Investment Banking Basics: Fundamentals of Capital Structures

PLI Pocket MBA 2019

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Equity Versus Debt Financing

Capital Raising or Funding

- Do you want to issue equity securities, or do you want to issue debt securities or obtain debt financing from a bank or similar nonbank funding source?
  - The ideal mix of debt-to-equity may depend on many things, including the company’s burn rate, whether it generates revenue or whether, like many life sciences or tech companies, it only has losses due to R&D or similar expenses, the company’s industry, the company’s contractual commitments and the company's need for operating flexibility
  - The company’s desire to issue equity versus debt also may be influenced by other factors, such as:
    - Overall financing costs or “efficiency” associated with capital or funds raised
    - Tax considerations: bias toward issuing debt to benefit from deductions on payments to holders
    - Rating agency considerations
    - For financial services companies, regulatory capital requirements

Equity vs. Debt Considerations

The optimal capital structure balance risks and returns to maximize shareholder value

	DEBT	EQUITY
ADVANTAGES	• Tax deductibility of interest expense • Cheaper source of capital than equity • No dilution of ownership	• Source of permanent financing • No adverse impact on financial flexibility • No increase of company's leverage
DISADVANTAGES	• Decreases financial flexibility • Cash flow commitment • Risk of default • Covenant restrictions • Must be repaid	• More expensive source of capital than debt • Creates dilution in ownership stakes • Dividends, if applicable, paid out on an after-tax basis

Equity vs. Debt Considerations *(cont'd)*

- Generally, it is easy to distinguish between equity securities (i.e., common stock and most preferred stock) and debt securities (i.e., notes or debentures); however, there are many types of securities that have some equity-like characteristics and some debt-like characteristics
- Characteristics associated with equity securities
  - Subordinated to debt securities
  - Loss-absorbing or "permanent" capital
  - No maturity date
  - No events the occurrence of which give rise to an event of default or debtor remedies, like payment acceleration
- Characteristics associated with debt securities:
  - Senior to equity securities in right of payment on a liquidation
  - Generally a stated maturity date
  - Generally senior to trade creditors
  - Rights to periodic payments
  - Specified events of default that if continued may trigger remedies, including payment acceleration

Determining the Optimal Capital Structure

In order to balance risk and return, companies should pursue a capital structure with a mix of debt and equity

- Financing solely with debt greatly reduces financial and increases the risk of default
- Financing solely with equity dilutes ownership stakes and EPS and fails to take advantage of the enhanced returns that reasonable amounts of leverage may provide including through the interest tax shield

Capital Structure

- A company's capital structure will depend in large part on its maturity and whether it is privately held or a public company
- The typical venture-backed company's capital structure is two-tiered
- Common stock for founders, and options or similar instruments issued to employees and consultants
  - Low valuation allows a company to provide attractive equity incentives
  - Often issued subject to vesting arrangements (subject to accelerated vesting)
  - "Plain vanilla" security with rights defined by statute
  - Often issued pursuant to stock option or stock incentive plans with a specified number of shares reserved
- Preferred stock for investors
  - High valuation allows company to raise capital with least dilution
  - Issued in one or more series at different prices over time
  - Customized rights, privileges and preferences defined in certificate of incorporation

Capital Structure *(cont'd)*

- Rights, privileges and preferences of preferred stock
  - Liquidation preference and participation rights
  - Conversion right
  - Price-based antidilution rights
  - Voting rights
  - Protective provisions
  - Additional contractual rights
  - Dividend preference
  - Redemption rights

Hybrid Issuances

Hybrid Products

- Hybrid products are those that have certain "debt"-like elements and certain "equity"-like elements
- For example, for tax purposes, perhaps the instrument is treated as "debt" even if for accounting purposes the instrument is booked as "equity" on the company's balance sheet
- Similarly, there may be instruments that sound like equity, such as certain types of preferred stock, but that are treated as debt
- Trust preferred securities, paired securities, certain redeemable preferred stock, convertible notes, certain types of convertible preferred stock and warrants all may be considered hybrid products

"On Balance Sheet" Sources of Capital

Debt Financing	Equity Financing	Hybrid Financing
Monetary obligations that must be repaid in accordance with a pre-arranged contractual agreement	**Investments in the company by its owners (shareholders)**	**Financing that has properties of both debt and equity**
• Short-Term Debt (maturity <1 year) – Notes payable – Commercial paper – Lines of credit – Bank overdrafts – Current portions of long-term debt • Long-Term Debt (maturity >1 year) – Loans – Bonds – Notes – Debentures – Capital leases • May be secured by the company's assets, properties, etc., or be a general unsecured obligation of the company	• Common Equity – Common stock, has voting rights, dividend payments at the option of the company • Preferred Stock – Pays dividends at a specified rate; has preferences over common in payment of dividends and liquidation of assets, no voting rights • Options/Warrants – Securities that give holders the right, but not the obligation, to buy shares of common stock directly from the company at a fixed price – Options • Usually given to the employees as part of their compensation to align employees' financial interests with the company's future success – Warrants • Usually issued to the holders of the company's debt in order to augment holders' overall yield • Frequently used as a financing instrument in early round-up financing – Options and warrants are often issued during acquisitions as part of a purchase price of the company	• Convertible Debt – Debt that can be converted into shares of common stock at a specified rate under specified conditions • Convertible Preferred Stock – Preferred stock that can be converted into debt or shares of common stock at a specified rate under specified conditions • Exchangeable Debt/Preferred Stock – Similar to convertible instruments except that these securities can be converted into common stock of a subsidiary or an affiliate of the issuer

Warrants

- In private financings for smaller and mid-sized public companies (PIPE transactions) and in public follow-on offerings for these companies, the issuers may be required to issue and sell common stock and warrants or "units" composed of a share of common stock and a warrant
- For various purposes, the securities exchange rules for listed companies create incentives for transactions that include warrants

