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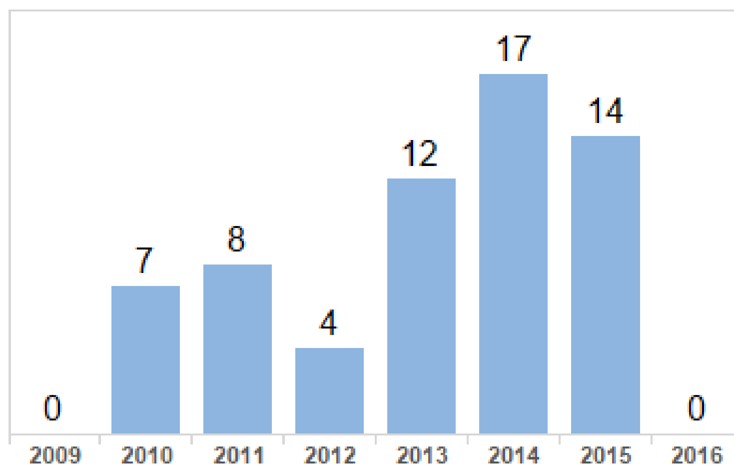
Cold IPO Market Forces Companies To Get More Creative

By **Tom Zanki**

Law360, New York (February 1, 2016, 4:12 PM ET) -- The weak market for initial public offerings and follow-on deals has companies scrambling for alternatives to meet their capital needs, and attorneys say viable funding options exist for them to choose from, albeit none as ideal as a robust public market.

Not a single IPO priced in January amid global market volatility, and the chilly environment affects private companies considering the public offering route as well as existing public companies looking to tap markets for additional funding.



Source: Renaissance Capital

Attorneys say there is no one-size-fits-all solution given that company needs and the appetite of their investor bases vary widely. But options can include private placements, strategic partnerships, debt financing or alternate routes to the public markets, such as reverse mergers, among other methods.

"There are alternatives for raising capital," said Baker Botts LLP partner Hillary Holmes, whose firm focuses on energy companies, an industry hit particularly hard in from collapsing oil and gas prices that preceded the IPO downturn. "They are not necessarily as ideal as broad access to a strong public market. Everybody agrees on that. Capital is more expensive now."

Robert Freedman, a partner at Fenwick & West LLP, whose firm specializes in the life sciences and technology industries, said late-stage private companies are finding it harder

to attract outside money, including crossover investors, a pivotal group known for buying stakes in companies shortly before, during and after an IPO.

"That kind of money is going to be much tougher to get because they don't have the confidence that the company will be able to go public in the near term," Freedman said of outside investors. "They want to see a potentially quicker return and more liquidity faster."

Private companies might fare better tapping their inside base of venture capital investors, who are likely more familiar with the business and, accustomed to market swings, bring a long-term perspective. But Freedman added that funding rounds may be less generous given the ripple effect of ailing public markets.

"All valuations are potentially taking a hit," he said.

Private Companies Face High Hurdles

Private companies that want to tap public markets without filing an IPO have a few options, but there are several drawbacks and contingencies associated with those options, attorney say.

Private companies can pursue what is called a reverse merger, in which a private company joins an exchange after buying a public shell company, enabling them to more easily secure future financing. Freedman said reverse mergers are becoming less common, partly because the U.S. Securities and Exchange Commission and major exchanges view the backdoor entry to public markets skeptically.

"But it's possible that there may be a step up in the number that do that if the IPO market stays closed," Freedman noted.

And in 2011, the SEC, concerned that lesser-quality foreign companies with unreliable financial statements were accessing U.S. markets through reverse mergers, approved tougher rules for such companies. Among them, Nasdaq and the New York Stock Exchange now require a one-year "seasoning period" through which most companies must first trade over the counter while filing audited financial statements with the SEC.

"A good company, a real-quality company does not want to be stuck on the OTC market for a year or more," Sichenzia Ross Friedman Ference LLP partner Gregory Sichenzia said. "There is a stigma attached there too."

Companies can get around the seasoning requirement if their deal includes an underwritten offering of at least $40 million. But Sichenzia added that reverse mergers still come with considerable expenses and, unless done simultaneously with a financing round, don't immediately yield cash the way an IPO does.

