



### **PIPEs: Raising Capital in a Bear Market**

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The plunge in share prices since early 2000 has created myriad problems for companies that went public during the long bull market of the 1990s. With cash reserves diminishing, a major challenge facing companies these days is raising capital now that the public equity and debt markets have largely slammed shut. In this difficult environment, a financing technique called a PIPE (private investment in public equity) can provide a quick and efficient route to capital for many companies.

#### **What is a PIPE?**

A PIPE consists of a private placement by a public company to selected accredited investors who commit to purchase a specific number of securities at a fixed price. Unlike a conventional private placement, a PIPE deal closes (and money changes hands) only after the Securities and Exchange Commission has declared effective a resale registration statement covering future sales of the securities purchased by the investors. In essence, therefore, the shares purchased can be sold in the open market at any time following the closing.

Beyond this basic structure, PIPEs come in various different flavors. They can involve the sale of common stock, preferred stock or debentures. They may or may not offer the investor down-side protection (in the form of shares or warrants whose purchase price can be reset) or anti-dilution protection. PIPE deals can be structured so as to obtain an effective shelf registration prior to syndicating the deal or by identifying the investor group before filing a registration statement with the SEC (in which case the transaction does not close until the registration statement has been declared effective). Of course, the terms and conditions of the deal are subject to negotiation between the parties; typically, however, shares are purchased at a discount of between 5% to 15% off the then-current market price.

The PIPE market has grown rapidly in recent years. According to PrivateRaise.com, a total of \$23.4 billion was raised through PIPEs in 2001 and a further \$7.9 billion was raised during the first five months of 2002. A wide variety of issuers have tapped the PIPE market, including telecommunications companies (\$4.8 billion raised through

PIPEs during 2001 and the first five months of 2002), pharmaceutical companies (\$2.6 billion), media firms (\$2.27 billion), healthcare companies (\$1.3 billion) and biotechnology firms (\$1.13 billion).

PIPEs have been raised by both large and smaller issuers. In the last 18 months, 56% of all PIPE transactions were executed by issuers with a market capitalization of less than \$50 million. During the same period, 54% of PIPE dollar volume went to issuers with a market cap of more than \$250 million.

*Why are PIPEs popular?*

From the issuer's perspective, PIPEs offer a number of distinct advantages:

- **Accessible capital.** The PIPE market has grown just as access to the public markets has diminished drastically. PIPEs are therefore an attractive option for companies that are unable or unwilling to tap the public markets.
- **Flexibility.** The size and structure of a PIPE can be tailored to meet the specific needs of the issuer. Moreover, PIPEs normally do not involve significant post-closing requirements, such as stringent operating covenants.
- **Timing.** PIPE deals can be closed expeditiously (often in five weeks or less).
- **Investor demand.** PIPEs appeal to a broad range of accredited investors, including hedge funds, private equity firms, mutual funds and strategic corporate investors. The list of investors to be approached can be targeted to meet the issuer's needs.
- **Desirability of institutional investors.** The presence of institutional investors among the issuer's shareholders often enhances overall confidence in the company and its securities. This is especially true following the recent flurry of financial scandals -- the issuance of securities to "smart money" (sophisticated investors who presumably have done their homework before making an investment) will likely be interpreted positively by the market.
- **Financial focus.** Unlike venture capital investors, who generally expect a significant role in the management of their portfolio companies (and who have recently started to invest in public companies), purchasers of PIPEs typically are interested primarily in the financial performance of their investment. This lack of investor interference allows the management of a PIPE issuer to focus on successfully building the business.

Investors prefer PIPEs mainly because they offer the certainty of immediate liquidity. In this regard, it should be stressed that PIPE investors' interests are essentially aligned with those of management and the other shareholders: they basically want to see the stock price go up. In addition, the market is likely to react positively to the increased float and enhanced liquidity achieved through the issuance of a PIPE, a benefit often underestimated by issuers. For these reasons, PIPE investments are likely to increase stability in the issuer's securities.

PIPEs involve a level of complexity beyond the experience of many bankers and financial advisers. Moreover, choosing a sub-optimal financial structure for a PIPE can have negative consequences for the issuer. Accordingly, companies considering the

issuance of a PIPE should select an experienced adviser who is able to identify and assess all key issues relating to the proposed transaction.

As stock market turbulence continues, PIPEs will remain an advantageous means for public companies to raise needed capital quickly and at reasonable cost. An experienced financial adviser, working with the issuer's senior management team and lawyers, can analyze the PIPE alternative as well as support the structuring and consummation of a successful transaction.

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