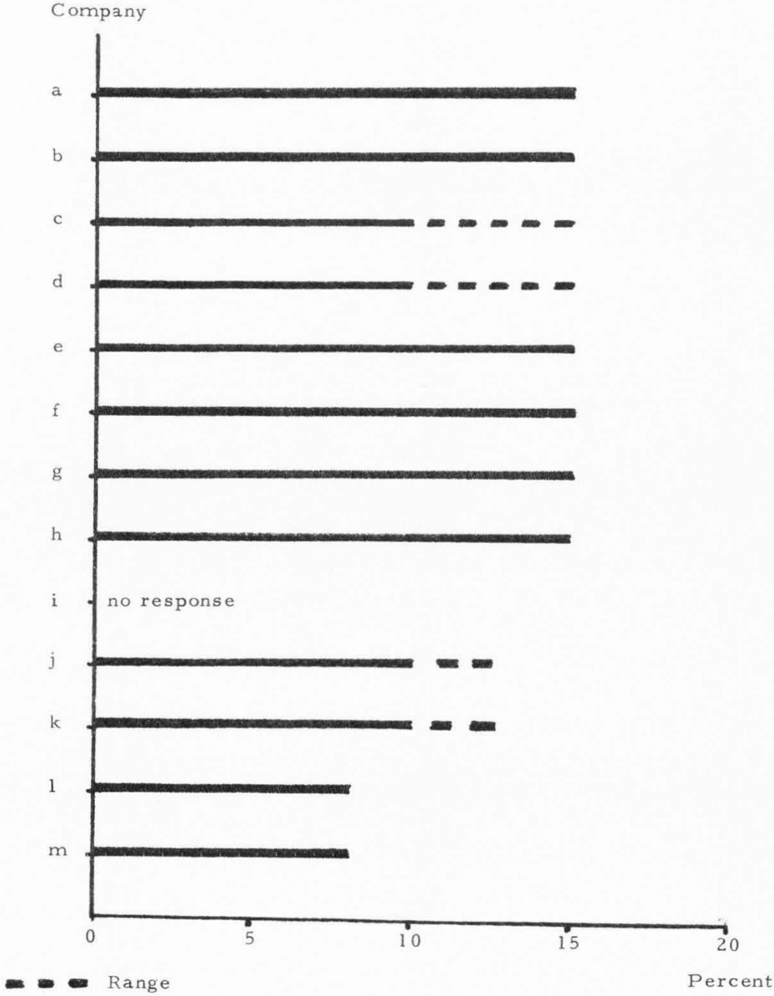


Figure 3. Underwriting Costs. Cost to the corporation for underwriting as a percentage of the aggregate issue price.

Costs to the issuer, other than underwriting fees, were not included in Figure 3. The costs include legal fees and auditing fees which vary greatly with each issue depending on the individual problems of submitting and receiving approval of an application for registration with the Security Exchange Commission and/or the State Securities Commission. These legal fees reportedly range from 2 1/2 percent to 15 percent of the size of the issue but are normally computed as a fixed cost rather than a percentage. In any case a company must anticipate a total cost of 20 to 25 percent of the aggregate offering price.

Services Offered

The range of services offered varied from the obvious minimum of planning the offering to a complete program of financial and organizational advice to include the placement of a representative of the underwriters on the firm's board of directors (Figure 4). Perhaps the underwriters are providing the services their respective customers desire, but the number of services offered by all of the California firms indicates the degree of sophistication that has been reached in that geographical region. It appears to the author that there exist far reaching benefits by having a better chance of success because of the additional guidance. The investors should be able to expect better returns at less risk from their investment. And the underwriter could profit from having more satisfied customers on both sides of the

| Company | Planning Offering | Organizational Advice | Financial Advice | Continued Advice | Other |
|---|---|---|---|---|---|
| a | X | X |  | X | X |
| b | X |  |  |  |  |
| c | X |  |  |  |  |
| d | X | X | X | X | X |
| e | X | X | X | X | X |
| f | X | X | X |  | X |
| g | X |  | X | X |  |
| h | X |  |  | X | X |
| i | X | X | X | X | X |
| j | X | X | X | X | X |
| k | X | X | X | X | X |
| l | X | X | X | X | X |
| m | X | X | X | X | X |

Figure 4. Services Offered by Underwriters.

transaction who will be likely to pursue additional transactions as well as be sources for additional customers.

The after-market services offered were consistent throughout the firms interviewed. Only one underwriter does not sponsor an over-the-counter market, and he and many others interviewed promote this type of market with other brokerage firms. This service is a necessity to insure the marketability of the issue.

Preparation Period

There was no significant variation between California underwriters on the time required to prepare an offering for sale. All firms estimated a period of three to six months is required to complete a registration with the proper authorities. With one exception all of the Utah firms felt this length of time was necessary. The other firm felt that registration could take as long as a year; but this firm is relatively new to underwriting, and their response should be discounted accordingly.

Completion Period

The time required for the underwriter to complete the offering after the registration has been approved can be an indication that, for some reason, funds cannot be readily induced to meet the demands of the corporation issuing the stock. From the interviews, it was apparent that most of the California firms and one Utah firm have been able to presell the issue on the basis that approval is pending

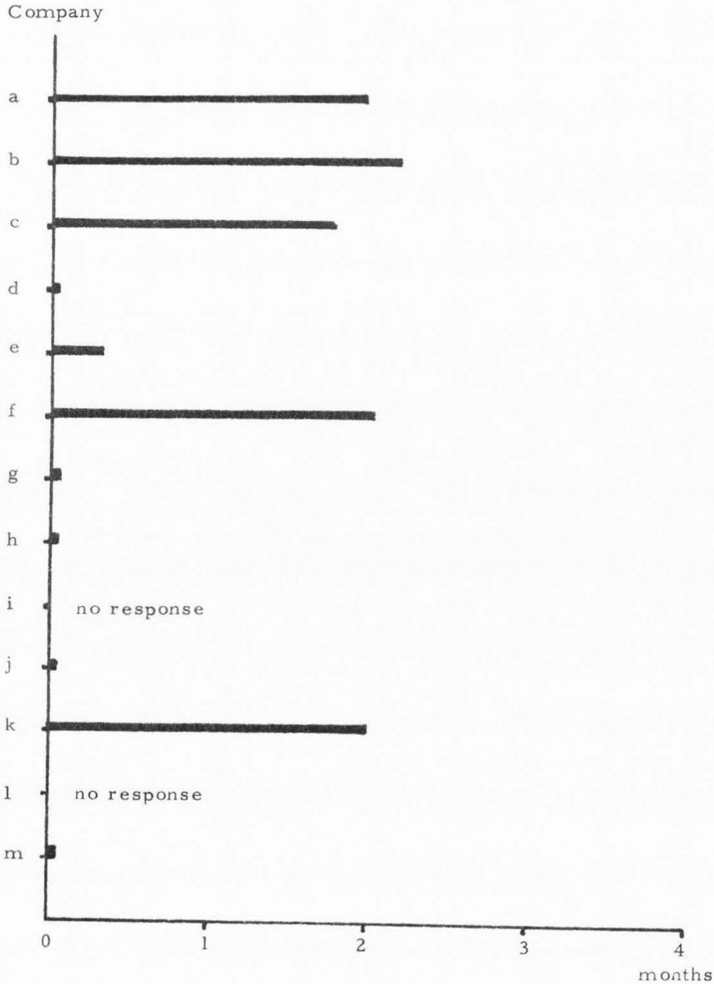


Figure 5. Completion Period. Time Required to sell issue.

(Figure 5). This enables them to complete the issue in a matter of hours after the registration is effective. The reason given by one underwriter was the money readily available for good investments. An underwriter is able to take advantage of this excess supply by underwriting promising companies that appeal to investors. Doing this will develop a satisfied clientele which will be waiting for another opportunity of similar quality. If this is true, firms which are not able to meet the quality of issue in demand might find difficulty in locating an underwriter who will work with them. There would seem to exist a hierarchy of investment possibilities with the least promising opportunities going wanting in times when money is less available for this type of use. It would seem to be the responsibility of the underwriter to make the determination based on his knowledge of both sides of the investment market.

