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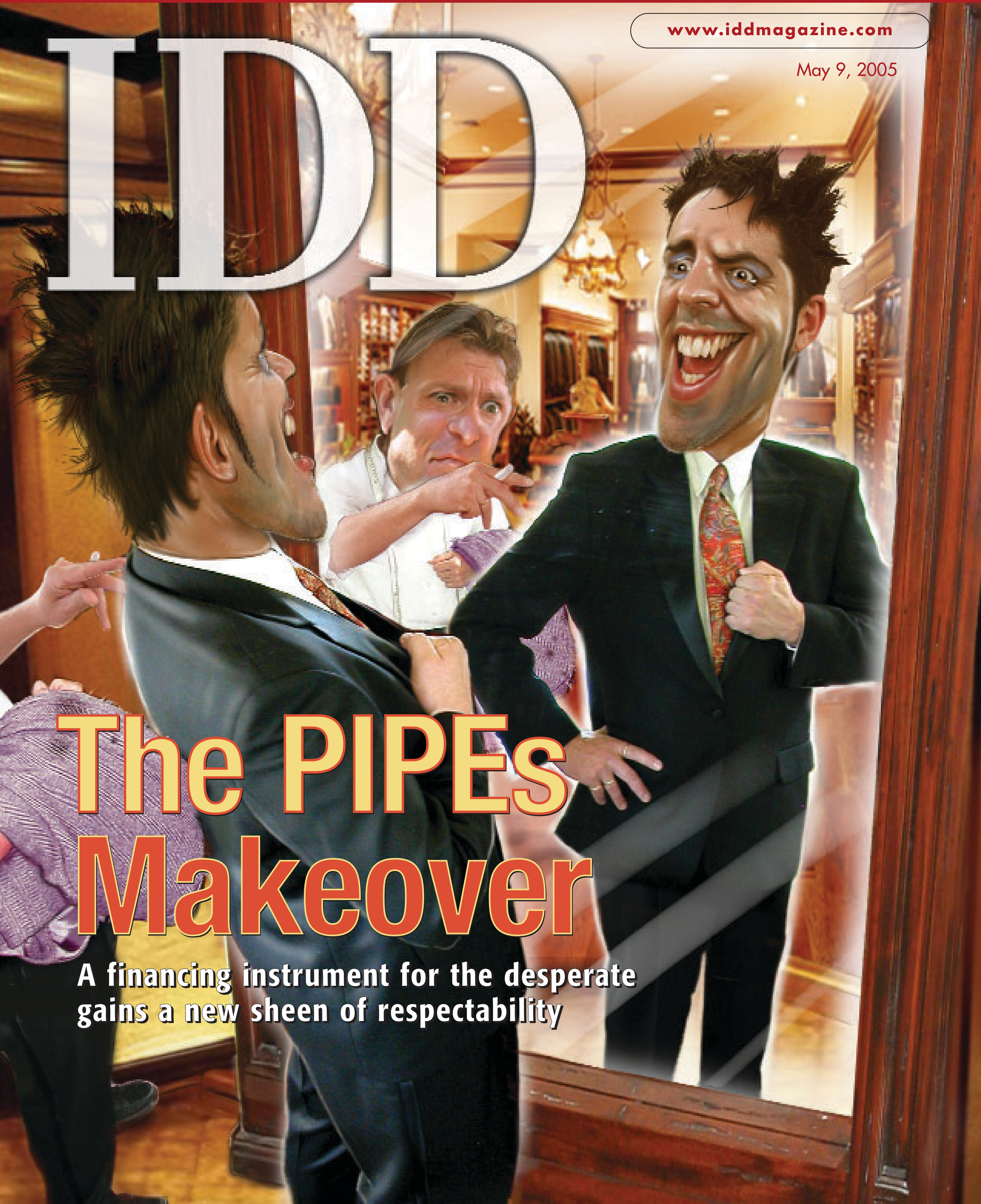

The PIPEs Makeover

A financing instrument for the desperate gains a new sheen of respectability

The PIPEs Makeover

BY PAUL SWEENEY

Without its $35 million PIPE financing, Bioenvision Inc., a New York-based biopharmaceutical company, might not be in business today—much less already in the marketplace with its anticancer drugs. "PIPE financing has been absolutely vital" to both the company and to drug development, says Christopher Wood, the 58-year-old British surgeon who is chairman and chief executive of the company. "It's been our lifeline."

Long considered a capital-raising instrument of last resort for the truly desperate, the PIPEs—private investment in public equity—market is getting a makeover these days. In the process, its image is shifting from the ignominious "death spiral" of the dot-com era to "lifesaver" for some issuers.

