

## The Alternative to an Initial Public Offering

For over a year, the market for initial public offerings (IPO) for promising private companies has been slow. In 2007, there were just 234 IPOs, down from a decade high of 486 in 1999. As a result, private companies and their investors (including venture capital and private equity backed companies) have been left without a crucial exit strategy. More importantly, these private companies that might have completed an IPO have been deprived access to the critical growth capital that the public markets can provide them. An alternative to an initial public offering is needed.



The challenging IPO market has given rise to an increasingly popular alternative to an IPO to raising capital—alternative public offerings, which combine a reverse merger into a public shell and a private investment in public entity (PIPE). According to DealFlow Media, in 2007, 222 reverse mergers were completed and 45% of them included a concurrent PIPE, raising almost \$1 billion.

Hedge funds, such as New York City-based Paragon Capital LP, have been capitalizing on this growing trend. “Alternative public offerings provide huge value for the shareholders and management of emerging growth companies,” says Kevin A. Pollack, Esq., a Managing Director at Paragon. “These transactions offer these companies the benefits of IPOs that they otherwise could not access—and quicker and less expensively.”

Paragon’s investments in alternative public offerings generate high valuations for the private companies involved—and high returns for Paragon’s hedge fund investors. Since its inception, Paragon has produced more than a 70% return per year.

### The End of the IPO Party

At the peak of the dot-com boom less than 10 years ago, IPOs were commonplace for both highly recognizable private companies and companies that were little more than a good idea. Since then, the capital markets landscape has changed dramatically in several ways.

First, the number of IPO underwriters for private companies has diminished substantially. Since the late 1990s, major players in the IPO space such as Hambrecht & Quist; Alex, Brown; Robertson Stephens and Montgomery Securities, have been merged or consolidated into larger banks that focus on bigger deals. The disappearance of these underwriters has created a gaping hole in the IPO market, leaving private companies underserved and undercapitalized.

Second, given the lack of underwriters interested in smaller IPOs and no investment research being written on small-cap companies, it comes as no surprise that investors have been reluctant to invest in these companies. At its low point in 2001, 2002 and 2003, there were just 83, 70 and 68 IPOs, respectively, according to IPO Home. In addition, according to the National Venture Capital Association, the approximate average deal size for a NASDAQ IPO during the 1990s was \$35 million versus \$115 million in 2006, and the approximate average market cap for

these companies was \$55 million during the 1990s versus \$330 million in 2006. Today, the IPO market has no interest in companies that are strong growing companies but may be valued at less than \$250 million.

The bar to accessing the IPO market clearly has been raised and, as a result, the number of smaller IPOs has plunged. According to IPO Home there was an average of approximately 35 IPOs raising less than \$25 million per year from 1997 through 1999. In contrast, from 2000 through 2006 there was an average of less than 10 under \$25 million IPOs per year, with just 7 in 2006.

Third, venture capital firms have found themselves with too many private companies in their portfolios yet too few IPO exits. According to the National Venture Capital Association, from 2000 through 2006 only 10% of venture capital exits had been through IPOs, versus 50% for the entire 1990s. This lack of exit through an IPO has had a negative impact on venture capital returns. According to Cambridge Associates, the median return of U.S. venture capital funds launched between 1998 and 2005 has been negative.

As a result of these factors and others, a large number of private companies have faced serious challenges in their quests to go public and raise critical growth capital. In record numbers these companies have turned to the best alternative—alternative public offerings.

#### Alternative Public Offering: Reverse Merger and PIPE Financing

In the absence of an active IPO market, alternative public offerings have become the new IPO. 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.

#### *Reverse Mergers*

A reverse merger occurs when a public entity acquires all of the stock of a private company in exchange for approximately 90% to 95% of the shares of the public entity. Then the newly merged company takes on the name of the private company, installs the private company's directors and officers, and files with the appropriate regulatory authorities. This transaction and change of control completes the reverse merger, transforming the formerly private company into a publicly traded company.

There are numerous benefits for a private company to become publicly traded. First, unlike a private company, a publicly traded company has an easily identified market value. If the private company owners are venture capital or private equity funds, then having an identifiable valuation is advantageous for their portfolios.

Second, publicly traded companies are valued more highly than private companies. The basic reason is that a private company generally sells for between four and six times its cash flow while as a publicly traded company it may be valued at around 20 times its trailing earnings.

A third benefit of being public is that a publicly traded company provides liquidity to its shareholders. Selling stock of a publicly traded company on the open market is far quicker and easier than selling shares of a private company, offering a strong exit strategy for investors.