## Types of Industries Underwritten

The majority of underwriters would underwrite any type of business. Three firms, however, were in some way selective. A California firm was interested only in companies which were involved in some technological field. Two reasons were given for this: the employees of the underwriter were better qualified to work with this type of company; and the sources of funds most readily available to the underwriter were primarily interested in the technical industries.

The two Utah firms who limited their activities were complimentary. One underwrites any type of industry except mining while the other underwrites only mining issues. No specific reasons were given for these particular interests, but investor clientele would seem to be the most logical reason.

## Operational Area

All of the underwriters interviewed can be considered as regional underwriters. The companies that are underwritten are primarily located in the same geographical area as the underwriter and little effort is made to operate outside that area. The departure from this procedure occurs mainly in the case of syndications for a very large issue.

## Sales Area

Six geographical areas were given as sources of funds: East Coast, Mid-West, Intermountain, Southwest, California, and Northwest (Figure 6). There appears to be no correlation between the number of geographical areas utilized and other data collected.

## Business Consultants

The reactions to a business consultant coming with a firm seeking the underwriter's services were quite mixed. Two underwriters indicated they are pleased and an equal number said they are irritated, while most stated that it does not matter either way.

| Company | Northwest | California | Intermountain | Southwest | Midwest | East |
|---|---|---|---|---|---|---|
| a | | X | X | | | |
| b | | | X | | | |
| c | | X | X | | | X |
| d | | | X | | | |
| e | | X | X | | | |
| f | | | X | | | |
| g | X | X | | | | |
| h | no response | | | | | |
| i | | | | | | X |
| j | X | X | | | | |
| k | | X | | | | |
| l | | X | | | X | X |
| m | | X | | | | |

Figure 6. Sources of Funds by Geographical Area.

Most underwriters interviewed felt that the few times this has happened the consultant was of no value to the operation. Apparently the various attitudes resulted from previous experiences, with the underwriter's self interest the determining factor.

Private Placement

In California, stock is currently being placed privately much more frequently than it is offered to the public. This procedure eases the registration process and reduces the number of sales contacts required, provided the funds are available. Most firms utilizing private placement offer stock to as many as ten investing individuals or institutions. It is obvious from Figures 7 and 8 that this facet of the finance industry is more fully developed in California than in Utah.

Private placement is used in California to fill the gap below the operating minimums placed on issue sizes by the underwriters. As Figure 7 would indicate at least two of the California underwriters actually place all stock issues privately rather than offering them to the public. It is the author's opinion that this is an area which is quite lacking in the Utah investment market. The investment opportunities seem to be present and according to the responses to previous questions, the geographical area of sale or availability of funds should not be a question. The same type of sources for money seem to be available to any underwriter willing to establish the lines of communication.

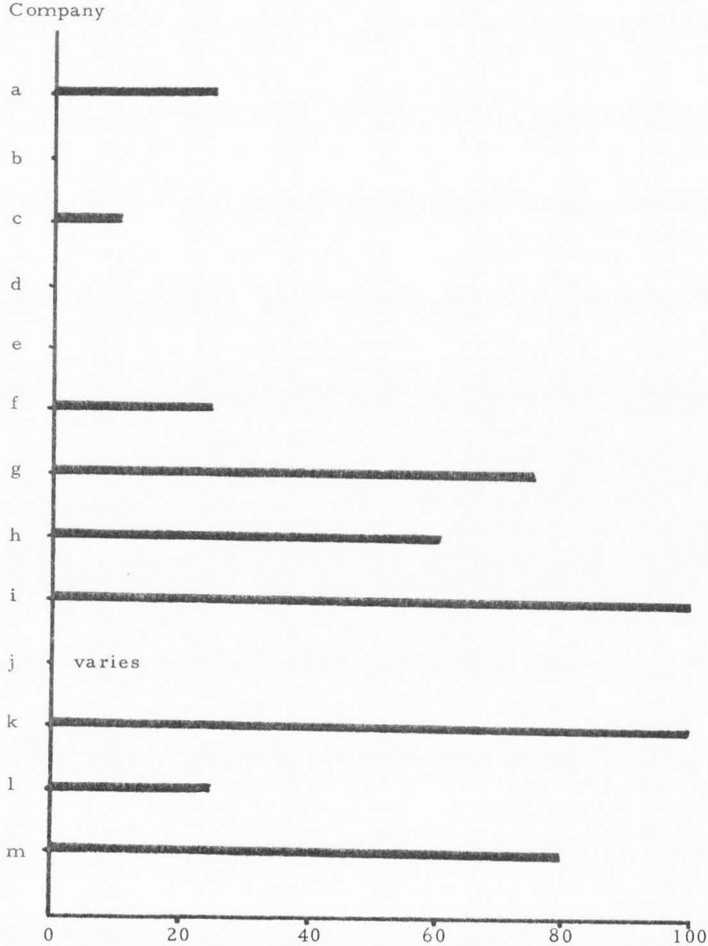


Figure 7. Private Placement.

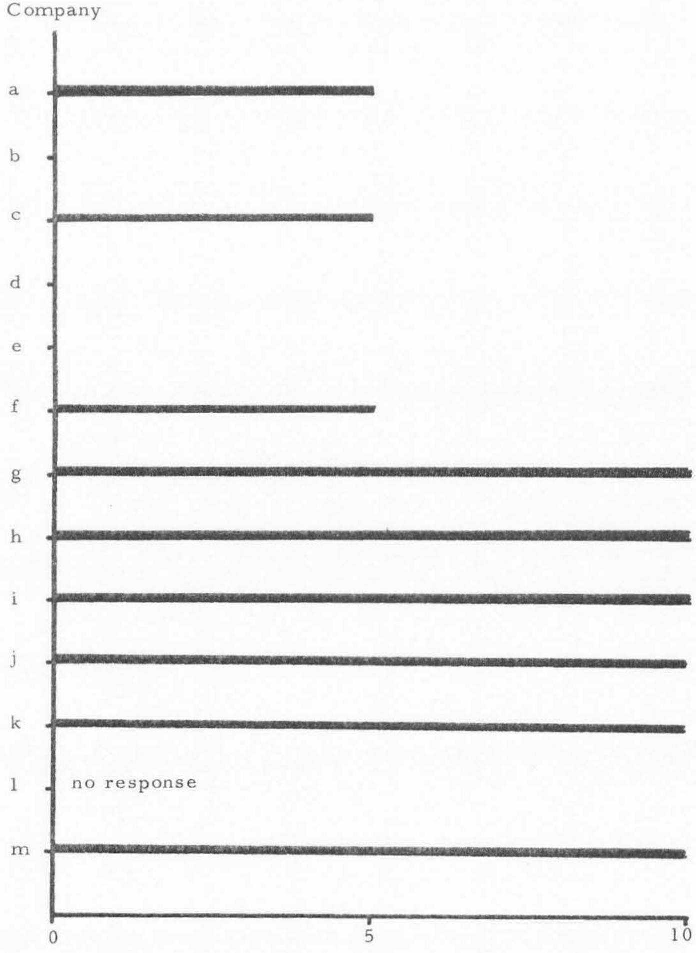


Figure 8. Private Placement Participants.

## Results of Questionnaire to Corporations

Size of Issue. Of the twelve corporations responding to the questionnaire at Appendix A, ten issues were Regulation A issues of $300,000 or less (Figure 9). Eight of the ten corporations were seeking that maximum allowable amount while the two other firms were seeking $50,000 and $45,000 respectively and either by choice or necessity acted as their own underwriter. Two of the responding firms had undergone S-1 offerings of $1,800,000 and $400,000 respectively.

Issue Price. A wide range existed in the reported issue prices. Six firms issued stock at prices ranging from 1 mill to 15¢ (Figure 10). Each of these issues were speculative in nature, lacking indication of previous success. The remaining five responses came from firms who were either industrial/technical by nature or had exhibited success in previous mining operations.

The pricing of an issue seems to be accomplished by various methods based on the experience of the underwriter. A general guideline used is a ratio of price to earnings if the firm has had any. This ratio is normally about the same as those of existing companies in related fields.