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PIPE financings, which hit $21.7 billion in 2004 in 1,700 deals, were up 13.6% over 2003 totals, according to PrivateRaise, a New York firm that follows the industry—though activity slowed in this year's first quarter, which was off 15.4% from the year-ago period. But issuance still has a ways to go to reach the heights achieved in 2000. As the tech bubble burst, some $24.8 billion of PIPEs were issued for companies, many of which had no other access to capital. Because some of those deals hastened the demise of the desperate companies that sought them, it has taken a while for the PIPEs market to recover.

But recover it has. Indeed, PIPEs are even acquiring a sheen of respectability, as larger deals are coming to market and some bulge-bracket investment banks are getting involved in agenting deals. Microcap companies in the life sciences, high technology and energy industries are finding PIPE financings a simpler and more confidential way to raise money than secondary offerings. In addition, some microcaps are going public earlier than they normally would because they know they can count on a subsequent PIPEs offering to get a second injection of capital.

PIPEs are also becoming a source of capital to finance mergers and acquisitions and retire high-coupon debt—not to mention providing an exit that allows private equity investors to cash out. Indeed, bigger PIPEs of $100 million or more have been taking off as part of the private equity bonanza sweeping Wall Street, offering investors such as Silver Lake Partners, billionaire Ron Burkle's The Yucaipa Co. and financier Carl Icahn a way to take huge positions and cop a board seat (or several) at the same time. One of the main advantages is that using a PIPE avoids loading up a company with debt during a takeover. In addition, regulators have cleaned up abusive features that gave PIPEs a bad name during the dot-com era.

And with both the public equity and bond markets less than exciting so far in 2005, the structure of a PIPE—which sometimes includes warrants and convertibles as well as straight equity—can be more alluring to investors.

"There's a lot of interest in PIPEs right now," asserts Byron Roth, chairman and CEO at Roth Capital Partners, a San Diego investment bank and leading PIPE placement agent in the U.S.

in 2004. "It used to be that, if you were an institution, you could buy the Nasdaq 100 [index] and sit behind your desk looking at a screen and have a great return," Roth adds. "Now, the screens have gone away and investors are saying, 'Give me things where I can make money.'"

It's hard to say exactly what the rates of returns on PIPEs are, given their private nature. But Richard Gormley, managing director at SG Cowen & Co., asserts that they outperform the traditional asset classes of stocks and fixed income. He reckons that, on the one hand, private equity funds that invest in PIPES are typically getting a return of probably three to five times invested capital over three to five years. At the other end of the spectrum, he says, a long-short hedge fund may be satisfied with a risk-adjusted 10% return in three to 18 months. In between, mutual funds investing for one to three years are looking "for something north of 20% over the hold period," Gormley says.

Issuers also benefit from PIPEs. "The flexible nature of the PIPE market allows issuers greater opportunity to finance their growth in creative and nontraditional ways," adds Gormley, who heads the PIPE investment banking practice at SG Cowen, which ranked fifth in volume and number of deals in the PIPEs league tables last year, according to PrivateRaise.

A deserved rep

One reason it's hard to ascertain the value of PIPEs is that they are hybrid securities incorporating equity sold typically at a 10% to 20% discount with or without warrants, preferreds and convertibles. Because of their private and complicated nature, they have great potential for abuse, which indeed occurred with deals that became known a few years ago as "toxic preferreds," "toxic convertibles" or "death-spiral convertibles."

Some investors, particularly hedge funds, were investing in PIPE transactions that included convertible preferred stock or convertible debentures with warrants. These were mostly done for dot-com companies that were desperate for cash.

"Death spiral" transactions were typically structured as convertible securities with variable, "conversion-pricing" ratios. This meant that buyers were able to convert fixed-dollar investments into floating share amounts that did not have a floor price. For example, if an investor contracted to pay $100 for 10 shares at $10 a share, but the stock went to $1, the investor would have 100 shares for his $100. The result is that existing shareholders were disadvantaged. A backlash in recent years has made such securities pretty much extinct.

"The dot-com craze put a bad taste in people's mouths," says Luke Iovine, a law partner in the New York office of Paul Hastings Janofsky & Walker, which advised on six PIPE transactions last year totaling $167.5 million. Iovine notes that a number of rule changes promulgated by the Securities and Exchange Commission and the National Association of Securities Dealers have largely done away with the destructive transactions. For example, now companies can't issue a PIPE whose structure would dilute the shares by 20% without prior shareholder approval.