Warrants *(cont'd)*

Basic terms:

- **Level of warrant coverage:** in a common stock and warrant transaction, investors will negotiate the extent of warrant coverage (a percentage of the number of shares of common stock sold)
- **Transferability:** will warrants be "detachable"?
- **Exercise price:** at market or above current market price?
- **Settlement mechanism:** do warrants provide for cash only or cashless (net) exercise?
- **Customary antidilution features:** warrants usually will provide for antidilution adjustments in the case of organic changes, such as stock splits, adjustments and dividends

Warrants *(cont'd)*

- **"Down round"(or full ratchet) adjustments:** compensates an investor to the extent that the issuer sells stock or equivalent instrument at a lower price
  - Would this cause the warrant to be classified as a liability?
- **Registration rights:** the holder may negotiate to receive the right to have the issuer register the resale of the shares underlying the warrant and may impose penalty payments in connection with the issuer's failure to meet its obligations
  - This may cause the issuer to have to estimate the associated penalty fees, which may be accounted for as a contingent liability
- **Fundamental change provisions:** these are intended to provide the holder with some liquidity and preserve value for the instrument if the issuer completed a fundamental transaction
  - Absolute obligation of the issuer to repurchase the security in connection with any fundamental transaction, or
  - May require a cash purchase to the extent common stockholders receive cash compensation in connection with the fundamental change transaction

Warrants *(cont'd)*

- Warrants typically meet the accounting definition of a derivative (defined in ASC 815-10-15-83)
- Zero initial investment
- Permit or require net settlement
- Underlying amount and notional amount, which combine to create a settlement provision
- They are required to be recorded as a derivative liability unless they qualify for a scope exception
- Scope exception
  - Contracts issued or held by that reporting entity that are both:
  - Indexed to its own stock
  - Classified in stockholders' equity in its statement of financial position

Exempt Offering Alternatives

Section 4(a)(2)

- Transactional exemption
- Issuer exemption
  - Most-utilized securities offering exemption
  - Application of the private placement exemption, however, has been the subject of significant debate due in large part to the brevity of its wording
  - Not a "public offering" has been defined by case law and SEC interpretation, and one may look to safe harbors as well
- Restricted securities—securities sold in a private placement may not be resold absent registration or exemption from registration
- **Amount of offering:** amount is unlimited
- **By?** Any issuer, whether reporting or non-reporting, can rely on Section 4(a)(2)

Section 4(a)(2) *(cont'd)*

- **Who can invest?** Sophisticated investors who can fend for themselves
- **What is the investor cap?** No applicable cap
- **Is an intermediary required?** Effectively, yes, given that the issuer cannot use general solicitation or general advertising; issuer could raise capital from investors with whom it has a pre-existing substantive relationship
- **Manner of offering:** the offering cannot involve general solicitation or general advertising
- **Offering disclosure requirements:** none
- **Reporting following the offering:** none; no requirement to file a Form D
- **Transfer restrictions:** securities will be restricted securities

Section 4(a)(2) *(cont'd)*

- **Bad actor disqualification:** the disqualification is not applicable to Section 4(a)(2) offerings
- **Manner of offering:** generally, a Section 4(a)(2) offering will involve a placement agent; the placement agent will identify investors. Investors will conduct their own diligence review
- **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; generally each investor will make payment to the issuer directly
- **State blue sky:** the securities are not "covered securities"; however, given offerings are limited to accredited investors or institutional accredited investors, typically state exemptions will be available

Rule 506 Safe Harbor

- Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D
- Traditional requirements of a Rule 506 private placement include:
  - No dollar limit on size of transaction
  - Unlimited number of accredited investors and no more than 35 unaccredited investors
  - No general solicitation or advertising (now prohibition against general solicitation has been eliminated for 506(c) offerings)
  - Resale limitations
  - Disclosure required for non-accredited investors
  - Form D filing within 15 days of first sale of securities
  - Good faith effort to comply (Rule 508)

Rule 506(b)

- “Traditional” Rule 506 offering
- **Amount of offering:** unlimited
- **By?** Rule 506(b) can be used by reporting and non-reporting issuers, so long as issuer and other covered persons are not subject to any bad actor disqualification
- **Who can invest?** Accredited investors and a limited number of non-accredited investors; in practice, offerings are limited to accredited investors
- **What is the investor cap?** None
- **Is an intermediary required?** Not technically required; however, given that the issuer cannot use general solicitation or general advertising, issuer could raise capital from investors with whom it has a pre-existing substantive relationship
- **Manner of offering:** the offering cannot involve general solicitation
- **Reporting following the offering:** filing of a Form D

Rule 506(b) *(cont'd)*

- **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons
- **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; generally, each investor will make payment to the issuer directly
- **State blue sky:** securities sold pursuant to Rule 506(b) are "covered securities"

Rule 506(c)

- Rule 506(c) permits the use of general solicitation, subject to the following conditions:
  - The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
  - All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
  - The conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied
- Reasonable steps to verify investor status
- **Amount of offering:** unlimited
- **By?** Rule 506(c) can be used by reporting and non-reporting issuers, so long as issuer and other covered persons are not subject to bad actor disqualification

Rule 506(c) *(cont'd)*

- **Who can invest?** Accredited investors only
- **What is the investor cap?** None
- **Is an intermediary required?** Not technically required; easier for an issuer to conduct a Rule 506(c) offering on its own
- **Manner of offering:** involves general solicitation
- **Reporting following the offering:** filing of a Form D
- **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons
- **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; generally, each investor will make payment to the issuer directly
- **State blue sky:** securities sold pursuant to Rule 506(b) are "covered securities"

