Alternative Equity Offering Structures Provide Access to Capital as Markets Remain Challenged (In Capital Markets Compass Issue 6 (May 2023))

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Global equity markets continue to navigate the dueling impacts of inflation, rising interest rates and a slowing economy. While the market for initial public offerings initially showed signs of a recovery in early 2023, the IPO market remains relatively sluggish and has faced set-backs such as uncertainties in the banking sector.[1] Meanwhile, the follow-on equity markets have remained robust as compared to the IPO market, as existing public companies relied on an array of offering structures to raise equity capital in the public markets in 2022 and 2023. Below, we discuss some of the more prominent equity-raising structures being utilized today by public companies, including by special purpose acquisition companies (SPACs) and former SPACs, which face particular challenges when it comes to raising capital.

In 2022, an estimated 1,900 alternative equity financing transactions, inclusive of private investment in public equity transactions (PIPEs), registered direct offerings, confidentiality marketed public offerings (CMPOs), at-the-market offering programs (ATMs) and equity lines of credit (ELOCs), raised over $135 billion in capital, according to Private Raise, a provider of comprehensive analysis of PIPE, Shelf Registration and SPAC transaction activity. The ATM and equity line markets were particularly robust in 2022, with an aggregate of 700 closed deals representing $61 billion raised, which helped offset the decrease in conventional PIPE deals. Excluding ATMs and ELOCs, an estimated 1,200 PIPEs, registered directs and CMPOs that raised approximately $74 billion closed in 2022. Deal activity was robust in the first quarter of 2023, with $33.95 billion raised across 497 deals, with ATM and ELOC deals accounting for $23 billion of the dollars raised in the first quarter of 2023.

This article discusses overall trends in the markets for alternative equity financing transactions in 2022 and early 2023, how such markets were influenced by trends in SPACs and de-SPAC transactions, and business and legal issues that both issuers and investors consider when deciding on a structure for a follow on equity offering.

Private Investments in Public Equity (PIPEs)

General Characteristics. A PIPE transaction involves a private placement of securities by a public company to one or more accredited investors. The securities sold in a PIPE may consist of common stock, convertible preferred stock, convertible debt, warrants or other equity or equity-linked securities of a public company, or a combination of any of the above.

Securities sold in a PIPE (including the common stock issuable upon conversion or exercise of warrants, preferred stock, convertible debt or other securities sold in a PIPE) are "restricted securities" and may only be resold by the investor pursuant to a resale registration statement or pursuant to an exemption from the registration requirements of the Securities Act of 1933 (the "Securities Act"). PIPE documentation will typically obligate the issuer to file a resale registration statement covering the securities purchased in the PIPE (or common stock underlying such securities) either prior to, or within a short period of time (e.g., within 30 days) following, the closing date. Regardless of whether such a resale registration statement is filed or becomes effective, securities held by investors that are not affiliates of the issuer will generally be eligible for resale under the exemptions provided by Rule 144 under the Securities Act six months after the closing date of the PIPE. Given the initial illiquidity of PIPE securities, they are typically sold at a greater discount to the market price than comparable securities could be sold in a registered offering.

The pace of PIPE activity was influenced by trends in the market for de-SPAC transactions in 2022. Traditionally, SPAC sponsors relied on PIPE deals to backstop de-SPAC transactions and mitigate redemption risk. The significant increase in redemption rates in connection with de-SPAC transactions in 2022, as well as other market factors, forced SPAC sponsors and their advisors to consider highly structured PIPE deals in order to complete de-SPAC transactions, including offerings of convertible debt, convertible preferred stock and other securities that offer provide downside protection to investors.

Advantages of a PIPE. The principal advantage of a PIPE is speed of execution as the securities are sold privately, which removes some of the filing and other documentation requirements associated with a public offering, such as the need to have an effective registration statement filed with the Securities and Exchange Commission (SEC) at the time the securities are sold. PIPEs are also highly customizable, providing both the issuer and the lead investor(s) in the PIPE the ability to structure an investment that achieves both parties' economic and other objectives.

Additional considerations related to a PIPE. In a PIPE offering, securities are typically sold at a greater discount to the market price than the discount associated with the sale of comparable securities in other offering structures, raising the cost of capital and potentially the dilutive effect on existing shareholders. Note that the sale of convertible securities, warrants and similar instruments via a PIPE may also continue to put downward pressure on a company's stock price as the market anticipates later sales on the part of the PIPE investors, particularly if the exercise or conversion price of the securities sold varies (or "floats") with the market price of the underlying security. PIPEs are subject to the so-called "20 percent rule" of the stock exchange in which the issuer's securities are listed. Both Nasdaq and the NYSE require listed companies to obtain shareholder approval for certain issuances of common stock or securities convertible into common stock, including the issuance of securities representing 20 percent or more of the issuer's outstanding common stock or voting power at a price below the minimum market price.

