



The alternative to an IPO: an increasingly attractive option for VC and PE portfolio companies

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For the past two years the market for initial public offerings for promising private companies has been slow. The number of US IPOs in 2008 plunged from 234 in 2007 to just 43, the slowest year for IPOs since 1978. Venture-backed IPOs have fared far worse - according to Dow Jones VentureSource, US venture-backed IPOs dropped from 76 in 2007 to a mere seven in 2008, and 2009 is looking to be more like 2008 than 2007. These disturbing statistics make very clear that private companies and their investors, especially venture-backed companies, have been left without a critical exit strategy and these companies have been deprived access to the critical growth capital that the public markets can provide them.

This challenging IPO market has given rise to an increasingly popular alternative that is being executed successfully even in this challenging environment - the alternative public offering. An alternative public offering combines two transactions: 1) a reverse merger, which is a means for a private company to become publicly traded, and 2) a PIPE financing, which is a private placement into the newly public company.

According to DealFlow Media, in 2007 and 2008 there were more than 100 and 70 alternative public offerings, respectively. Even during the tumultuous first half of 2009 there were more than 15 alternative public offerings. These statistics actually underestimate the number of companies that have become publicly traded through a reverse merger. SDC statistics show that there were nearly 200 and 275 reverse mergers in 2007 and 2008, respectively, and according to DealFlow Media there have been almost 125 reverse mergers for the first three quarters of 2009. The reason there have been more reverse mergers than alternative public offerings is that there are a sizable number of companies that find it advantageous to raise no capital at the time that they become publicly traded through a reverse merger; instead, they raise capital later at an even higher public valuation and with less dilution.

The mechanics of the reverse merger are simple. In a reverse merger, the private company reverse merges into and takes control of a public shell company, which is an existing publicly trading company without operations. The newly merged company then takes on the name of the private company, installs the private company's directors and officers, and files with the appropriate regulatory authorities.

Whether a private company pursues an IPO or a reverse merger, there are numerous benefits to becoming publicly traded, including offering investors a simple exit strategy of selling stock on the open market. Perhaps most importantly, public companies are valued more highly than private companies. Consequently, public companies can raise capital at a higher valuation with less dilution. In addition, public companies can use stock to make acquisitions, which is crucial for companies involved in rolling up small companies, and use stock options to attract and retain key employees.

However, alternative public offerings offer private companies significant advantages over an IPO. In an alternative public offering, there are no red herrings to be distributed; instead, the registration statement is filed after the reverse merger and PIPE financing, which greatly accelerates the timing of the completion of the alternative public offering transaction. More importantly, because these transactions are negotiated between the private company and the owner of the public shell company, completing a transaction is not dependent on market conditions beyond the control of a private company's management. In other words, a private company has control over the timing of its reverse merger, whereas with the IPO route a private company could entail the burdens of high costs and a substantial time investment only to have its IPO shelved by its bankers for any number of reasons. Alternative public offerings provide companies with the benefits of IPOs - and quicker and less expensively. Empirical studies, such as the August 2009 Floros & Shastri comparative analysis of smaller IPOs and alternative public offerings demonstrates that companies pursuing alternative public offerings are more successful and more easily able to raise capital once they are public.

Raising capital is a huge motivation for private companies pursuing alternative public offerings. According to Sagient Research Systems 2008 was a record year, with more than 1,000 PIPE transactions raising over \$120bn, up from \$80bn in 2007. Not only has the aggregate amount of capital raised increased, but there also has been a growing universe of PIPE investors. According to a mergermarket survey during the third quarter of 2009, 68 per cent of respondents expected private equity and venture capital firms to be the most active PIPE investors in the year ahead. These firms have more readily available capital than other investors and are increasingly finding investing in publicly traded companies to be more attractive than investing in private companies.

Given current trends, venture capital and private equity firms may want to consider increasing their focus on investing in publicly traded companies. Further, with the difficult IPO market, venture capital and private equity firms may want to take a closer look at alternative public offerings as a viable path for their portfolio companies. Otherwise, they may risk delaying their exit or, even worse, having their portfolio companies miss out on the critical financing that could be obtained if they were to become publicly traded.

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