Regulation A

- The SEC adopted final rules that:
- Amend and modernize existing Regulation A
- Create two tiers of offerings:
  - Tier 1 for offerings of up to $20m ($6m for selling stockholders); or
  - Tier 2 for offerings of up to $50m ($15m for selling stockholders)
- Set issuer eligibility, disclosure and reporting requirements
- Impose additional disclosure and ongoing reporting requirements, as well as an investment limit, for Tier 2 offerings and, given these investor protection measures, makes Tier 2 offerings exempt from certain blue sky requirements
- Became effective June 19, 2015
- **Amount of offering:** Tier 1 up to $20 million in 12-month period, Tier 2 up to $50 million in 12-month period

Regulation A *(cont'd)*

- **By?** Eligible issuers are issuers organized in and with their principal place of business in the United States or Canada, other than funds, blank check companies, issuers subject to various disqualifications.
- **Who can invest?** Accredited and non-accredited investors
- **What is the investor cap?** A non-accredited natural person is subject to an investment limit and must limit purchases to no more than 10% of the greater of the investor's annual income and net worth, determined as provided in Rule 501 of Regulation D (for non-accredited, non-natural persons, the 10% limit is based on annual revenues and net assets). The investment limit does not apply to accredited investors and will not apply if the securities are to be listed on a national securities exchange at the consummation of the offering
- **Is an intermediary required?** No
- **Manner of offering:** the offering may involve "testing the waters"
- **Offering disclosure requirements:** an issuer must prepare and file with the SEC and have qualified an offering statement on Form 1-A

Regulation A *(cont'd)*

- Part I (Notification) requires certain basic information regarding the issuer, its eligibility, the offering details, the jurisdictions where the securities will be offered and sales of unregistered securities
- Part II (Offering Circular)
  - Part II contains the narrative portion of the Offering Circular and requires disclosures of basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A-type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related party transactions; and a description of the offered securities
  - This is similar to Part I of Form S-1, and an issuer can choose to comply with Part I of Form S-1 in connection with its Offering Circular
    - An issuer that chooses to list its securities concurrent with the completion of a Regulation A offering will be required to use Part I of Form S-1 in connection with the Offering Circular
    - Other Tier 2 issuers are likely to use Part I of Form S-1 as well

Regulation A *(cont'd)*

- **Financial statement requirements:** differ for Tier 1 and Tier 2 offerings:
  - Tier 1 and Tier 2 issuers must file balance sheets and other required financial statements as of the two most recently completed fiscal year ends, or for such shorter time as they have been in existence, subject to certain exceptions
  - The financial statements for an issuer in a Tier 2 offering are required to be audited by an independent auditor that need not be PCAOB-registered, except as noted below
  - An issuer in a Tier 2 offering that seeks to have a class of securities listed on a national securities exchange concurrent with the Regulation A offering must include financial statements audited in accordance with PCAOB standards by a PCAOB-registered firm
- **Advertising:** an issuer may solicit any investors (not subject to the requirements applicable to EGCs, for example); materials may be used both before and after the offering statement is filed
- **Intermediary restrictions and requirements:** an issuer can conduct a Regulation A offering with or without a financial intermediary

Regulation A *(cont'd)*

- **Reporting following the offering for non-Exchange Act companies:** Tier 1 issuers would have no ongoing reporting obligation, other than to file an exit report on Form 1-Z within 30 days after the termination or completion of a Regulation A-exempt offering. Tier 2 issuers will be subject to ongoing reporting. Tier 2 issuers would be required to file:
  - Annual reports on Form 1-K (120 calendar days after the issuer's fiscal year end);
  - Semi-annual reports on Form 1-SA (90 calendar days after the end of the first six months of the issuer's fiscal year);
  - Current reports on Form 1-U;
  - Special financial reports on Form 1-K and Form 1-SA; and
  - Exit reports on Form 1-Z
- **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons
- **State blue sky:** securities sold pursuant to Tier 1 will be subject to state blue sky requirements; securities sold pursuant to Tier 2 will be "covered securities"
- **Transfer restrictions:** securities sold pursuant to Regulation A are not "restricted securities"

Regulation Crowdfunding

- **Amount of offering:** up to $1.07 million in a 12-month period through crowdfunding
- **By?** Issuers that are not reporting companies, not funds and not subject to disqualification
- **Who can invest?** Accredited and non-accredited investors
- **Is there an investor cap?** An investor is subject to an investment limit on amounts invested in any 12-month period through crowdfunding equal to:
  - The greater of: 52,200 or 5% of the lesser of the investor's annual income or net worth if either annual income or net worth is less than $107,000; or
  - 10% of the lesser of the investor's annual income or net worth, not to exceed an amount sold of $107,000, if both annual income and net worth are $107,000 or more
- **Is an intermediary required?** Yes. An issuer can only engage in crowdfunding through a broker-dealer or a funding portal and can use only one intermediary for an offering
- **Manner of offering:** the offering must be conducted only through the platform

Regulation Crowdfunding *(cont'd)*

- **Offering disclosure requirements:** an issuer that elects to engage in a crowdfunded offering will be required to prepare initial disclosure about the issuer and the offering on Form C
- Form C requirements resemble the Form 1-A requirements for a Regulation A offering and include a discussion of:

Use of Proceeds	The Targeted Offering Size
Offering Price	Business
Directors and Officers	Beneficial Ownership and Capital Structure
Indebtedness	Related-Party Transactions
Exempt Offerings	Risk Factors
Transfer Restrictions	Management's Discussion and Analysis

Regulation Crowdfunding *(cont'd)*

- **Financial Statement Requirements:** in addition, a Form C must include certain financial statements prepared in accordance with U.S. GAAP. Audited financial statements must be conducted in accordance either with AICPA standards or PCAOB standards. Requirements depend on the target offering size.
- **Advertising:** an issuer's ability to advertise or promote the offering is limited to certain offering notices (basic offering details) and certain communications with potential investors made through the platform
- **Intermediary restrictions and requirements:** the intermediary is subject to educational and other obligations and limitations
- **Reporting following the offering:** until an issuer terminates its reporting obligations, it is required to file amendments for material changes (C/A), periodic updates (C-U) and annual filings (C-AR)
- **Transfer restrictions:** securities sold in such an offering are subject to certain transfer restrictions for one year

Framework for Evaluating Exempt Offering Alternatives

Who Is the Issuer?