At-the-Market Offerings (ATMs)

The increased popularity of both ATMs and ELOCs was a major driver in offsetting an overall decrease in follow-on equity offering activity in 2022, representing almost half of dollars raised in the follow-on equity markets in 2022.

General Characteristics. An ATM offering (sometimes also referred to as a "continuous offering program" or an "equity distribution program") is a public offering of securities in which the issuer sells equity securities (typically common stock) through a sales agent into the public market over time and at then prevailing market prices (rather than at a fixed price). As is the case with registered direct offerings, prior to making sales through an ATM program, the issuer must have an effective registration statement on file with the SEC. To facilitate an ATM, the issuer will typically enter into a distribution or sales agreement with one or more sales agents, which provides the issuer the ability to make ongoing sales when the issuer decides it would like to raise equity capital.

Advantages of ATMs. ATMs are appealing to issuers that want the flexibility to raise capital on an as-needed basis but are not designed to raise substantial amounts of capital at one time. ATM programs are often viewed favorably in volatile equity markets, because they allow public company issuers to put an ATM program in place and then wait and raise capital quickly with limited additional advance disclosure (minimizing arbitrage opportunities) when market conditions are appropriate. Moreover, once an ATM program is in place, a company can raise capital under the program without requiring management to devote substantial time and resources to marketing efforts, and transaction costs are fairly predictable. To the extent there is sufficient volume to sustain sales into the market, the prices of the shares sold pursuant to the ATM will be at market prices, and not subject to a discount like in other offerings discussed in this article. In addition, the sales agent fees are typically less than underwriting discounts payable in the other capital-raising structures.

Additional considerations related to ATMs. An issuer must have a shelf registration statement for a primary offering on file with the SEC that is already effective in order to conduct sales through an ATM program. Accordingly, an issuer seeking to maximize flexibility would be well served to ensure it has an effective shelf registration statement with sufficient registered securities to facilitate either an ATM program or a Registered Direct or CMPO, which are discussed below. An issuer with a smaller market capitalization may find that the SEC rules restricting the amount of securities that may be offered (the "baby-shelf" rule) and sold in a primary offering undermines, at least in part, the value of an ATM program compared to an ELOC.

Additionally, as with any public offering, both the issuer and the distribution agent will need to be comfortable that the issuer's public disclosure is adequate and current, and free of material misstatements or omissions at any time when the securities are being sold. Accordingly, distribution agreements provide for customary underwriter protections, including accountant comfort letters, opinions of counsel, representations and warranties of the issuer and certificates to the agent from officers of the issuer. The distribution agent will require that certificates and other documents be updated periodically and require ongoing "bring-down" due diligence exercises to be performed, including, for example, delivery of quarterly auditor "comfort letters." As a result of these diligence requirements, ATMs result in up-front costs for the issuer, even if little or no capital is eventually raised. On the other hand, investing in the diligence and documentation up-front also avoids having to begin the process from scratch at the time the issuer is looking to raise capital, as would be the case in a customary public offering. Finally, the ability to use the ATM is subject to there being sufficient trading volume to sustain sales into the market.

Equity Lines

Small to mid-cap companies often turn to "equity lines" or "ELOCs" for much-needed liquidity in turbulent markets. SPACs and companies that went public via de-SPAC also increasingly turned ELOCs in 2022 and the first part of 2023. Prior to 2022, a SPAC looking to consummate a merger with an acquisition target typically relied on raising funds in the PIPE market (typically selling common stock at $10 per share) in order to mitigate the risk of a high redemption rate from its public stockholders in connection with a de-SPAC transaction. 2022 saw the simultaneous trends of high redemption rates in de-SPAC transactions together with a softening of the PIPE market for de-SPACs. As a result, SPACs increasingly turned to alternative financing structures, including ELOCs (as well as structured PIPEs, commonly involving convertible securities).

General Characteristics. Equity lines are financing agreements whereby an issuer enters into an agreement with an investor, pursuant to which the investor agrees to purchase securities (typically pursuant to an agreed-upon pricing formula) from the issuer in the future if certain conditions are met. After the issuer and the investor execute the definitive agreements to establish the equity line, the issuer files a resale registration statement covering the resale by the investor of the securities subject to the equity line. Once the registration statement is declared effective, the issuer can then "draw" upon the equity line by selling the subject securities to the investor per the terms of their agreement. Alternatively, issuers that are eligible to make primary offerings on Form S-3 and already have a universal shelf registration statement on file with the SEC, can immediately file a prospectus supplement registering the securities subject to the equity line and do not need to wait for the SEC to declare a registration statement effective. These arrangements allow an issuer to draw against its equity on an as-needed basis, typically for a period of months or years.