Issue Size Acceptance. Only three firms talked to underwriters who objected to the size of the issue (Figure 11). Curiously, these firms were not those shown in Figure 9 who had extremely small

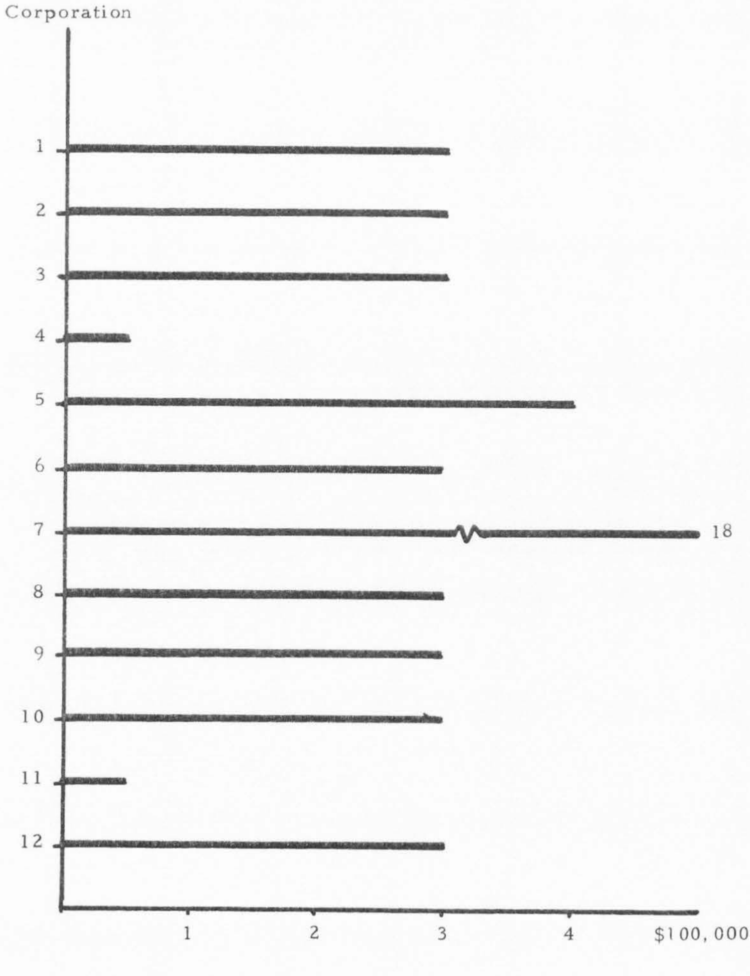


Figure 9. Size of Issue. Proceeds sought in underwriting.

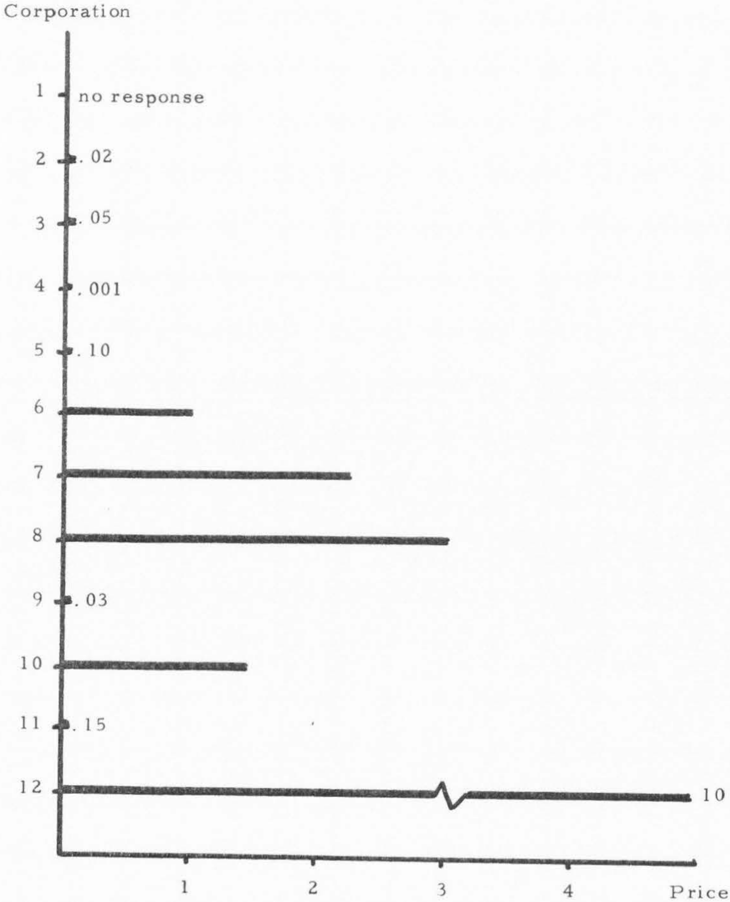


Figure 10. Issue Price. Price per share of issue.

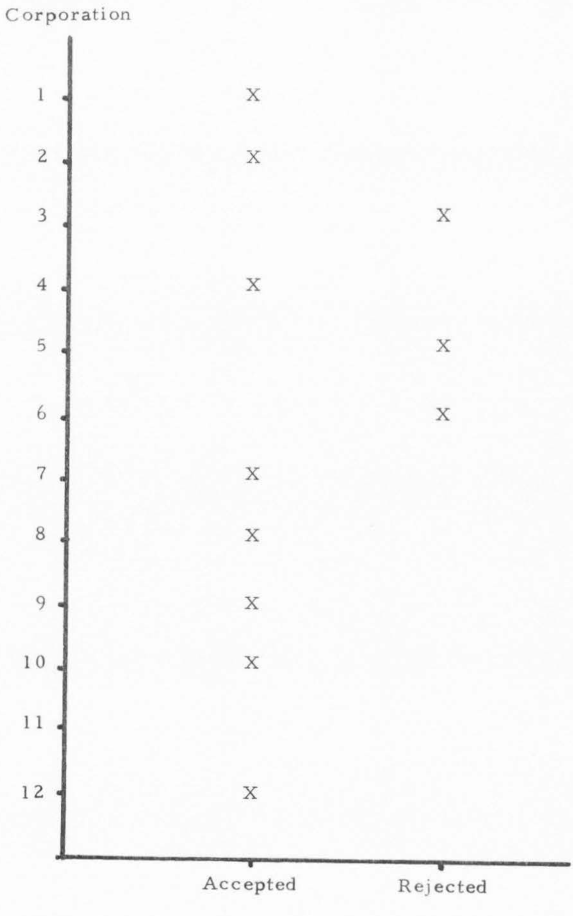


Figure 11. Issue Size Acceptance.

issues but were seeking $300, 000 and one seeking $400, 000. Eight firms had no difficulties and one firm did not respond.

It would appear that the act of rejection by the underwriter is based more on size of the issue relative to existing assets rather than the absolute dollar value of the issue. This could also be an easy way to reject the quality of the prospective issue.

Reasons for Rejection. The following reasons were given by underwriters for not assisting in the stock issue (Figure 12). Five corporations were turned away due to poor market conditions. As indicated above, some corporations were rejected because of their size. Four indicated that they experienced this type of restriction. Three firms were rejected because of the nature of their business. Type of issue and quality of company were each given to two firms as a reason for not participating in the underwriting. One firm who, as shown in Figure 13, had contacted numerous underwriters, met each of five forms of restrictions listed, including the reason that the underwriter was too busy.