- Is the issuer an SEC-reporting company?
  - If so, the issuer will want to limit its focus to Section 4(a)(2), Rule 506(b) and Rule 506(c). Generally, an SEC-reporting company will find it challenging to undertake a Rule 506(c) offering
- What if the issuer is a private, non-reporting issuer?
  - If the issuer is not an SEC-reporting company and the issuer is domiciled in the United States, the issuer will want to consider Regulation Crowdfunding, intrastate crowdfunding, Rule 504 and Regulation A, in addition to Section 4(a)(2), Rule 506(b) and Rule 506(c)

What Are the Issuer's Goals?

- Is the issuer principally focused on raising additional capital? If so, how much?
  - As discussed in prior slides, certain offering exemptions are available only for offerings under a specified dollar threshold
  - Can various exemptions be used? Are there integration safe harbors?
- Are there goals beyond merely raising the capital?
  - For example, is the issuer seeking to attract particular types of investors?
  - Who are the investors? Where are the investors?
  - Is the issuer seeking to make itself better known generally by making information about itself available broadly through SEC filings?
  - Is the issuer concerned about liquidity opportunities for existing securityholders? Liquidity opportunities for the new investors?
- Is the contemplated offering only a part of a more comprehensive funding plan?

Who Are the Potential Investors?

- Does the issuer have existing institutional investors?
  - If the issuer is an established company, likely it will have undertaken prior rounds of financing and will have existing investors, some of which may be venture or private equity investors or angel investors. Such investors may have a strong preference for limiting participation to other institutional or professional investors and likely will not want to see broad outreach to non-accredited investors that may not be known to the issuer
- If the issuer is an emerging company, does it want to seek out institutional or strategic investors? Does it want to attract investors from among its customers?
  - Even early-stage companies may choose to limit their investor base to institutional accredited investors and accredited investors known to the company or introduced to the company by a financial intermediary (placement agent). There may be strong reasons for doing so—for example, the company may want advice from its institutional investors, may want institutional investors that can serve on the board of directors or board of advisors or may want to limit the number of holders to professional investors that know the sector and are accustomed to making investments in early-stage companies

Who Are the Potential Investors? *(cont'd)*

  - A company may have some concerns about reaching out to investors with whom it does not have a pre-existing relationship. For example, investors may not be experienced in investing in early-stage companies and may have unrealistic expectations or require a level of engagement that distracts management from its responsibilities. The company also may find it challenging to keep track of its investors
  - Consumer product–oriented companies, by contrast, may want to have customers among their shareholders
- A fundamental question, therefore, will be whether the issuer wants to include non-accredited investors in the offering
  - If the issuer would like to include non-accredited investors, it will be limited to Rule 506(b) or Rule 504 (subject to preparation of certain disclosures), intrastate crowdfunding, Regulation Crowdfunding or Regulation A
  - In the case of Regulation Crowdfunding and Regulation A, the investor will be subject to investor caps

Will an Intermediary Be Used?

- Is the issuer reaching out to existing investors? To investors with which the issuer already has a pre-existing relationship? Or seeking to reach potential investors identified by an intermediary or by the issuer?
  - This is closely tied to the type of investor that the issuer would like to identify
- Do the rules require that an intermediary be used?
  - In a crowdfunded offering under Regulation Crowdfunding, an issuer is required to use an intermediary that is either a broker-dealer or a funding portal
  - In offerings without general solicitation, although there is no express requirement to do so, it is very challenging for an issuer to conduct an exempt offering without a financial intermediary

Will an Intermediary Be Used? *(cont'd)*

  - In an offering using general solicitation, such as a Rule 506(c) offering or a Regulation A offering, an issuer could undertake the offering without a financial intermediary
  - It will be essential for the issuer to consider whether it engages an intermediary, whether the intermediary is a "matchmaking portal" or other unregistered person (not required to be registered as a broker-dealer) or a broker-dealer
- Why is the issuer selecting a particular type of intermediary?
  - Consider whether a matchmaking portal or other unregistered person will be able to provide the anticipated results

Is General Solicitation Important?

- Will testing the waters or a widespread campaign be essential to the offering?
  - The issuer should consider carefully whether general solicitation is important—for example, is it necessary in order to reach the customer base? Are the customers likely to be investors?
  - If general solicitation is essential, then the choices are limited to Regulation Crowdfunding, intrastate crowdfunding, Rule 504 (depending on whether the issuer uses the state registration approach), Rule 506(c) and Regulation A
  - Now, if the issuer wants to use general solicitation and must include non-accredited investors, then that eliminates Rule 506(c) as an alternative
  - Then, the issuer might want to compare and contrast as among the remaining alternatives the required offering disclosures and financial statement requirements
  - Is "testing the waters" prior to investing resources in a Tier 1 or Tier 2 Regulation A offering important to the issuer?

What Offering Disclosures Will Be Used?

- Does the issuer understand the information and disclosure requirements associated with the various exemptions when non-accredited investors are proposed to be included?
- Is the issuer prepared to undertake the preparation of a Form C for an offering made pursuant to Regulation Crowdfunding or of a Form 1-A for a Regulation A offering?
  - An issuer should review closely the offering requirements associated with Form C and/or Form 1-A
  - Both require significant narrative descriptions of the company’s business, management, financial results and related matters
  - Has the issuer considered the costs associated with the preparation of the required financial statements? Has it engaged accountants to assist?
- Has the issuer considered the ongoing reporting requirements once it has completed the financing?