As the PIPEs market has come back, boutiques have led the way in placing the securities. "The smaller firms are certainly the most active," says Brian Overstreet, president of Sagient Research Systems, which owns PlacementTracker, a San Diego-based firm that compiles data on the PIPEs industry. "They're the ones crunching out deal after deal."

A glance at the league tables for number of deals in 2004 shows just how prolific the boutiques have been. Roth Capital was the leading agent with 42 (it was also tops in volume with $584.1 million), followed by New York boutique Rodman & Renshaw with 31 deals, according to PrivateRaise. In third place was H.C. Wainright & Co. with 22 deals, and in fourth was San Francisco-based Shemano Group with 17 deals. Only when fifth place rolls around does a familiar name appear: SG Cowen, which chalked up 16 deals last year. Gauged by volume, the first big name to appear in the tables was Bank of America, which came in second at $541.7 million.

In a plain vanilla PIPE, it is up to the company issuing the new stock to file a registration statement with the SEC within 120 days, making the shares fully tradable and eligible for resale. Most PIPEs are issued by small companies that raise $5 million to $20 million at a pop. A slew of boutiques are prospering off that business.

Enter the RDs

While that may be the bulk of the market, bigger PIPEs–sometimes in the form of registered direct offerings–are an emerging phenomenon.

In an RD, as they are known, a company can sell securities directly to qualified institutions at any time over a two-year period once the registration is declared effective by the SEC. One big advantage to RDs is that they are available to institutional investors whose charters do not allow them to purchase unregistered securities. Even so, these PIPEs are a small part of the market, making up only about 10%, industry sources say.

But RDs, which are typically larger than "plain vanilla" PIPEs, are the kind of PIPEs that often interest the bigger placement agents. "Pretty much every firm on the Street," Overstreet says, "not only has the capability to do PIPEs, but did at least one PIPE transaction–if not multiple ones–last year." For example, Credit Suisse First Boston acted as placement agent for only three PIPEs last year, averaging a hefty $113.05 million each, according to PrivateRaise.

These outsized PIPEs, both plain vanilla and RD, are increasingly favored by leveraged buyout firms and strategic investors such as Silver Lake Partners–the top PIPE investor in dollar terms last year, ponying up $503 million to take a huge stake in Thomson, the French electronics group. "These PIPE deals are highly negotiated, typically backed by only one or two financial sponsors and have a lot of different governance provisions," notes Niv Harizman, managing director at CSFB.

Roth Capital's Roth:

'A big piece of the market now is PIPEs that are really part of IPOs.'

Another reason that the bigger Wall Street firms are jumping into the fray, says SG Cowen's Gormley, is that larger companies that once shunned PIPEs are more willing to do them. "Registered direct PIPEs are usually $25 million to $50 million, and follow-ons are typically for $50 million or more," he says. "But the trend is that RDs are getting bigger and bigger because larger companies are coming into the market."

The arrival of such big institutional investors as Wellington Management Co. and T. Rowe Price Group Inc., among other mutual funds, on the roster of PIPEs investors is further indication that these securities are adding value to the portfolio, Roth says. Since PIPEs involve the issuance of new shares, he notes, they are often the best, if not the only, way for an institution to take a meaningful equity stake in thinly traded companies.

Institutional ownership means not only added capital but a seal of approval for the issuer. "If bankers believe that a company has promise, institutional investors can buy these securities pretty cheaply and they lend credence [to the company]," says Paul Hastings' Iovine. "Other people will say, 'Holy Smokes– these guys must be on to something."

Moreover, PIPEs can serve as an alternative to an initial public offering for fledgling companies that want to pull off what financiers call a "reverse IPO." Under this mechanism, a private company merges with a publicly traded shell company and employs a PIPE to raise capital. "We've seen a resurgence of those by private companies that can't do an IPO," says Jeff Davis, president of SCO Financial Group, a New York boutique investment bank that specializes in life-sciences companies.

Flexible financing

Increasingly, PIPEs are becoming a kind of security blanket for microcaps, allowing them to go public earlier because they can rely on a PIPE for a second round of capital.

Last year, 255 companies went public, compared with 91 in 2003, according to Thomson Financial. But the companies doing IPOs in 2004 were going public sooner, as evidenced by their lower market capitalization, than the class of 2003. In 2004, 41.9% of IPOs fell short of the $250 million mark, says Roth of Roth Capital. In 2003, only 38% fell below that size. One big reason for that, he says, was the recognition that a quick and inexpensive PIPE financing could follow hard on the heels of an IPO. "A big piece of the market now is PIPEs that are really part of IPOs," Roth says.