Many different reasons for rejection have been cited by underwriters and issuers alike. One reason not given in response to the questionnaires but in subsequent interviews was the lack of investor appeal. This was particularly evident in an interview with a business consultant working with a small manufacturing firm earning in excess of 20 percent on invested capital. As near as could be determined the firm had all of the qualifications of a firm ready for a public

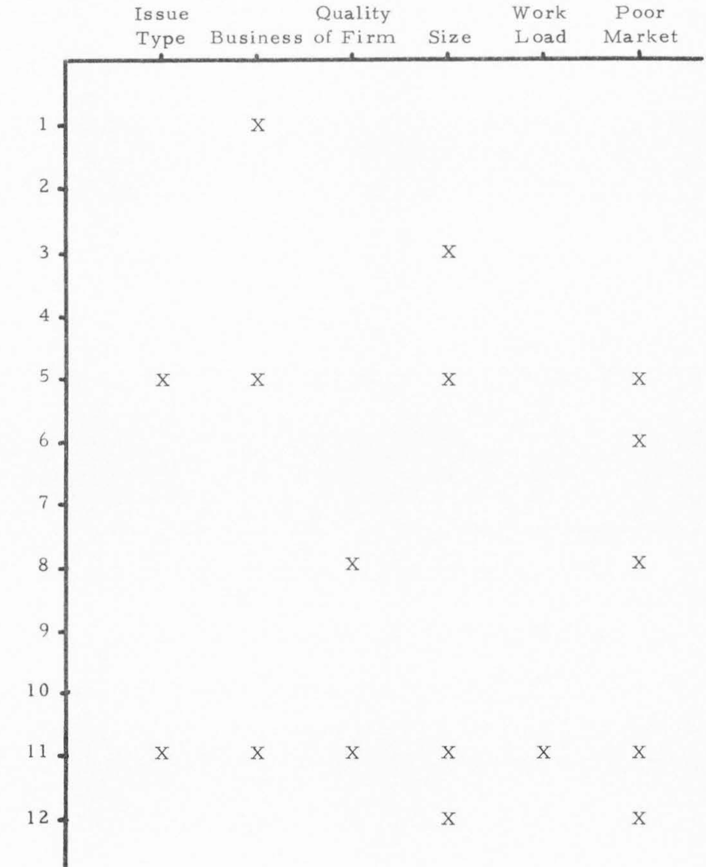


Figure 12. Reasons for Rejection.

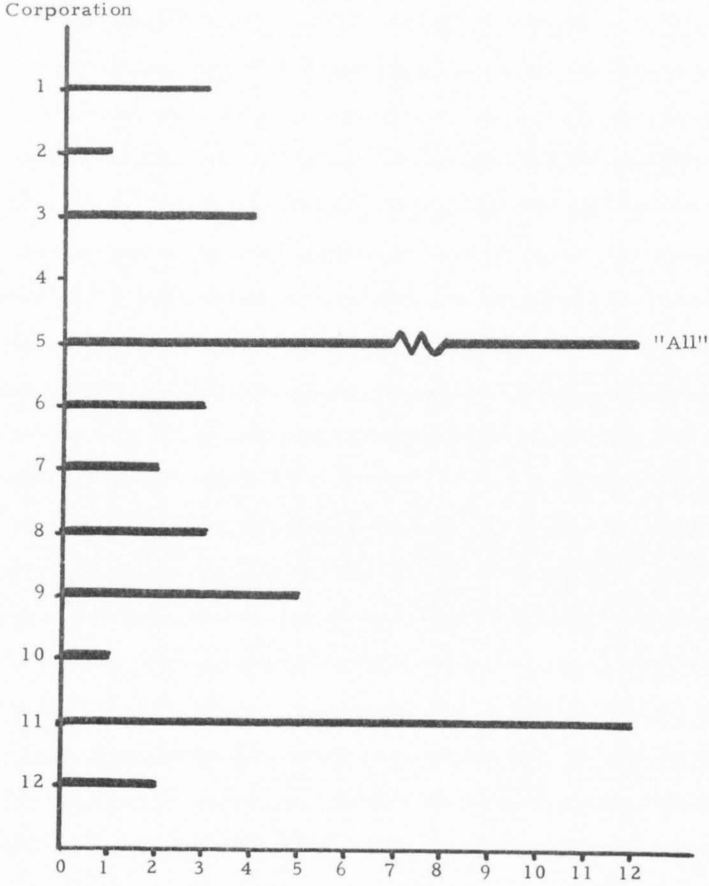


Figure 13. Number of Underwriters Contacted.

issue. All of the leading underwriters in Utah indicated that their current customers were demanding stocks of a more speculative nature. The current demand is for high-risk stocks which will pay off in multiples instead of fractions.

Underwriters Considered. Two firms went to great lengths to locate an underwriter who would handle their issues (see Figure 13). One firm contacted "all underwriters in Salt Lake City and Provo" and the other contacted 12 different underwriters. The number visited has some relationship with the number of reasons for rejection given to the question covered in the previous paragraph. The significance of this data could be in the fact that one firm was seeking only a small ($45, 000) amount of capital. The other firm probably lacked investor appeal.

One firm sought no help from underwriters, selling the issue themselves, while the remaining nine firms approached from one to five underwriters; three being average.

Underwriter's Spread. The commission charges of the underwriter are computed as a percentage of the aggregate sale price to the public. Quoted spreads varied from 7 percent to 20 percent as seen in Figure 14. Only two firms found underwriters who would handle an issue for less than 10 percent. Most firms approached underwriters who charged a spread of 10 to 15 percent. Two firms reported high spreads of 17 and 20 percent respectively.

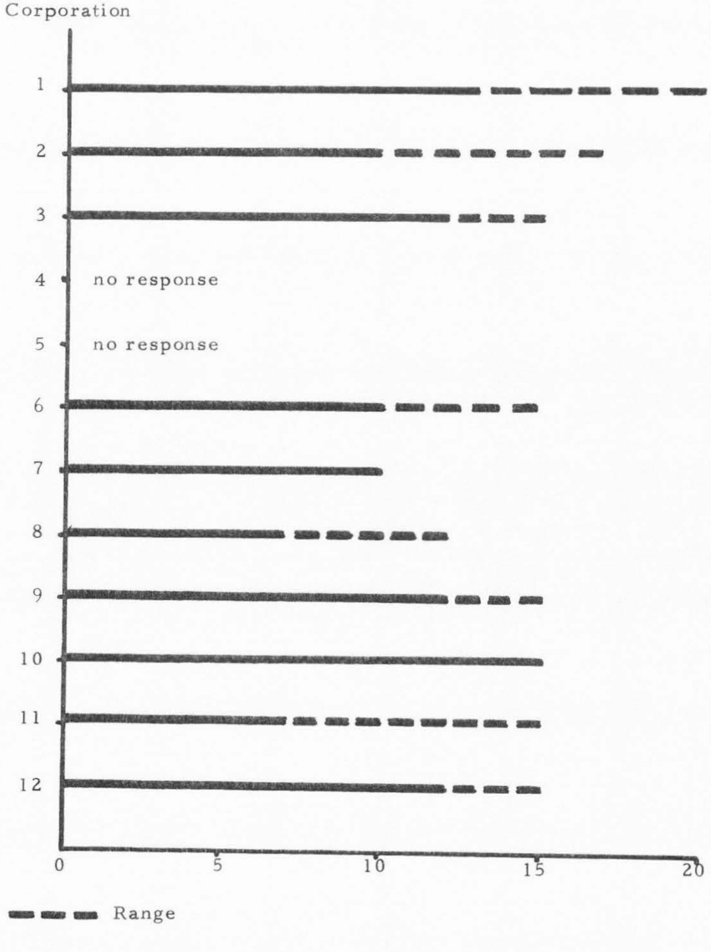


Figure 14. Quoted Underwriter's Spread. Percentage of issue proceeds asked by underwriter(s).

The difference in prices could result for many of the reasons given as reasons for rejection because these conditions could necessitate a more extensive and, therefore, more costly sales promotion.

Services Provided. A major point of interest can be seen in Figure 15 in considering the services provided by the underwriter of the issues of the firms responding. Six firms reported that their underwriter offered nothing more than the selling of the stock. This would seem to be a very narrow scope of operation for such a firm when others are offering much more at no greater cost--perhaps with the exception that the two underwriters who charged a 7 percent spread were reported by two firms who received no additional services. There is no way of knowing if the responses in question represent the same underwriter.

Three firms reported that their underwriter offered at least one of the three services thought important (i. e. planning of the offering, organizational advice, financial advice). As previously noted this area appears to be one in which additional effort would result in benefits to all concerned.