Rule 506(c), Crowdfunding and Reg A

- These three types of offerings, which have very different requirements, often are incorrectly referred to as “crowdfunding” transactions
- Of course, all three have in common the ability to use general solicitation and the ability to “test the waters,” but that’s where the similarities end
- For an issuer, it will be important to distinguish among the three:
  - In a Rule 506(c) offering, sales may be made only to accredited investors; there is no specific disclosure requirement
  - In a Regulation A offering, whether Tier 1 or Tier 2, the issuer will be required to prepare an offering statement (Form 1-A) and have that offering statement qualified before the offering can commence.
  - Similarly, Regulation Crowdfunding requires the preparation of a Form C. The disclosure requirements as between the two are comparable; however, the offering thresholds are quite different, as is the method of the offering

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Tier 2 of Regulation A Versus IPO

- An issuer may consider a Tier 2 Regulation A offering (up to $50 million in proceeds) and do so with or without pursuing a listing on a national securities exchange
- If an issuer intends to list on an exchange, then it should take into account that financial statements will be required to be prepared that are PCAOB-compliant
- Once an issuer undertakes a Tier 2 offering with a listing on a national securities exchange, the issuer will become subject to the corporate governance requirements of the exchange, as well as full Sarbanes-Oxley corporate governance requirements (albeit as an "EGC" issuer)
- In many respects, this outcome will be similar to the outcome if the issuer had undertaken an IPO as an EGC
- There are some important differences to consider

Financing Alternatives For SEC-Reporting Companies

Choosing a Financing Approach

- Subject to meeting certain conditions, an issuer that has been an SEC-reporting company for at least 12 months may be eligible to file a shelf registration statement. For an issuer that is eligible to use a shelf registration statement on a primary basis, the range of financing alternatives for a follow-on is broad. The vast majority of follow-on offerings are now made in reliance on a shelf registration statement, as shelf take-downs
- Generally, when considering the options with issuers, we tend to review
  - Timing considerations
  - Use of proceeds
  - Disclosure considerations
  - Market conditions
  - Volatility of the issuer’s stock

Financing Continuum

Private	Hybrid		Public
• Conventional private placements • Private placements with trailing registration rights, or PIPEs	• Traditional PIPEs • Structured PIPEs • Private equity lines	• Registered direct offerings • 144A offerings	• Underwritten offerings • Wall crossed offerings or "CMPOs" • Bought deals • At-the-market offerings • Equity shelf programs • Rights offerings
Less Liquid	More Liquid		Liquid

Summary Financing Alternatives

More Senior

Financing Instruments	Uses	Characteristics
■ Debt Financing		
– Bank Revolver	Finance receivables, inventory and other working capital	– 1-5 years – Committed line – Fairly restrictive covenants
– Bank Term Loan	Medium-term capital	– 3-8 years – Fully drawn at close – Principal amortization requirements – Fairly restrictive covenants
– Capital leases	Medium/long-term capital	– 10-15 years – Company generally has an option to purchase leased property – Property capitalized as an asset; lease obligation treated as long-term debt; interest payable on lease obligation treated as interest expense
– Notes/Bonds • Medium term notes (3-5 years) • Long term notes (7-12 years) • Asset backed bonds (5-30 years) • Industrial revenue bonds (10-20 years)	Medium/long-term capital	– 3-30 years – Generally limited or no amortization requirements – Generally less restrictive covenants as compared to bank debt
■ Hybrid Financing		
– Convertible Debt – Convertible Preferred Stock	Medium/long-term or permanent capital	– 5-20 years or permanent – No amortization – Generally the least restrictive covenants
■ Equity Financing		

Less Senior

Ranking in Capital Structure

SENIORITY OF THE FINANCING	
	• Order in which the investors are paid off in the case of a liquidation of the company • Generally, bank lenders have a first priority claim against liquidation proceeds, followed by the subordinated debt holders, convertible debt holders and preferred stock holders • Equity holders are generally only entitled to receive a payment after all the debts and preferred stock holders' claims are fully satisfied • In practice, this strict statutory " rule of priority" is almost never followed, as a compromise is usually achieved between the holders of the company's securities, where each class of holders receives a certain percentage (generally less than 100%) of their investment

PAYMENT PRIORITY	RANKING OF CORPORATE OBLIGATIONS
HIGHEST ↓ LOWEST	• Taxes owed • Senior secured debt/First mortgage debts (first claim on collateral) • Accounts payable/Trade creditors • Senior unsecured debt • Senior subordinated unsecured debt • Subordinated unsecured debt • Preferred stock • Common stock

PIPE Transactions

What Is a PIPE?

- A PIPE (Private Investment in Public Equity) is the privately negotiated sale (i.e., a private placement) of a public issuer's equity or equity-linked securities to selected accredited investors, where the sale is conditioned upon a resale registration statement being filed with, and declared effective by, the SEC (permitting immediate or prompt resale)
- Investors enter into a purchase agreement to buy securities. The purchase agreement, or a separate registration rights agreement, provides that the issuer is required to file a resale registration statement covering the resale of the purchased securities (or the shares of common stock underlying the purchased securities)
- Designed to enable a public company to issue equity or equity-like securities to investors more rapidly than a typical registered offering
- Usually consists of "primary shares," but may also be in the form of a "secondary offering" or a "primary/secondary" offering

PIPEs: Changing Terminology

- "PIPE" has come to mean any private investment in a public company, including:
  - A traditional PIPE;
  - A private placement with delayed (or trailing) resale registration rights;
  - A private convertible preferred (fixed or floater) or structured PIPE;
  - A venture-style, or change-of-control, private placement;
  - A registered direct; and
  - A private "equity line" or equity shelf program

