



Exempt Markets and Securities

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I am going to let you in on a not widely known segment of the Canadian capital markets. Ask most investors what comes to mind when they think of investments and most will respond stocks and bonds. However, from the data I have seen, these instruments are only half of the money flowing in the Canadian capital markets. During a past meeting with provincial securities regulators, I learned that more money was actually raised last year in what are called the exempt markets than the public markets. The exempt markets are a little known segment of the Canadian capital markets, but can offer diversification and other benefits to a traditional portfolio.

What are exempt markets and securities? Usually, if an issuer is going to raise money from the general public, it must file a prospectus. However, exempt securities are securities that are issued under National Instrument 45-106 and are exempt from prospectus requirements. Some of these exemptions include:

- **Accredited Investor** – If an issuer is raising money from an investor who is investing money as principal and is accredited, then no prospectus needs to be filed. For an individual to be considered an accredited investor they must own financial assets worth more than \$1 million or have a net income of \$200,000 per year in each of the 2 most recent calendar years (\$300,000 if combined with a spouse). Certain institutions, such as pension funds, are also considered accredited. The most likely rationale for this type of exemption is that an individual with the aforementioned level of wealth or income should be a savvy enough investor not to need full prospectus disclosures and will do their own due diligence.
- **Friends, Family and Business Associates** – An issuer can raise funds from close friends or business associates and family without a prospectus.
- **Offering Memorandum** – Prospectus requirements do not apply if an issuer prepares an Offering Memorandum and delivers it to the investor at the time of purchase along

with getting him or her to sign a risk acknowledgement form.

- **Minimum Investment Amount** – If an issuer raises money for an amount not less than \$150,000 at a time in cash, then no prospectus is required.

The above are some of the main examples and there are variations by province. Historically, as long as an investor met the above requirements, issuers could contract individuals to seek out investors for them and then pay a commission on the amount raised. However, recently, new securities regulations have come into force in the form of National Instrument 31-103 which requires firms raising money in the exempt markets to register as Exempt Market Dealers (EMDs) and individuals of such firms as dealing representatives. These EMDs now resemble Investment Dealers except that the former deals in exempt market securities and the other in public securities. Similarly, exempt dealing representatives are analogous to stock brokers working at the investment dealers.

Our firm, Fundamental Research Corp, has produced research on some of these exempt market issues. We will now have a look at some of them so that you can get a sense of just how unique and diverse these alternative investments are from more mainstream stocks and bonds.

Prestige Hospitality HW Limited Partnership (from a report dated January 31, 2011) - Prestige Hospitality Corp. has franchise and management agreements with subsidiaries of Hilton Worldwide to build and operate the Calgary Airport Hotels and Conference Centre, which will be built as a four-phase development project featuring three hotels and a commercial office tower. The \$9.5 million offering that was the subject of our report, was related to Phase 2, which involves the development of the Homewood Suites by Hilton Hotels – the second of three planned hotels. The objective of the investment opportunity is to provide an annual yield to investors through income generated from hotel operations and

long-term capital appreciation from the potential increase in the values of land and the hotel business. Each LP unit is \$1,000 and our analyst believes that the expected hold horizon was at least 6 years.

Neo Exploration Inc. (report dated January 25, 2011) - Neo Exploration Inc., based in Calgary, Alberta, is a private oil and gas company. Its flagship projects are the high-netback horizontally developable light oil Cardium play in Crossfield, Alberta and the Bakken play in Sinclair, Manitoba. The company essentially also has 100% WI in a huge shallow gas development play (Taber) in Alberta. Neo has a farmout agreement with a private energy trust to develop the Crossfield project. The trust would fund the capital costs associated with up to the first 20 wells in return for a 50% WI (Working Interest). Neo's production, at the time of the report, was about 200 boepd (barrels of oil equivalent per day) net - 65% gas. Our analyst expects production levels to increase in CY2011 (Current Year) as the company continues to develop its light oil assets. In addition to owning oil and gas assets, the company also provides asset management services to other oil and gas companies in return for an interest on the projects it provides services for. At the time of the report, Neo was looking to raise up to \$6 million, including \$4 million from flow-through shares. The minimum subscription amount was \$9,750.