After-Market Services. As Figure 16 shows most of the firms were dealt with underwriters who also sponsored over-the-counter market in the stock. The three firms indicating that there were no services offered include two firms who did not engage an underwriter. Two firms were fortunate to find underwriters who would agree to provide continued advice after the completion of the offering.

| Corporation | Planning | Organizational | Financial | Other |
|---|---|---|---|---|
| 1 | X | | | |
| 2 | X | | | |
| 3 | | | X | |
| 4 | | | | |
| 5 | | | | |
| 6 | X | X | X | |
| 7 | X | | X | |
| 8 | | | | |
| 9 | | | | |
| 10 | | | | |
| 11 | | | | |
| 12 | X | X | X | |

Figure 15. Services Offered Prior to Issue.

| Corporation | Over-the-Counter Market | Continued Advice | Other |
|---|---|---|---|
| 1 | X | | |
| 2 | X | | |
| 3 | X | | |
| 4 | X | | |
| 5 | | | |
| 6 | X | | |
| 7 | X | X | |
| 8 | | | |
| 9 | X | | |
| 10 | X | | |
| 11 | | | |
| 12 | X | X | |

Figure 16. After-Market Services Provided.

<u>Services Needed</u>. Seven firms felt that some additional services would have been beneficial. Three firms felt that some aspect of planning the issue could have received better attention. The points raised in this connection were: a lack of effective analysis or consideration of existing market conditions; a failure to assist in determining an issue price which was appropriate; and the inability of the underwriter to conduct an interstate offering.

Two firms indicated a dissatisfaction with the manner in which the stock was sold or with the fact that their underwriter would agree only to a best efforts arrangement to sell whatever stock possible. Two others felt that the after-market did not receive the desired attention of the underwriter in either provided or promoting an over-the-counter market.

<u>Over-the-Counter Market</u>. With the exception of the firm which had an S-1 offering and one firm which was not underwritten, all issues being traded had from one to five brokerage firms making a market in their issue. Figure 17 shows that most firms had little difficulty in having a market developed for their stock.

<u>Preparation Time</u>. The time spent in the preparation of the offering varied from two months to a year with most issues requiring six months or less. The S-1 offer could be expected to take longer because of the close scrutiny given to this type of issue by the Security Exchange Commission, while a Regulation A issue is designed to be a more streamlined process (Figure 18).

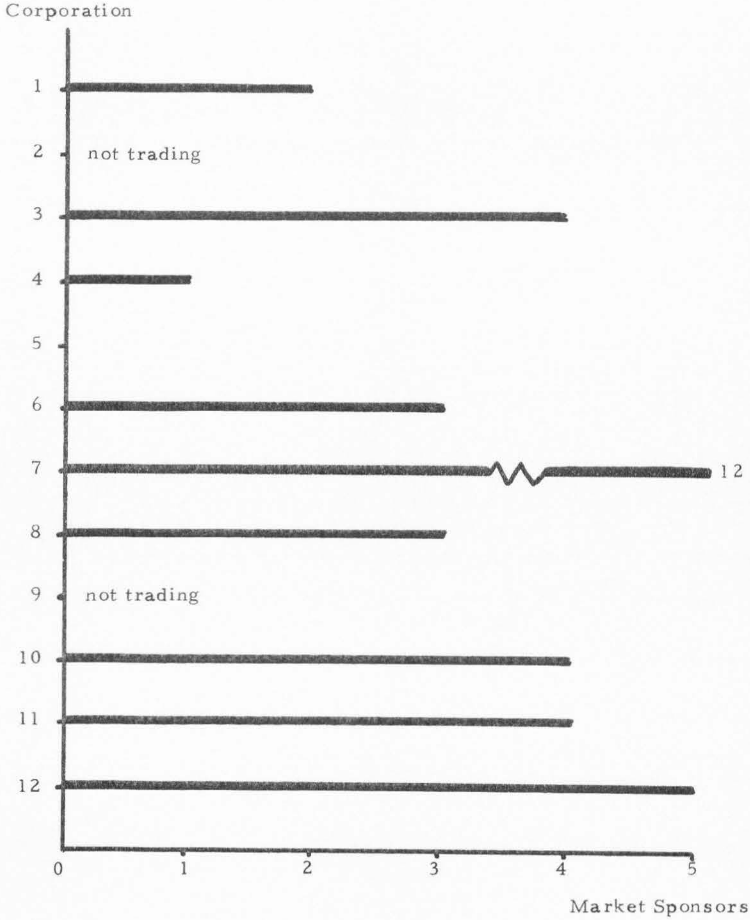


Figure 17. Over-the-Counter Market. Number of brokerage firms sponsoring the market of issue.

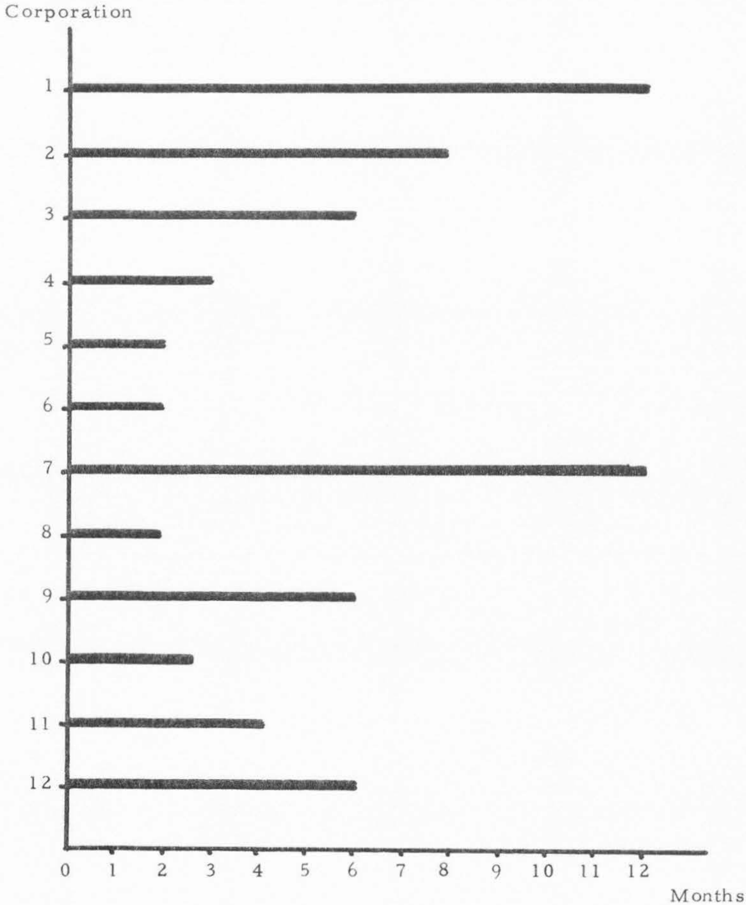


Figure 18. Preparation Time. Time required to complete all necessary actions prior to the actual issue of stock.

Time to Completion. The time necessary to complete the sale of the stock once the issue has been approved is of major interest to the firm being underwritten. Two firms had issues which had not been completed after 12 months and one firm, which did not use an underwriter, took two years to sell all its stock.

The ideal situation was experienced by a firm which was able to have the entire issue of stock sold in one day (Figure 19). The underwriter had obviously done an excellent job in the preparation of the issue and making the necessary contacts in preparation for the approval of the stock issue. Most of the firms did not have this success and were forced to wait as long as six months for the proceeds of the issue.

Location of Underwriter. All of the firms who were underwritten worked with firms located in Utah (Figure 20). Two firms also had connections with underwriters outside the state; one being in New York City and the other being located in Seattle.

Means of Underwriter Acquaintance. Only one firm was introduced to their underwriter by a business consultant (Figure 21). The other companies were referred to their underwriters by personal or business acquaintances.