"It's not ideal," Sichenzia said. "There is no guarantee you are going to do this process in conjunction with a capital raise."

Private companies can also go public through what are known as Form 10 filings, which contain disclosures similar to an IPO prospectus that, once approved by the SEC, enable those businesses to become public reporting companies.

Such companies will typically raise money through a private placement with institutional investors immediately before the Form 10 process, hoping to expand their investor base after the Form 10 is effective and eventually qualify for uplisting to a major exchange.

"The thought is you can raise money easier if you have a publicly reporting vehicle," Mintz Levin Cohn Ferris Glovsky & Popeo PC member Jeffrey Schultz said.

Those companies can expand their investor base through a retail private investment in public equity, or PIPE, which are available to retail and institutional investors, or over-the-counter public offerings, helping them meet an exchange's listing standards. Fertility treatment company OvaScience Inc. was listed on the Nasdaq after taking the Form 10 route.

The Form 10 process has some similarities to a reverse merger except there is no combination with another public shell company and the company would not be subject to the extra seasoning requirements of the exchange.

Businesses that need immediate access to cash can choose other paths, including partnering with larger companies. Life sciences companies will sometimes sell future revenue streams of early-stage drugs to major pharmaceuticals in exchange for an upfront cash payment to help advance those therapies to market.

Companies can also consider various forms of debt financing, including issuing debt securities that are later convertible into IPO shares.

After exhausting all their capital-raising options, many companies will simply opt for sale instead and escape the unpredictable markets. The use of dual-track offerings, in which companies file an IPO while simultaneously conducting a sale auction and then choose the better route, is increasingly common. While a robust public market expands a company's options, attorneys say a sure thing can be hard to pass up.

"If you have a good offer, it's definitely something that should be seriously considered," Schultz said. "With an M&A exit, you know what it is. You are not subject to the whims of a capital markets."

Public Companies Also Struggle to Raise Funds

Listed companies in need of capital can return to public markets and issue new shares through follow-on offerings, but fewer are doing so as that market has chilled along with the IPO downturn.

Public companies can instead choose PIPE deals in which businesses sell shares to private investors, but typically at a discount, among other restrictive terms.

PIPEs, after a long-dormant stretch, have become more common recently in the energy industry. Plains All American Pipeline LP recently raised $1.5 billion through a private placement of preferred units that pay an 8 percent annual yield. The units are convertible into common units after two years, providing liquidity for investors..

Holmes noted that only stronger issuers are likely to complete deals as attractive as Plains All American, but expects that more companies will consider such options because they provide critical funding amid a tough down market.
Plains, a midstream energy infrastructure provider, said the deal satisfies its equity financing needs through 2017.

Public companies can also consider rights offerings, which enables existing shareholders to buy new shares directly from the company in proportion to their existing holdings, usually at a discount and within a specified time period.
Olshan Frome Wolosky LLP partner Spencer Feldman said some companies might prefer rights offerings to PIPEs because outside investors that purchase PIPEs may demand steeper discounts and other harsh terms.

"A rights offering may be the most democratic way to raise funds in a volatile market, so

existing shareholders can get the first crack at buying in at attractive prices, with outside investors ready to soak up any unsubscribed rights as standby purchasers," Feldman said.

Public companies might also consider at-the-market transactions, or ATMs, which are partly similar to follow-on offerings, but rather than selling a large number of shares at once through a fixed price, ATMs sell smaller increments of shares gradually based on prevailing market prices.

ATMs don't raise nearly as much as money as a traditional follow-on offering, though they provide flexibility to take advantage of market fluctuations. Holmes said more than 100 master limited partnerships in the energy space have active ATM programs.

"It's very opportunistic," Holmes said. "MLPs like the ability to access the market in short order in this type of environment where things are up and down and unpredictable."

For all the talk of alternatives, capital markets attorneys stress that equity markets can turn on instant. When they do, IPOs are still the preferred option given the visibility, liquidity and credibility that comes with trading on a major exchange.

And attorneys say they are ready to strike deals once the market improves.

"This is all just starting," Freedman said. "While the markets have been weak the last three or so months, it doesn't mean it is going to stay that way. We have lots of companies that are waiting to go and have been on file for a while once the window opens."

--Editing by Katherine Rautenberg and Patricia K. Cole.

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