Fourth, a publicly traded company can use its stock as a currency to make acquisitions, which is crucial for private companies involved in rolling up small companies.

Fifth, a publicly traded company can use its stock to provide incentives to its employees through stock options. This sweetener can play a key role in attracting and retaining employees.

Sixth and finally, one of the most important advantages offered by becoming a publicly traded company is greater access to capital at a higher valuation. The ability to access capital through a PIPE financing when combined with a reverse merger allows for an alternative public offering to be substantially equivalent to an IPO.

### *PIPE Financing*

Over the past decade, private investments in public entities (PIPEs) have become an important institutional financing method adopted by the major firms on Wall Street as a flexible financial tool to finance public companies. In recent years the PIPE market has been booming: according to Sagient Research Systems, in 2007 a record \$80 billion was raised in almost 1,400 PIPE transactions, up from \$28 billion for 2006. There also have been recent changes in securities regulations that make it easier for small-cap public companies to pursue PIPE transactions, which should significantly increase the number of PIPE deals done.

Given the huge number of companies seeking PIPE financing, PIPE funds can be highly selective and invest in the most advantageous PIPE deals. "The investment strategy with the highest absolute return with reduced risk is a PIPE investment," says Alan P. Donenfeld, President of Paragon Capital LP.

The statistics indicate that he is right: according to HedgeFund.net, from 1995 through 2006 PIPE funds have produced compounded annual returns of 26.9%, as compared to 10% for the S&P 500. In addition, PIPE funds have significantly outperformed the S&P 500 and other investment strategies in terms of return and risk/volatility, as measured by the Sharpe Ratio. The higher the Sharpe Ratio, the more consistent and less volatile the returns. Since 2001, PIPE funds have returned an average annual compounded return of 21.78% with an annual Sharpe Ratio of 3.47 versus a 3.78% average annual compounded return and 0.48 annual Sharpe Ratio for the S&P 500. "If you know how to source, evaluate and structure PIPE investments, it's a tremendous strategy to be in," Donenfeld adds. "At Paragon, not only do we have the expertise to invest in PIPEs, but we also have the expertise to combine them with reverse mergers for a tremendous synergy that can generate exceptional returns."

### *Alternative Public Offerings*

The combination of a reverse merger and PIPE is powerful: many private companies face challenges raising capital while private, yet without that capital they cannot grow to a size that would allow them to become public. The alternative public offering addresses this conundrum by providing promising private companies with access to the public markets and a greater ability to attract capital. By accessing the PIPE market at the time of a reverse merger, newly public companies can raise capital as soon as they go public, which is exactly what would happen in an IPO. For those private companies that have access to the IPO market, an alternative public offering still can offer significant advantages.

First, alternative public offerings are far quicker transactions than IPOs. In an alternative public offering, the registration statement is filed after the reverse merger and PIPE financing, which greatly accelerates the timing of the completion of the transaction. Second, alternative public offerings are far less expensive than IPOs, which entail the burden of upfront registration and underwriting fees. Third, alternative public offerings are less risky than IPOs since alternative public offerings are negotiated between the shell owner and the institutional investors, as compared to an IPO which involves red herrings being distributed to a significant number of investors. The success of an IPO is highly dependent on market conditions beyond the control of a private company's management. Lastly, alternative public offerings can be completed for much smaller companies than a high cost IPO.

#### Chinese Companies Utilize Alternative Public Offerings

In recent years Chinese private companies have gravitated towards alternative public offerings. A major reason for this trend is the restrictions by China's government on the number of Chinese private companies that can go public in the U.S. via IPOs. According to DealFlow Media, of the 222 completed reverse mergers in 2007, 69 involved Chinese private companies, and since 2004 approximately 180 Chinese companies have completed reverse mergers. Although China currently is the hot market for alternative public offering candidates, companies in India, Korea and Vietnam are anticipated to be a source of many future alternative public offerings.

#### Conclusion

As alternative public offerings continue to thrive, hedge funds such as Paragon and other investors can be expected to play a greater role in assisting otherwise underserved private companies utilize alternative public offerings. In one recent month, Paragon bought control of 3 public shells under its proprietary deal structure, including the OTC BB shell Prevention Insurance.com, Inc. "A promising company can reap huge rewards through partnering with us given our position as a shell owner and PIPE investor," Donenfeld said. "Given our expertise with PIPEs and reverse mergers, we plan to continue investing in these attractive transactions for some time to come."

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*Private Equity Professional Digest* is published by Sun Business Media, LLC.

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