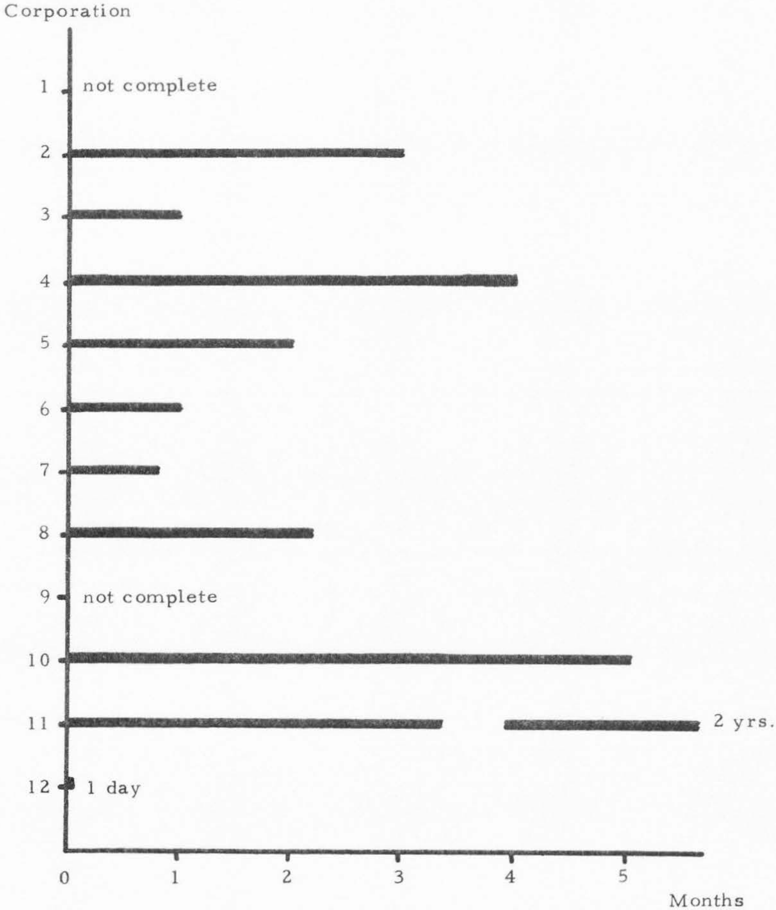


Figure 19. Time to Completion. Time required to complete the sale of stock.

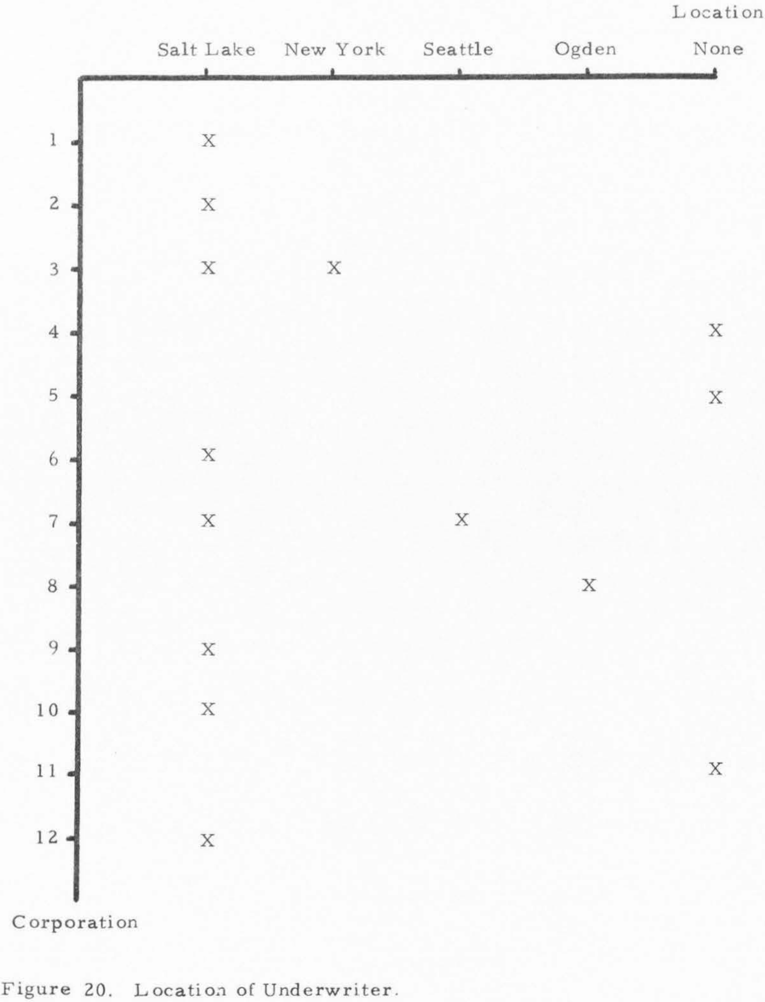


Figure 20. Location of Underwriter.

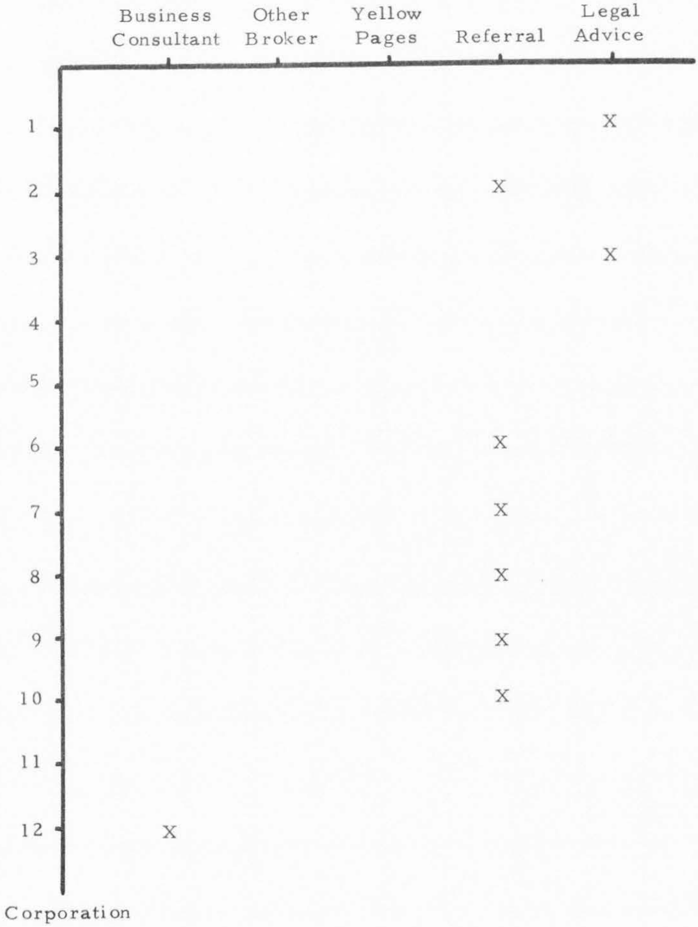


Figure 21. Source of Underwriter Acquaintance.

# CONCLUSIONS

## Suitability

Obviously, not every firm is in a position to seek public equity capital at the present. Many firms are not involved in an industry where there exists a strong demand for its goods. No amount of money from any source would change the situation. Some firms are so small that it would be impossible to provide sufficient risk capital to qualify for an issue large enough to justify the expense. Private placement is a solution to this type of problem.

If a firm does have the necessary qualities to justify a public issue of stock and is inclined to do so, it could profit from the action.

## Underwriting Process

A decision must be made regarding the use of an underwriter. A firm considering a stock issue should visit as many underwriters as possible to gain an idea of what services are available and the costs involved. At this point many people become discouraged thinking that the benefits do not justify the costs and loss of ownership. At least three alternatives are still open to the firm: 1) They can seek a private placement of stock which can be done at much less expense but with a greater loss of control; 2) They can go through the issuing process acting as their own underwriter. The firms who reported this approach were not greatly pleased and indicated that the reduced cost did not outweigh the time and effort required to prepare all the necessary papers and find buyers for the stock; and 3) They can select an underwriter which appears to offer the best deal.

The spectrum of underwriters gives a firm ample opportunity to select an underwriter to meet their needs. There are underwriters who offer nothing more than a sales service to peddle the stock. At the other end are firms which offer a wide variety of services. The cost of the underwriter does not seem to be related to the services offered, so it would appear to be to the advantage of the firm to seek the most for the money. Perhaps there exists an implied service provided by the first type of underwriter; that of assuming the risks involved with selling a stock which would not have universal investor appeal. Stocks of this type are not generally accepted by firms which offer advisory services.