Advantages of ELOCs. Similar to an ATM, which is described further below, an equity line can provide an issuer with access to cash from time to time and allow an issuer to quickly take advantage of periods of favorable market sentiment. While the all-in-cost of capital is often higher for equity lines as compared to ATMs, equity lines do offer "firm commitments" from the investor as compared to a typical ATM program, which is conducted on a commercially reasonable efforts basis. Investors may also favor an equity line over other forms of investment, because the securities are purchased over time in tranches at a pre-determined discount to the market prices (which may be based on forward or backward pricing formulas). Because the equity line shares are registered for issuance under a shelf registration statement or for resale, the finance provider may quickly and freely resell the equity line shares for profit. ELOCs allow companies with relatively small market capitalizations to raise significant amounts of capital, as an issuer can register the securities subject to the ELOC using a Form S-1 if it is not eligible to use a Form S-3 for a primary offering. The ATM, Registered Direct and CMPO structures discussed above and below do not offer the flexibility to use a Form S-1. In addition, issuers can avoid limitations imposed by the 20 percent rule if the average price of all securities issued pursuant to the ELOC is above the minimum price established at the initial signing of the ELOC.

Additional considerations related to ELOCs. Since issuers can draw upon equity lines as needed, they are likely less helpful to an issuer that needs an immediate, one-time cash infusion into its business. Also, because the shares to be sold to the investor pursuant to an equity line must be registered on an effective resale registration statement that is filed with the SEC, an issuer is required to consider additional costs and timing considerations if it does not have, or is not yet eligible for, a Form S-3 Registration Statement. Similar to an ATM program, the equity line finance provider will typically conduct the bulk of its due diligence up front, which allows the company to quickly access financing on an as-needed basis going forward. The SEC requires the finance provider to be named as an "underwriter" in the prospectus covering the resale of the shares sold in the equity line. As such, many equity line finance providers, as with ATM finance providers, require delivery of negative assurance letters and in some cases comfort letters, which are typically not required in a PIPE or registered direct offering.

Registered Direct Offerings

General Characteristics. A registered direct offering is a public offering of securities (often consisting of a combination of common stock and warrants) directly to a select group of investors pursuant to an effective shelf registration statement. Similar to the marketing process in PIPE transactions, registered direct offerings typically are marketed to one or more accredited investors, usually through a placement agent, and usually sold pursuant to a purchase agreement with each investor.

The execution of a registered direct offering is not subject to risk of delay as a result of SEC review, as might be the case in the traditional public offering context, because securities are offered and sold pursuant to a registration statement that is already effective prior to the initial marketing and announcement of the offering.

Advantages of Registered Direct Offerings from an Issuer's Perspective. As with a PIPE, a key advantage of registered direct offerings is that they are marketed to potential institutional investors before the offering is announced, allowing issuers to test the market without the publicity (and opportunities for arbitrage) associated with traditional public offerings. To address selective disclosure concerns, potential investors are typically required to enter into confidentiality agreements before being provided with full information about the offering. Registered direct offerings are typically announced and priced on the same day, and an issuer can therefore avoid the downward pressure on its stock price that frequently occurs between the time a traditional "road show" is first announced and the date the offering is priced.

Although registered direct offerings resemble PIPE transactions to the extent that they typically are marketed to a select group of accredited or institutional investors and not purchased by an underwriter on a principal basis, the shares sold pursuant to a registered direct offering are registered with the SEC and, therefore, are freely tradeable in the public market upon issuance, subject to limitations generally applicable to "control securities" held by affiliates of the issuer. As a result, shares sold in a registered direct offering are generally priced more favorably to the issuer than securities sold in a PIPE offering, which often must be sold at a greater discount to prevailing market prices.

Additional considerations related to Registered Direct Offerings. An issuer must have a shelf registration statement for a primary offering that is already effective in order to conduct registered direct offerings (though WKSIs can file an automatic shelf registration statement, which is immediately effective, for this purpose). As discussed above, issuers with smaller market capitalization may be restricted in their ability to utilize a universal shelf registration statement due to the SEC "baby-shelf" rule.

Registered direct offerings also typically require a placement agency agreement, and placement agents (who are subject to underwriter liability under federal securities laws because registered direct offerings are considered public offerings of securities) typically conduct due diligence on the issuer, which in some instances may include obtaining comfort letters and engaging in other aspects of the diligence process that are customarily performed in connection with a traditional underwritten public offering, although the extent of the diligence efforts may vary depending upon the nature of the investors and the terms of the transaction.

While registered direct offerings engender the liability exposure of a public offering, they are ordinarily not treated as "public" offerings for purposes of the stock exchange "20 percent rule," because they do not typically involve sufficient public marketing efforts and, accordingly, are subject to stock exchange limitations on private placements.