Traditional PIPEs

- Investors irrevocably commit to purchase a fixed number of securities (common stock or fixed rate/price preferred stock) at a fixed price not subject to market price or fluctuating ratios
- Investors do not fund at the time that the purchase agreement is signed. Instead, after signing, the issuer files a registration statement covering the resale of the securities. The transaction closes once the SEC has indicated its readiness to declare the registration statement effective
- As a result, the investors in the traditional PIPE have available a resale registration statement at the time of closing
- In a traditional PIPE, the investor bears price risk from the time of pricing until the time of closing. That is, the market price of the shares may decrease before the investor closes on the purchase
  - The issuer is not obligated to deliver additional securities to the PIPE investors if the stock price fluctuates

Additional Standard Terms of a Traditional PIPE

- Purchase agreements generally contain a limitation on the number of "black-out periods" for the registration statement
- Purchasers are named as "Selling Stockholders" in the resale registration statement
  - Note: the SEC assumes that broker-dealer investors are engaged in a distribution. (Among other results, these selling stockholders could have potential liability as "underwriters")
- The resale registration statement generally must be kept effective until all of the shares may be sold without volume limitation under Rule 144
  - Many agreements require that the registration statement be kept effective for a maximum period of one or two years. If affiliates participate as investors often reject the maximum period

Registered Direct Offerings

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Registered Direct Offerings

Registered Directs allow an issuer to achieve public-style pricing while maintaining the relative confidentiality of a private placement

- A Registered Direct offering is a “best efforts” placement of registered common stock off an issuer’s existing effective shelf registration statement, generally to a limited number of institutional investors; the securities are immediately eligible for resale
- Registered Direct offerings have characteristics of both public and private offerings; thus, they are governed by the rules, regulations and market practices specific to each type of offering
- A Registered Direct is a “private style” public offering that is, in some ways, an extension of the PIPE; the number of registered direct offerings has been trending upwards in the last several years
- Registered directs are sometimes being marketed and sold by placement agents as “registered PIPEs” or “strategic publics”

Standard Terms of Registered Directs

- If a shelf registration statement does not already exist, a registration statement on the appropriate form is filed with the SEC
- Offering is conducted on an agency basis by the placement agent. Although the placement agent is likely to be a statutory underwriter, use of the firm's capital is not required
- Offering is either on an <u>all or nothing basis</u> (escrow required) or on a <u>minimum/maximum basis</u> (escrow required) or on an <u>any or all basis</u> (escrow <u>not</u> required)
- Purchasers generally do not negotiate or sign individual purchase agreements with the issuer
- Closing can occur as soon as the registration statement is declared effective (if there is no shelf in place)
- Closing occurs on a normal T+2 schedule

Why Choose a Registered Direct?

- Over a PIPE transaction?
  - **Same efficient marketing:** if an issuer has an effective shelf registration statement, a registered direct offering can be marketed as a PIPE transaction on a "stealth" basis
    - Often a preliminary prospectus is filed, making the offering known to the public. However, the issuer and placement agent may agree not to file a preliminary prospectus supplement until late in the process
  - **Often better pricing:** investors receive registered, freely transferable securities; thus, no "liquidity" discount
  - **Prompt pricing and closing:** if the issuer has an effective shelf registration statement (or is a WKSI that can file an automatically effective shelf), the offering can be priced and closed promptly. In some cases, pricing can occur overnight or in a few days
  - **Not limited to accredited investors:** because these transactions are registered, offerings can be made to any potential investor, subject to suitability requirements

Why Choose a Registered Direct? *(cont'd)*

- Over a traditional underwritten follow-on offering?
  - **Short selling:** in a fully marketed underwritten offering, the market has advance notice of the potential offering, and market participants may begin shorting the issuer's common stock in anticipation of the offering
  - **Potentially better pricing:** depending on the length of the marketing period and general market conditions, shorting activity in the issuer's securities may cause the market price of the issuer's stock to decline (sometimes significantly) by the pricing date. As a result, the pricing in a marketed follow-on generally may be lower than the price in a registered direct offering
  - **Speed and costs:** registered directs are typically faster (and cheaper) than firm commitment deals
  - **No capital commitment:** from the placement agent's perspective, a registered direct offering does not require any capital

Confidentially Marketed Public Offerings

- Given extreme market volatility, focus on speed of execution has intensified
- Important for issuers to be able to avoid shorting activity or other aberrational trading that may result from a "launch" announcement or from a broad-based marketing effort
- As a result, recent offerings have been marketed over an overnight or one-day period to shorten exposure to price/market risk
- Additionally, issuers and underwriters have confidentially pre-marketed their offerings prior to the public announcement

Methodology and Process

- A proposed offering is confidentially marketed prior to the public announcement of the offering to a select group of institutions, including:
  - Mutual funds and hedge funds that are among the issuer’s largest shareholders;
  - Private equity investors; and
  - Sovereign wealth funds
- For SEC-registered offerings, confidential pre-marketing should not be done without an effective shelf registration statement in place
- Investors may be provided material, non-public information (“MNPI”) regarding the issuer/offering:
  - Wall-crossed investors must agree to keep the MNPI confidential
  - Wall-crossed investors must agree not to trade while in possession of the MNPI

Why a CMPO?