## Issue Size

Although there are underwriters who will accept almost any size issue, the fixed costs of an issue make small issues uneconomical. Figure 22 would indicate that the larger the issue the smaller the percentage of the proceeds which would accrue to parties other

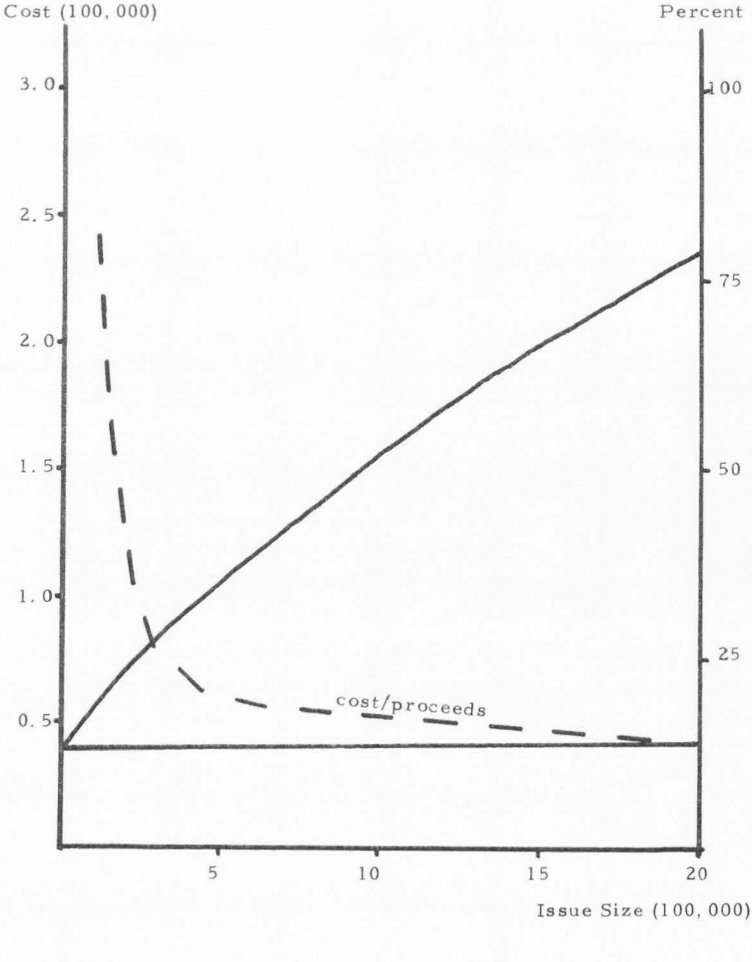


Figure 22. Issue Costs. Costs which firms could expect when undergoing a stock issue as a total and a percentage of the proceeds.

than the issuer. The upward limit should be governed by such things as risk capital, dilution and other Security Commission requirements and the degree of control the existing owners wish to maintain.

## Private Placement

The use of private placement as a means of obtaining funds has not been developed in Utah. Many firms could profit more from this process than by initiating a public offering. Obviously there are disadvantages, as has been noted. But apparently the California firms feel that the advantages outweigh the disadvantages.

Market conditions have a lot to do with the use of private placement. Prior to the market slump beginning in 1969 public offerings were used much more frequently than recently. The demand for new issues has not been evident since the slump began. As a result private placement became the prime means of acquiring funds.

Due to the reduced number of investors, each individual is putting up a greater portion of the total capitalization of the company. With this greater commitment comes a demand for greater assurance of the future success of the firm. The underwriters using private placement claim to provide this assurance. They do this by carefully screening potential companies and preparing those accepted. When an underwriter solicits funds through private placement, their sources of funds accept the offering as evidence of approval of the company's condition. The success of the underwriter is not determined now solely by his ability to move the stock. The investors will evaluate the underwriter by how well the company has been prepared or screened. The investors must experience an acceptable return or they will seek other types of investment or other places to invest their money. The underwriters who have developed a clientele of satisfied investors find that less time must now be devoted to the selling process and more time can be devoted to the preparation of the company. The company profits by quickly receiving the funds to finance their growth and by having expert advice available to improve their chances of success. The investor benefits from the improved chances of success.

## Sources of Funds

It would appear that the source of funds that is most highly developed in Utah is the speculator, who is playing the game for a big score rather than a steady return on his investment. In California the more conservative type of investment is more common--in fact the underwriters on the coast will not handle the type of stock that is in demand in Utah.

Institutions demand conservative investment opportunities over pure speculation. Underwriters in California have developed a clientele which includes a number of institutional investors. It is to these institutions that the bulk of the issues go rather than to individuals. In Utah the opposite is the case--institutional investors are rarely involved in the purchase of local issues but individuals receive the greater portion.

The motives behind the investments by these two types of investors would seem to point out the reasons for the difference. The individual, it is thought, does not in general invest in the stock market for his financial benefit or to accomplish a specific goal. His purpose is to play the game, to be involved, or to try his luck. There is not the emotional reward to invest in a company that is capable of a 10 percent return on investment as comes from an investment that just might give a return of ten times investment. This is a legal form of gambling in Utah.

The institutional investor must be more careful because other people's money is at stake and the purpose of the investment is for a sure return not the chance of a return. Institutions only ask a return a little better than other investment opportunities without a proportional increase in the risk involved. Stock of a company that meets the criteria of needed qualifications is a prime candidate for this type of investment.

Institutional investors are often the source of private placement capital. They are large enough to provide the increments of capital needed and can do so for the length of time necessary for the growth and expansion of the new firm. Before these funds can be made available, the underwriter must be able to show the potential of the new firm and their own competence in the preparation of the firm for the issue.

# RECOMMENDATIONS

## Problem Solution

Two possible solutions are immediately apparent. The existing underwriters can broaden their scope of activities similar to what is being done in California. This would include a better screening and preparation of firms prior to the underwriting. Also, on the other side, additional sources of funds must be cultivated. These sources must have investment goals that can be met by the stock being issued. Obviously, this type of money is available or the California underwriters would not be experiencing their success.

Another approach would be the development of an entirely new type of financial institution that specialized in this type of activity. It is reported that a bank in Salt Lake is experimenting with a subsidiary organization that seeks venture capital for growing companies. Perhaps this will be the answer, but firms outside the banking framework would appear to have a better chance of success because of the conservative activities in which banks can legally participate.

## Further Research

Additional research should be done in the area to determine the feasibility of the possible solutions. The most economical approach would seem to be through existing framework, but additional study may show this not to be practicable. Therefore, it would be necessary to evaluate the other possibilities cited or even develop others. The solution to the problem would be a help to numerous Utah firms and result in a boost to the economy of Utah.

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Weaver, Robert A., Jr. Initial Public Financing for the Small & Medium Sized Business. Washington, D. C.: Investment Bankers Association of America, 1969.

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Hershman, Arlene. "Private Placement the 'New' Money Game," Duns Review, XCIII (February, 1969), 23-25.

Levy, Robert. "The Perils of Going Public," Duns Review, XCIV (September, 1969), 46-47.