Confidentially Marketed Public Offerings (CMPOs)

Characteristics. A CMPO is an offering of securities registered on a shelf registration statement, but confidentiality marketed in advance of a formal launch. Much like a registered direct offering, in a CMPO, an underwriter (rather than a placement agent) confidentially markets a potential CMPO to a small number of institutional investors, often without initially disclosing the name of the issuer, until the potential investor provides an indication of its firm interest and agrees not to trade in the issuer's securities until the CMPO is either completed or abandoned. The investor can then be brought "over the wall" to negotiate the terms of the CMPO, after which the offering "flips" from confidential to a public offering, involving a prospectus and other public filings which inform the market of the CMPO. Following the public announcement, a short public offering period usually takes place overnight, which is designed to potentially attract additional investors (including retail investors) into the deal and to demonstrate marketing efforts required for the transaction to be considered a "public" offering within the meaning of applicable stock exchange rules.

Advantages of a CMPO. Because a CMPO is initially marketed on a confidential basis (with the public marketing component only occurring if there is sufficient demand from the investors targeted through the confidential marketing), if, for any reason, the CMPO is abandoned, the market is not typically made aware of that fact, and the issuer is able to mitigate or avoids the associated downward pricing pressure that may be triggered by an abandoned or failed marketed public offering. Additionally, similar to a registered direct offering, because the securities in a CMPO are sold pursuant to an effective registration statement, the securities can be immediately resold by investors and, consequently, may not be subject to as great an illiquidity discount as might be the case in other alternative offering structures. Unlike most registered direct offerings, however, assuming the marketing effort during the brief public offering period is sufficient to satisfy stock exchange requirements for a "public" offering, a CMPO will not be subject to the "20 percent rule."

Additional considerations related to CMPOs. As is the case with registered direct offerings and ATMs (see more on ATMs below), prior to conducting a CMPO, the issuer must have an effective registration statement on file with the SEC. The public offering phase of a CMPO must satisfy the applicable Nasdaq or New York Stock Exchange (NYSE) criteria to qualify as a "public offering." If a CMPO does not qualify as a "public offering," additional exchange rules may be implicated, including the requirement to obtain shareholder approval under the 20 percent rule, as described below in more detail. In addition, an issuer may find the due diligence process to be challenging, because of the often-compressed timelines for CMPOs that may cause the underwriters' due diligence to consist of a barrage of activity in a short period of time.

Conclusion

Regardless of the type of transaction being pursued, even if the securities to be issued are initially unregistered (as would be the case in a PIPE), or if the issuance is not considered by the applicable stock exchange to be a "public offering" (as is typically the case in registered direct offerings), issuers remain subject to general anti-fraud rules, including Rule 10b-5 under the Securities Exchange Act of 1934 and, in the case of a transaction pursuant to a registration statement, are also subject to potential liability under Sections 11 and 12 of the Securities Act, for material misstatements or omissions in connection with the sale of those securities.

Companies conducting capital-raising transactions are also likely to face challenging Regulation FD questions and other issues related to material non-public information (MNPI). The fact that an issuer is contemplating a capital-raising transaction may itself constitute MNPI. Accordingly, an issuer should evaluate and, during the course of any offering, may need to re-evaluate, whether such an offering can be conducted when the company or its corporate insiders are in possession of MNPI, particularly if a blackout period has been imposed. If an issuer plans to disclose any MNPI solely to investors or potential investors in the offering, issuers typically require investors to enter into confidentiality agreements that obligate them to keep any MNPI confidential and not to trade in the issuer's securities until the "cleanse" date — the earlier of the date on which the MNPI has been disclosed to the public (which may be subject to a deadline imposed by the confidentiality agreement) or the date on which the MNPI is no longer material. Ultimately, any MNPI related to an offering and provided to investors during the negotiation would ordinarily be disclosed in a prospectus supplement and/or in a current report on Form 8-K.

As reflected by the robust PIPE activity reported by Private Raise for 2022 and 2023, the equity capital markets remained open to public companies even in a challenging market. ATMs and ELOCs have continued to increase in popularity, providing companies the flexibility to issue a limited number of shares from time to time to a finance provider or into the market when market opportunities arise. Companies looking to raise a larger amount of capital in one offering can consider traditional PIPEs, registered direct offerings and CMPOs.

This article is a summary for general information and discussion only. It is not a full analysis of the matters presented and may not be relied upon as legal advice. Any company exploring or pursuing any of the transactions described above should consider engaging directly with legal counsel.

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1 In 2021, US-listed companies raised over $155 billion in proceeds through their initial public offerings, compared to only $8.6 billion in 2022. In the first quarter of 2023, global IPO volumes fell 8 percent as compared to global IPO volumes in the first quarter of 2022, with proceeds down by 61 percent. "What will it take for the IPO market to return," EY, April 20, 2023

To read the full newsletter, please click here.

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