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Private Investment in Public Equity: An Overview

PIPEs allow smaller public companies access to elusive capital

Small and midsized public companies often face significant hurdles in their efforts to raise money. Many of these companies do not have the same level of access to the capital markets as their larger competitors due to a number of factors including: the cost of raising public capital, a lack of visibility to institutional investors, a dearth of analyst coverage, low trading float and the tendency of investment banks to focus on "easy prey."

The capital markets have attempted to provide such companies with access to needed capital by creating an increasingly popular financing technique commonly known as a "PIPE" (Private Investment in Public Equity) transaction. PIPE transactions, when done properly and for the right reasons, give smaller public companies access to capital at a lower cost than typical underwritten offerings, while increasing institutional investment in the company and improving the public float of securities.

Anatomy of a PIPE

In a typical PIPE transaction, the issuer sells shares of common stock at a discount to current market prices. As a "sweetener" for the transaction, the issuer also issues warrants (usually with a five-year term) enabling the holder to purchase additional shares at a price equal to or at a premium to current market prices. Since the shares issued in a PIPE transaction are "restricted securities" under the federal securities laws and therefore are not freely tradable by the investors, the issuer is required to file a registration statement shortly after closing to provide for the public resale of the shares. In the event that filing of a registration statement or its effectiveness is delayed past a set deadline, or the registration statement becomes unavailable for more than a specified period, the issuer is required to pay liquidated damages to the holders (typically 1 percent or 1.5 percent per month) to make them whole for the lack of liquidity.

PIPE Benefits

A PIPE transaction can be done quickly and much more cheaply than a registered public offering. Many institutional investors have form purchase documents that can be used to generate deal documents for a particular issuer in a matter of hours. The placement agents active in the PIPEs market have close and ongoing relationships with PIPEs investors and can market a proposed transaction quickly and efficiently. In many cases, a PIPE transaction can go from contemplation to closing in two weeks or less. In addition, even though the issuer is required to file a registration statement covering the shares issuable in the transaction, the issuer is not required to incur that expense until after it has received the investment proceeds. Also, as a result of a quirk in the federal securities laws, the issuer is frequently able to use a short-form registration statement (which allows for incorporation by reference of reports filed under the Securities Exchange Act and updating through the regular filing of periodic reports) to register the shares for resale when the issuer would not be allowed to use that form for a registered public offering.

PIPE Risks

As indicated above, when done right, a PIPE transaction is an effective and efficient means of accessing capital. However, as the market has become bigger and more popular, it has attracted less reputable placement agents who are interested primarily in earning fees and investors focused on the short-term structural gains possible with a PIPE and not the investment quality of the issuer. Accordingly, it is important for issuers to understand the market and know the reputations of the various players to avoid getting caught up in a

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bad situation that ends up damaging the issuer and the market for its common stock.

Problems arise on PIPEs transactions from a number of different areas. For example, the Securities and Exchange Commission has taken the position that knowledge of a pending PIPEs transaction may constitute material nonpublic information. This can lead to a chicken-and-egg problem in which an investor may want to know about a proposed deal but not want to be restricted from trading. In the past, placement agents would call investors and advise them of pending deals.

While this information was supposed to be confidential, it became increasingly clear that potential investors, or friends of potential investors, were trading on the basis of this information, typically by shorting the stock of the issuer in anticipation of a PIPE being priced at a discount to market. The SEC is currently investigating these trading practices and the expectation is that significant enforcement actions will soon be forthcoming. However, to their credit, most reputable placement agents have determined to clean up their own practices by requiring potential investors to sign agreements acknowledging that they may receive this market information in the future and agreeing not to trade in the related securities once they are made aware of a potential deal.

As PIPEs transactions have proliferated, they have become a favored investment of short-term arbitrage investors. These investors purchase PIPE securities, not based on the investment quality of the company, but rather on market mechanics, such as the ability to borrow shares to sell short to hedge their investments and the amount of float in the marketplace. These investors typically purchase PIPE securities and immediately sell a similar number of shares short. By doing so, they are able to "lock-in" a profit on the transaction because of the difference between the market price of the stock and the discount offered to the PIPE investors. As soon as they are legally able to do so, they unwind their hedge, in effect using the shares purchased in the PIPE to offset their obligation to deliver the shares sold short. Having locked in their profit on the transaction, the investor then is free to hold the warrants for whatever upside potential there may be in the underlying stock.

While short-selling is an important technique in maintaining the integrity of the financial markets, in a PIPEs transaction, this type of unchecked short-selling can spell disaster for the issuer. Frequently, investors have sold shares short without having located the shares they are required to deliver in the sale. As a result, there can be huge downward pressure on the price of an issuer's stock as the investor is allowed to carry a "failed" trade until it is able to complete settlement using, in effect, the shares purchased in the PIPE. This type of short-selling has become so prevalent that recently both the SEC and Nasdaq have taken steps to limit the ability of short-sellers to make short sales without having actually located the shares to be delivered. However, many long-term investors believe that the SEC and Nasdaq initiatives are only partial solutions and that more remains to be done to curb these abuses.

Ideally, a PIPEs issuer would like all of its securities to flow to buy-and-hold investors. These investors need the same level of liquidity because of investment restraints and valuation issues, but are not typically active traders in the securities they purchase. In some cases, investors have held their shares for many years, becoming a part of a stable investment base and a ready source of future financing. Placement agents know from experience which investors are short-term arbitrageurs and which ones are longer-term investors. However, depending on the quality and reputation of the placement agent, it may not have access to the "best" investors, or the more desirable investors may shy away from a deal because of the participation of "bad" investors. A reputable placement agent will try to build an order book that best suits the needs of a particular issuer. However, there are plenty of placement agents that are active in this market who would sell the PIPE to anyone in order to earn a fee. Here again, counsel experienced in the marketplace can be quite helpful in steering deals to good placement agents and advising issuers with respect to particular investors.

PIPEs issuers also need to understand and abide by the "rules of the road" for PIPEs investments. For example, both Nasdaq and the American Stock Exchange have rules that may require PIPEs transactions to be approved by stockholders if they are not structured correctly. While some deals will of necessity require stockholder approval, an issuer who needs capital is not likely to want to submit a deal to its stockholders if a change in structure avoids the obligation to do so. Further, because a PIPE transaction is a private placement of securities under federal securities laws, it is important to preserve the exemption. How the PIPE is marketed and what prior financing activity the issuer has done may significantly impact the issuer's ability to do a PIPE transaction. Finally, an issuer that is quoted on the Over the Counter Bulletin Board or the "Pink Sheets" will not be able to obtain all of the efficiencies of a PIPE.

Conclusion

PIPEs have become an increasingly popular mechanism for small and mid-sized public companies to raise needed capital. Done correctly, a PIPE offers tremendous advantages to an issuer and can be an efficient and cost-effective way to raise money. However, PIPEs do have risk and can be exploited at the issuer's peril if not done properly. ■