Covid-19 and Alternative Financing for Public Companies

Swifter and customised solutions sought

HAMLIN LOVELL TALKS TO SCHULTE ROTH & ZABEL PARTNER ELE KLEIN

Stressed capital markets are spurring many companies to seek alternative sources of financing, including PIPEs (Private Investments in Public Equity) and related products. Many larger and investment grade companies can still access public markets - albeit at inferior pricing as compared to prior to the coronavirus pandemic - but some smaller, medium sized and speculative grade companies (and those with no credit rating) may find it more difficult, inflexible, time consuming or even impossible to issue bonds or raise equity in a conventional manner. The Harvard Law School Forum on Corporate Governance in its 2017 paper titled *The Economics of PIPEs* reported that, 'firms raising funds through PIPEs tend to be small, with 93% of common stock PIPE issuers having a market capitalization below $1 billion'. In stressed markets, larger companies have jumped in.

The volume of US PIPE issuance is also rising because the need for alternative financing is somewhat counter cyclical. It peaked at circa $120bn in 2008, and has been less than $45bn every year between 2009 and 2019, with the highest volumes seen in 2012 and 2016, after two minor credit market routs: the European sovereign crisis in 2011 and the mainly energy-related widening of credit spreads seen in 2015. PIPEs are now picking up again, with 2020 year to date issuance as of April ahead of 2019.

Customised deal structures

A private deal can provide more flexibility for both sides in negotiating terms. PIPEs and credit deals can offer investors the chance to buy equity at a discount, and/or obtain a premium yield on debt. Conversely, some PIPEs can even command a premium and/or reduce interest costs for issuers, especially where they include equity kickers such as warrants, and/or creditor protections from being higher up in the capital structure. "This can result in pricing and terms being attractive to companies and investors," says Ele Klein, Schulte Roth & Zabel partner who heads the firm's top-ranked PIPE practice and serves as co-chair of the global Shareholder Activism Group and as a member of the firm's Executive Committee. The Harvard Law School Forum paper reported that the combination of discounts and warrants means, 'Over the year following the issuance, PIPE investors average a 12.1% abnormal return relative to firms with similar characteristics'.

For now, most deals involve common stock, but Klein expects to see "more deals involving equity linked securities such as convertible preferred stock and convertible bonds over time, and more appetite for building senior and secured structured deals higher up the capital structure".

Equity issuance prices, conversion prices or warrant prices can be fixed or variable and resettable. Where they vary, there can be floors or caps. These fluctuations are one way to reduce investors' equity market exposure. "Funds following arbitrage or market neutral strategies can structure deals that allow for equity hedging, or even embed hedges in the structure. Some 144A deals are structured so that the company issues a convertible bond and equity at the same time as a hedge," explains Klein.

Other provisions can also be customized. Dividend or coupon payments could be cash pay - or payment in kind (PIK), accumulating more debt typically to be repaid at maturity.

"Deals based on registration statements generally do not involve lockups. Some deals involve restricted stock, which might be functionally locked up for 3-12 months because of registration requirements. Such equity will normally be valued at a discount until it becomes freely tradable," says Klein.

Faster capital

Investors might need to wait some months to monetise their positions, but some companies cannot afford to. Time is of the essence for firms that have seen revenues drop precipitously or even disappear, and that could be close to breaching debt covenants, in the wake of the Covid-19 crisis. PIPE structures can raise emergency cash very quickly: "an overnight deal can be possible (though an existing registration statement is needed to do freely tradable stock). This is much faster than roadshows, which can take weeks or months," points out Klein. Pure PIPEs and 144A deals make use of an exemption under the Securities Act of 1933 while "Registered Direct" (RD) deals or "shelf takedowns" use a shelf registration statement.

PIPEs can also be faster when they do not need to be offered to all shareholders. The UK has recently seen over a dozen deals after disapplying preemption rights for equity issuance up to 19.9% of a company's capital; the US has never statutorily had preemption rights and has not necessarily required shareholder approval for issuance up to 20%. More sizeable US PIPEs have recently been expedited by one exchange relaxing its requirements; "..the NYSE requirement for shareholder approval for certain issuances, has been partly waived until June 30, and this is likely to be extended if current conditions continue," says Klein. "Most deals are being done on the NYSE or Nasdaq, but they could be done on the OTC or Pink Sheet markets. Some overseas companies with a US listing, including Canadian and Chinese firms, may also use PIPEs," he adds.

In any case, there are ways to structure deals around these requirements. For instance, a financial hardship exemption can be availed of to bypass shareholder approval, and Klein expects that a growing number of firms will exploit this.

PIPEs also provide another capital raising avenue for companies that might be temporarily restricted from other sorts of offerings for e.g. if Covid-19 is delaying their public reporting; RDs require that firms are up to date with SEC reporting. (In the UK, the FCA regulator has actually requested that firms delay reporting dates by two weeks to allow them to account for the impact of Covid-19.)

A wide spread of asset managers and accredited investors are taking advantage of these opportunities. Almost any equity fund, hedge fund, and private equity or venture capital fund, could subscribe for PIPEs. There are a few dedicated PIPE funds while a variety of other hedge fund strategies, including activists, convertible arbitrage, credit and multi-strategy funds, may selectively and opportunistically invest in PIPEs.

Activists

Klein is renowned for heading up SRZ's leading activist practice. "Most PIPE deals are passive investments, but activists bring not only capital but also knowledge and expertise: as in the 2019 Papa John's deal with Starboard Value, which named Starboard CEO, Jeffrey Smith, as Chairman of Papa John's, providing leadership as well as capital. Every situation is different. Activists may seek protective provisions, such as a board seat or covenants," explains Klein.

PIPEs can feature on both sides of an activist battle. As lower equity valuations might attract more M&A, some companies are putting in place "poison pills" to deter acquirors. PIPEs can be used by companies, including cash-rich firms, as part of their defence tactics to try and fend off a hostile takeover.

Distressed debt

The pandemic might result in the biggest distressed debt cycle since 2008 and PIPEs could play a role here as well. "Companies going through bankruptcy and insolvency processes can also sometimes raise capital through PIPEs, subject to the approval of courts, though it is complicated to put in place protections to do such deals on a priority basis," says Klein. "In more troubled companies, investors may seek collateral, restrictive covenants, put rights and event of default redemptions," he adds.

US Government

Whether and where the US Government might fit into alternative financing remains to be seen. "In some cases, if the Government is providing substantial bailouts it may remove the need for alternative financing. In other cases, it is too early in the process to see how and where the Government takes equity or loans", says Klein.

"Overall, PIPE deals can be a win-win situation for everyone," Klein sums up. **THFJ**