Assiniboia Farmland Limited Partnership (report dated September 29, 2010) - Assiniboia Farmland Limited Partnership's primary business is to acquire farmland located in Saskatchewan and lease them to farm operators. The Partnership's objective is to attain long-term capital appreciation through an increase in land values in Saskatchewan, and generate 3-5% annual income for investors. It is the largest farmland investment partnership in Canada with a portfolio of about 93,000 acres of farmland with a market value of about \$50 million. Our analyst believes that Saskatchewan offers an attractive investment opportunity as its land values seem to be significantly undervalued compared

to neighboring jurisdictions.

As you can probably see, the above offerings are uniquely different and diverse. Exempt market securities may provide certain benefits to a traditional portfolio of stocks and bonds in the form of diversification and cash flow. Also, because the assets are not traded, investors do not have to suffer daily volatility. For example, the accompanying table shows the correlation of asset returns from 1970-98.

As can be seen in Table 1 for example, the correlation between farmland and other assets is either extremely low or negative, indicating that adding farmland to a portfolio may reduce portfolio risk.

However, as with all things in finance, there is no free lunch. Exempt market securities are largely private and do not trade on stock exchanges. As a result, many times, if an investor needs to cash out, they can only do so by having the issuer redeem the shares. Depending on how long the investor has held the shares, the issuer may deduct some sort of fee/penalty. Other times, if there is no redemption provision, the investor will need to find a buyer for their shares themselves. Because many of the issues are private, there may be less disclosure available.

As mentioned above, exempt market securities are available through various exempt market dealers. Some of the EMDs where the above offerings may be available include Raintree Financial Solutions, Omnis Investments Limited, and Foundation Securities Corporation although there are certainly more EMDs across Canada. Some EMDs produce and raise money for their own products while others only raise money for third-party issuers.

It is an exciting time right now in the exempt market industry as it is in early stages and evolving due to the new

	T-Bills	Bonds	Farmland	Canada	France	Germany	Italy	Japan	UK	USA
T-Bills	1.00	0.93	0.08	-0.16	-0.12	-0.11	0.04	-0.13	-0.09	-0.04
Bonds		1.00	0.00	-0.18	-0.12	-0.08	0.06	-0.03	-0.06	-0.01
Farmland			1.00	-0.03	-0.21	-0.21	-0.13	-0.19	-0.05	-0.19
Canada				1.00	0.49	0.19	0.34	0.32	0.40	0.61
France					1.00	0.70	0.74	0.45	0.46	0.45
Germany						1.00	0.63	0.30	0.39	0.38
Italy							1.00	0.43	0.29	0.38
Japan								1.00	0.23	0.17
UK									1.00	0.57
USA										1.00

Source: Dr. Marvin Painter, Efficient Investment in Saskatchewan Farmland, University of Saskatchewan. Correlation ranges from -1 to 1. If two assets have a correlation of 1, they are said to have perfect positive correlation. When one asset is up, so is the other. If -1, then perfect negative correlation exists. When one is up, the other is down. If 0, then no correlation. Diversification, in the technical sense of the word, means that ideally, assets in a portfolio should have as little correlation as possible in a portfolio so that losses in one stock are offset by gains in another.

regulations. Investors and financial advisors who wish to learn more about the exempt markets should take note of the upcoming “Alternative Investment Opportunity Conference - Exempt Market Investment Opportunities in Canada” in Vancouver on June 11 (<http://www.emdshow.com>). The venue offers investors, advisors and anyone operating in the exempt markets a place to potentially discover new investment opportunities and learn about this segment of the Canadian capital markets with such speakers as Andrew Bell, host of BNN’s Alternative Investments Show, the B.C. Securities Commission and Bill Rancic, Donald Trump’s original Apprentice, who is also a real estate developer (many exempt market offerings are in the real estate sector).

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