- Over a registered direct offering? In general, many of the advantages of a registered direct offering also apply in the context of a pre-marketed public offering
  - **Wider distribution:** an advantage of a registered direct offering is that it is marketed in a targeted manner. However, that often means that the offering is not as widely distributed as other public offerings, in which case a pre-marketed public offering may be attractive (it can be opened up to retail investors)
  - **20% rule:** if an issuer anticipates offering and selling a number of shares that exceeds 20% of the total shares outstanding prior to the offering, and those shares will be sold at a discount, a registered direct offering may not be considered a "public offering" under the rules of the applicable exchange, thus presenting shareholder vote issues under the 20% rule. A pre-marketed public offering may be an attractive alternative because it is underwritten (important for NASDAQ) and in the second (public) stage can be opened up to a broader universe of offerees
  - **Perceived better pricing:** many issuers still view an underwritten offering to be the most desirable financing alternative
  - **Underwriter can stabilize or overallot** (if it chooses to do so): depending on market conditions, this may be important

Bought Deals

- Firm commitment transaction (sometimes referred to as an "overnighter") wherein the underwriter purchases the securities from the issuer without pre-marketing
  - An issuer or a selling securityholder may need certainty of execution and, as a result, may prefer a bought deal to a CMPO
  - Generally, a bought deal will only be feasible for a WKSI
  - Usually, it is easier to execute a bought deal following the filing of a 10-Q or 10-K when the issuer's disclosures are current
- The underwriter must use its best efforts to re-sell the securities (once purchased)

At-The-Market Offerings

What Is An At-The-Market Offering?

- An offering of securities into an existing trading market at publicly available bid prices
- Commonly referred to as “equity distribution” or “equity dribble out” programs
- Shares are “dribbled out” to the market over a period of time at prices based on the market price of the securities
- Generally, sales do not involve special selling efforts

Compare to Traditional Follow-on

At-the-Market Offering

- A continuous offering
- Shares are dribbled out
- Sold on an agency basis through one or more placement agents; may be sold on a principal basis
- Issuer determines amount, floor price and duration of any issuance
- Amounts, floor prices and duration of placements may vary over the life of the program and can be changed at any time

Follow-on Offering

- A “bullet” or single offering
- Shares are sold all at once
- Sold as principal through a syndicate of underwriters
- The clearing price and size of issuance are based on investor demand at a specific point in time

Why Use an ATM?

- Raise equity by selling stock into the natural trading flow of market
- Minimal market impact
- Requires no commitment of any kind; sales may be executed on an agency basis
- Increases the issuer's ability to better time its issuances and match offering proceeds to specific uses
- Often effective whether or not the market is receptive to other types of offerings

What Type of Issuers Use ATMs?

- Used by issuers that:
  - Have a frequent need to raise additional capital;
  - Wish to engage in regular balance sheet maintenance;
  - Seek to raise small amounts of organic growth capital; and
  - Seek to finance a small acquisition or series of small acquisitions

Debt Financing Alternatives

Debt Funding Sources

- Bank loans
- Domestic and offshore public bonds
- Convertible bonds
- Hybrid bonds
- Private markets — i.e., Schuldschein, French EPP and other European initiatives
- Mortgage finance
- Securitization

Comparison of Debt Financing Alternatives

	Bank Debt	Fixed-Rate Bond Debt	Convertible Debt
Description	• Short or long-term debt paying floating rate cash coupon, often secured by the company's assets, etc.	• Long-term debt paying a fixed rate cash coupon with bullet redemption at par	• Securities that are convertible into a fixed number of common shares
Advantages	• Cheapest form of capital/lowest coupon • Tax-deductible interest • Pre-payable at any time, sometimes with penalty • Flexible drawdown availability • Increasing availability based on asset growth • No common equity dilution • Vendor financing may be available for up to 100% of the company's equipment needs • The company may be able to negotiate terms that allow it to leverage off vendor's strong credit rating	• Longer-term capital • Tax-deductible coupon • Locks in long-term fixed rate • No amortization requirement • No common equity dilution • Incurrence-based covenants for high yield debt are more flexible than maintenance covenants for bank debt • Creates awareness in public capital markets • Extensive market for Rule 144A offerings (with exchange) and for investment grade issuers • Quick execution through Rule 144A offer (with exchange)	• Lower coupon relative to straight debt • Issuer "sells equity at a premium" • Tax-deductible coupon • No covenants • Better balance sheet treatment – potential conversion will positively affect the company's credit profile • Extensive market for Rule 144A offerings • Broadened investor base
Disadvantages	• Short/medium-term capital • Increases leverage • Exposure to floating interest rates • Significant covenant restrictions • Maintenance-based covenants limit financial flexibility • Often require security in underlying assets, thus limiting structural flexibility • Generally require principal amortization • Availability subject to operating performance	• Increases leverage • Highest cash-coupon financing • Generally has 5-year non-call feature (high yield) or no-call for life (investment grade) • Refinancing risk • Restrictive covenants for non-investment grade issuers • Difficult to amend • May require full road show to execute • Necessitates dealings with rating agencies	• Increases leverage • Generally has 3-year non-call feature • Generally dilutive (less than common stock) • May cannibalize common stock investor base • Risk of "hung" convertible in low share price growth scenario • Draws on company debt capacity

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Funding Diversification

- Long-term capital structure
- Reliable source of funding
- Maturity profile of debt/tranching
- Ability for delayed drawdown
- Fixed rate versus floating rate
- Minimum size
- Other currencies besides USD available

Application of Rule 144A

- A Rule 144A offering involves two transfers of the security
- Sale from issuer to investment bank (the initial purchaser) is not a Rule 144A sale. It is a “true” private placement under Rule 4(a)(2)
- Sales from investment bank to its customers (“resales”) are exempt under non-exclusive safe harbor provided by Rule 144A

Key 144A Elements

- Sales only to QIBs (often undertaken in connection with Regulation S offering)
- Requirement to notify purchaser of reliance on Rule 144A (included in offering circular)
- Securities offered cannot be of same class as a listed security
  - Fungibility — convertibles/warrants
    - ADSs
    - Debt
    - Exchangeable securities
- Current financial information must be available (included in offering circular)

Rule 144A Alternatives

- There are various permutations of Rule 144A offerings:
  - A “traditional” Rule 144A offering
    - The financial intermediary acts as an initial purchaser and takes underwriting risk
  - A 144A-qualifying transaction
    - The financial intermediary acts as a placement agent and a settlement agent; the issuer sells to QIBs only in a 4(a)(2) offering
- Non-SEC reporting issuers will
  - Conduct Rule 144A for life transactions where there is no obligation on the part of the issuer to register the resale of the securities
- SEC reporting issuers may choose:
  - A Rule 144A with resale registration rights, or
  - A Rule 144A offering with an A/B exchange offer

What Securities Are Covered?