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# APPENDICES

## Appendix A

## Questionnaire

### Size

1. What, if any, minimum size restrictions (dollars to be raised) do you practice?
   a. ________________
   b. variable ________________ to ________________
   c. no minimum

2. What, if any, maximum size restrictions do you practice?
   a. ________________
   b. variable ________________ to ________________
   c. no maximum

### Cost

3. What is the cost to the issuing company? (check all applicable)
   a. below 10%
   b. 10% to 12 1/2%
   c. 12 1/2% to 15%
   d. 15% to 17 1/2%
   e. over 17 1/2%

4. What elements determine cost variations? (check all applicable)
   a. size of issue
   b. type of issue
   c. quality of company
   d. type of company
   e. geographical location of company

### Services

5. What services do you offer the potential company?
   a. planning the offering
   b. organizational advice
   c. financial advice
   d. continued management advice
   e. other ________________________________________________

6. Do you offer after-market service?
   a. no
   b. sponsor over-the-counter market
   c. promote over-the-counter market with other firms
   d. other ________________________________________

7. How many firms normally sponsor over-the-counter markets in your issues?
   a. none
   b. 1 to 3
   c. 4 to 5
   d. over 5

8. How long does it normally take from introduction to time of offering? ________________________________________

9. How long does it normally take to complete offering? __________
________________________________________

10. Do you limit your services to a particular type of business?
    a. no
    b. manufacturing
    c. service
    d. financial

Resources

11. What geographical areas will you service? (check applicable)
    a. Pacific North West
    b. California
    c. Utah
    d. South West

12. What geographical areas receive bulk of distribution?
    a. Pacific North West
    b. California
    c. Intermountain States
    d. Arizona/New Mexico

13. What are the sources of potential customers?
    a. business consultants ______%
    b. non-underwriting brokers ______%
    c. yellow pages ______%
    d. personal acquaintance referral ______%
    e. other (specify) ______% ________________________________________

14. How do you react to a customer who appears with a business consultant in tow?
    a. pleased
    b. indifferent
    c. irritated
    d. other (specify) ________________________________

15. How frequently are business consultants brought in by customers?
    a. never
    b. seldom
    c. regularly

16. How do you value the business consultants brought in by customers?
    a. helpful
    b. have no value
    c. create problems
    d. retard progress

17. What percentage of issues receive private placement?
    a. none
    b. 25%
    c. 50%
    d. 75%

18. What distribution does private placement normally receive?
    a. one person or institution
    b. five persons or institutions
    c. ten persons or institutions
    d. over ten

# Appendix B

## Underwriter Addressees

Birr Wilson
155 Sansome
San Francisco, California

Davis Skaggs
160 Sansome
San Francisco, California

Hambrecht Quist
235 Montgomery
San Francisco, California

Henry Swift
510 Montgomery
San Francisco, California

Schuman Agnew
650 California
San Francisco, California

Sutro & Company
460 Montgomery
San Francisco, California

William Hutchison
44 Montgomery
San Francisco, California

Bonneville Underwriters
136 South Main
Salt Lake City, Utah

First Fidelity Underwriters
610 East South Temple
Salt Lake City, Utah

First Utah Underwriting
Continental Bank Bldg.
Salt Lake City, Utah

Parker-Jackson-Mann
431 South Third East
Salt Lake City, Utah

Parker-Mawood
Continental Bank Bldg.
Salt Lake City, Utah

Prince-Covey
29 East Second South
Salt Lake City, Utah

Wilson-Davis
37 East First South
Salt Lake City, Utah

## Appendix C

## Questionnaire for Corporations

1. How large was your issue? $ ______________

2. What did it sell for? $ ______________

3. Did any underwriters object to the size of your issue? ________

4. Did you find any underwriters who practiced any of the following restrictions? (check applicable)
   a. type of issue
   b. type of company
   c. quality of company
   d. size of company
   e. too busy
   f. poor market conditions

5. How many different underwriting firms did you approach? _____

6. What was the range of quoted costs? _________ to __________

7. What services were offered? (check applicable)
   a. planning the offering
   b. organizational advice
   c. financial advice
   d. other ______________________________________________

8. What after-market service is available to you?
   a. none
   b. over-the-counter market
   c. continued advice
   d. other ______________________________________________

9. What services would have been beneficial? _________________

   ______________________________________________________________

10. How many firms are currently sponsoring over-the-counter markets in your issue? ______________________

11. How long did it take to prepare the offering? ________________

12. How long did it take to complete the offering? ________________

13. Where is your underwriter located? ________________________

14. How did you locate your underwriter?
    a. business consultant
    b. non-underwriting broker
    c. yellow pages
    d. personal acquaintance referral
    e. other ________________________________________

## Appendix D

## Firm Addressees

Cybernetics International Corp.
280 Park Avenue
New York, New York

Ringling Bros. -Barnum & Baily
Combined Shows, Inc.
1250 Connecticut Avenue, N. W.
Washington, D. C. 20036

Beehive Medical Electronics, Inc.
1473 South Sixth West
Salt Lake City, Utah

Shaft Drillers, Inc.
5925 Spring Mountain Road
Las Vegas, Nevada 89103

Pacific Engineering & Production
Company of Nevada
Henderson, Nevada

Medical Development Corp.
2132 Richards Street
Salt Lake City, Utah

Auric Metals Corp.
926 Kennecott Building
Salt Lake City, Utah 84111

CMC Industries
5899 South State Street
Murray, Utah

Computer Logic Corporation
455 East Fourth South Street
Salt Lake City, Utah

Computron Corporation
c/o Kenneth S. Cook
6888 South 500 East
Midvale, Utah

Killebrew, Inc.
68 South Main
Salt Lake City, Utah

Centaur Enterprises, Ltd.
333 South 200 East
Salt Lake City, Utah

Warlock Computer Corp.
Route 7
Georgetown, Conn. 06829

Mortgage Investment Trust
of Utah
Walker Bank Building
Salt Lake City, Utah

Process Systems
3061 Sheridan Street
Las Vegas, Nevada 89102

Intermountain Exploration
P. O. Box 473
Boulder City, Nevada 89005

Dairy Management Corp.
c/o Lloyd A. Clement
70 Raymond Court
Logan, Utah 84321

Admiral Hospitals Incorporated
3700 Wilshire Blvd.
Los Angeles, California

New Era, Inc.
610 East South Temple
Salt Lake City, Utah

Tape-Licator, Inc.
444 South State Street, Suite 408
Salt Lake City, Utah

January Mining Company
1399 South Seventh East, Suite 11
Salt Lake City, Utah 84100

Loretto Mining Company
266 Phillips Petroleum Bldg.
Salt Lake City, Utah

Gulf Energy Corporation
1001 Deseret Bldg.
Salt Lake City, Utah

Quantex Corporation
2330 South Main, Suite 9
Salt Lake City, Utah

Mortgage Investment Company, Inc.
5th Floor Walker Bank Bldg.
Salt Lake City, Utah

Micro Investment Corporation
Box 895
Cedar City, Utah

Arnold Machinery Company, Inc.
2975 West 21st South
P. O. Box 2220
Salt Lake City, Utah 84110

Permaloy Corporation
2861 South 1100 West
Ogden, Utah

Silver Mountain Mining Co.
4783 Idlewild Circle
Salt Lake City, Utah

Rocky Mountain Nuclear Corp.
610 East 200 South
Moab, Utah

Clear Air, Inc.
222 West 20th Street
Ogden, Utah

Area Investment & Development Company
7545 South 2700 East
Salt Lake City, Utah

Arms Development Company
3324 South State
Salt Lake City, Utah

Apache Corporation
C T Corporation System
175 Main Street
Salt Lake City, Utah

National Heritage Corporation
1822 East 21st South
Salt Lake City, Utah

Search, Incorporated
530 East 5th South, Suite 101
Salt Lake City, Utah

Hi-Ho Silver & Gold Corp.
731 East South Temple
Salt Lake City, Utah

Western Research & Manufacturing Co.
2260 West 5th South
Salt Lake City, Utah

Last Chance Mining Co., Inc.
580 Kennecott Bldg.
Salt Lake City, Utah

Tintic Gold Mining Company
580 Kennecott Bldg.
Salt Lake City, Utah

## Appendix E

## Thumbnail Sketch of Responding Corporations

Firm 1. A small firm without history of earnings or previous business success attempting to establish dairy.

Firm 2. Mining Operation.

Firm 3. Mining Operation.

Firm 4. Investment Corporation.

Firm 5. Mining Operation.

Firm 6. Drilling of large diameter shafts for mining and mineral production purposes.

Firm 7. Engineering and Production.

Firm 8. Manufacturing Company.

Firm 9. Mining operation without history of earning or previous business success.

Firm 10. Computer softward company without previous business operation.

Firm 11. Mining Operation.

Firm 12. Manufacturing/Service Organization.

# VITA

John A. Kerr

Candidate for the Degree of

Master of Science

Thesis: The Problems Confronting Small Utah Companies Seeking the First Increment of Public Equity Capital

Major Field: Economics

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