Roth's involvement with Interchange Corp. illustrates the second dip principle, and shows how an IPO and PIPE can work in tandem. The Laguna Hills, Calif.-based Interchange, an Internet company that provides online search services for the advertising industry, first went public in a Roth-underwritten IPO at $8 a share in October 2004, raising $25.3 million. In December, the company followed with a PIPE financing, agented by Roth, that raised another $15 million at $18.25 a share, according to Doug Norman, Interchange's chief financial officer. Norman says that the additional financing allowed it to purchase a Swedish company, Inspire Infrastructure, which added new technology and expanded Interchange's reach into Europe.

"We raised the money for working capital," says Norman, "but once we had the money, we used it for the merger. It gave us the resources."

The biggest PIPEs

Another growing trend in the PIPEs world: their use as an alternative to a leveraged buyout for private equity firms, as well as a tool for activist shareholders and venture investors.

Silver Lake Partners, for example, was the top PIPE investor in 2004, laying out $503 million on only two deals. Another buyout shop, Icahn Associates Corp., in August 2004 bought $190 million of the $200 million PIPE placement issued by XO Communications Inc., a Reston, Va.-based provider of telecommunications services.

In addition to Silver Lake's injection of $503 million into Thomson, Yucaipa's use of a PIPE to gain control of Pathmark Stores Inc. turned heads last year. Instead of doing an LBO and loading up the company with a mountain of debt, says Yucaipa partner Michael Duckworth, the firm will take a 40% equity stake with the purchase of 20 million newly issued shares of common stock at $7.50 a share. Yucaipa can also name five of 11 board members (see *IDD*, "Yucaipa's PIPE Dream for Pathmark," 4/25/05).

"Our thesis is that Pathmark is a tremendous asset with great per-store [sales] volume," says Duckworth. "But it's been overlevered for about 20 years since a Merrill Lynch Partners buyout. Essentially, we'll be paying down debt and injecting capital into the company."

Meanwhile, PIPEs can often serve as a complement rather than an alternative to secondary offerings. Vasogen Inc., a Canadian biotech company, has done both follow-ons and PIPEs over the last 13 months, raising $58 million in a secondary and $42 million through a PIPE as it conducts costly drug and treatment studies.

The secondary public offering in March of last year was valuable not just for the money and the human trials it financed, says Chris Waddick, Vasogen's chief financial officer, but because it allowed for a road show. That gave the company the opportunity to tell its story. The secondary was co-led by Royal Bank of Canada and Needham & Co., a New York boutique. "All of our previous fund raising had been Canadian," he says. "We saw probably 120 to 130 institutions that became aware of us. That was the real driver behind the secondary offering."

Just two months ago, a subsequent PIPE using a shelf registration (and agented by SG Cowen) raised $42 million for Vasogen but played a different role. "Definitely the PIPE was lot quicker, easier and quieter," says CFO Waddick. "We had an existing shelf registration in place, and that made it more attractive because we got a lower discount, and because of the ability to give investors freely tradable shares." The discount was only 8%, compared with the normal 10% to 15% for a PIPE.

As crucial to development as PIPEs can be, companies often look forward to leaving them behind. And that often means saying good-bye to the boutique investment bank that sustained them through their development into successful companies. Indeed, for many companies, bidding farewell to the boutique is a sign that they've arrived.

Bioenvision, whose CEO hailed two PIPE financings totaling some $35 million as his company's "lifeline," is a case in point. The biopharm's injectible, in-hospital treatment for acute leukemia, Clofarabine, recently was approved by the Food and Drug Administration. Modrenal, also developed by Bioenvision, has proven effective as a treatment for advanced breast cancer and gained "urgency approval" from regulators in the U.K.

Bioenvision's stock, which had been illiquid and traded "by appointment only" for about $1 a share on the OTC Bulletin Board in 2002, migrated to the American Stock Exchange and, subsequently, to Nasdaq, where it has spiked as high as $12—though it is trading at about half that now. "Investors who got in first have made 10-12 times their initial investment," says Davis, Bioenvision's banker at SCO Financial.

Now Bioenvision has a market capitalization of $250 million, and it wants to tap the financial markets for a secondary offering of $60 million. To do so, it has hired UBS and JPMorgan to act as lead underwriters on the deal. Now, CEO Wood is looking forward to the road show and to telling his company's story to big institutional investors.

That means saying goodbye to SCO Financial, the boutique that nurtured and found $17 million in PIPE financing for it as recently as 2004. But there are no hard feelings, says SCO Financial's Davis. Wishing them well, he says, "They were best in show." IDD