- Rule 144A may be used in the distribution of both equity and debt securities
- Rule 144A may be used in the distribution of securities issued by U.S. and foreign companies and is available for securities issued by both SEC-reporting and non-reporting companies
- Rule 144A is not available for listed securities
- Rule 144A may be used to distribute the U.S. tranche of a global offering registered outside the United States (144A/Reg S offerings)

High Yield Bonds

- BB(Ba) or lower
- Speculative—repayment is not assured
- Successful offerings below B- are not common

Introduction to High Yield Covenants

- Indenture
  - Indenture is a contract between company and indenture trustee (bank acting on behalf of investors)
  - Outlines rights of bondholders and company
  - Includes covenants
  - Defines events of default
  - Required for U.S. SEC-registered public offerings under the Trust Indenture Act of 1939

Covenants

- Underlying reason for covenants
- Covenants usually apply to issuer and its Restricted Subsidiaries
- Positive or affirmative covenants—impose duty on borrower, usually innocuous
  - Furnish annual reports
  - Maintain paying offices
  - Replace lost bonds
- Negative or restrictive covenants—prevent company from taking actions detrimental to bondholders
- Maintenance versus incurrence covenants
- Protect cash flow for debt service
- Protect creditors' access to assets
- Limit cash flow from issuer to junior securityholders

High Yield Debt Standard Covenants

Investment Grade

- Restrictions on liens securing debt
- Limitation on sale/leaseback transactions
- Consolidation, merger and sale of assets
- Purchase of notes upon change of control and ratings event

High Yield

- Limitation on incurrence of indebtedness
- Limitation on liens
- Limitation on restricted payments
- Limitation on transactions with affiliates
- Limitation on dividend and other payment restrictions affecting subsidiaries
- Purchase of notes upon change of control
- Limitation on asset sales
- Consolidation, merger and sale of assets

Convertible Debt Overview: General Terms & Conditions

- Coupon rate
  - The annual cash interest payment made by the Company to holders of the security, typically paid semi-annually
  - Privately negotiated securities can be structured with PIK option
  - PIK rate higher than cash rate
- Maturity
  - Typically 5 to 7 years—can be as high as 20 or 30 years and structured with short-dated call options and/or investor put options
- Conversion premium
  - The percentage premium over the stock price at issuance at which investors may opt to convert the convertible security into common stock
- Call protection
  - Period during which the Company does not have the right to call securities from investors
  - Typically non-investment grade securities are non-call for life
  - Early call features require attractive coupon and premium terms for investors
  - Provisional call terms dependent on stock price performance

Convertible Debt Overview: General Terms & Conditions *(cont'd)*

- Investor put option
  - Investor's right to require the company to repurchase bonds
- Takeover protection
  - Fundamental change (cash takeover) triggers investor put option
  - Make-whole payments made to investors upon a cash takeover based on pre-defined prices
  - Cash takeover defined as 90% of consideration paid in cash
- Dividend protection
  - Protects the investor from increases in the common stock dividend yield
  - Conversion ratio is adjusted by an amount equal to the value of the common stock dividends paid per bond
- Rank
  - Position in the company's capital structure
  - Typically unsecured obligations
  - Senior or subordinate
  - Typically structurally subordinated to subsidiary debt, including trade creditors

Conversion Settlement Impact: Full Share (Plain Vanilla) Versus Net Share

	Full Share	Net Share
Conversion	Settled in common stock	Lesser of conversion value or principal amount settled in cash. Premium over par paid in common stock
Balance Sheet	LTD decreases	LTD decreases Cash decreases
Stockholder's Equity	Increases by total shares underlying convertible	Could increase
Public Float	Increases by total shares underlying convertible	Could increase
Diluted EPS	"If Converted" method used in diluted EPS calculation [FAS-128]	"Treasury Stock" method used in diluted EPS calculation

General Covenants

- Convertible debt securities do not typically contain financial covenants, i.e., minimum net worth, maximum leverage, fixed coverage or working capital covenants
- Events that could trigger default include:
  - Payment of securities
    - Principal and interest payments
    - Conversion obligation
    - Repurchase notice or fundamental change
    - Failure to cure any defaults within a certain period
  - SEC reports
  - Compliance certificates
  - Further instruments and acts
  - Maintenance of corporate existence
  - Rule 144A information requirement
  - Payment of additional interest

Convertible Debt – Benefits & Considerations

- Benefits
  - Tax-deductible interest expense decreases after-tax cost of capital
  - Ability to issue common stock at a premium to current market (conversion settlement in common shares)
  - Option to minimize share dilution via net share settlement feature (cash or common settlement)
  - Flexible call structures can reflect Issuer’s view on stock
  - No financial covenants
  - Appeals to broad investor base
- Considerations
  - Treated as debt on the balance sheet
  - Periodic cash coupon payments (conversion settlement in common shares only)
  - Periodic non-cash interest expense (conversion settlement in cash or common shares)
  - No equity credit given by rating agencies
  - Share dilution, if converted (FAS-128) or treasury stock method (with cash-settled instruments)
  - Obligation to repay principal, if not converted
  - No increase in the public share float prior to conversion (“plain vanilla”)

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