Daily Deal (New York, NY)
September 19, 2000 Tuesday

The back door

BYLINE: by Stacy Mosher
SECTION: VC
LENGTH: 1869 words
HIGHLIGHT: Equity line financing can be a lifesaver to a drowning company. It also may be a vehicle for a stealthy takeover

It is a story almost as old as money itself. Entrepreneurs start a business, but in a short time it begins to falter.

The owners turn to financiers for capital to stay afloat. Money is provided, but the financiers are concerned about more than altruism or even returns on their loans or investments: They use their leverage to take a major stake in the company, put their own people on the board and eventually push the founders out.

The newest variation on this theme stems from the downturn in technology valuations that has made it hard for many startups to get funding. Known as equity line financing, the technique allows a company to draw down capital in phases by issuing corresponding amounts of shares and warrants to the lender. While the number of actual equity line draw-downs to date has been relatively small, the facility has become more popular in the past six months.

To many struggling startups, equity line financing appears to offer flexibility and control without the immediate dilution of shares associated with a standard private placement or venture capital financing arrangement.

But the client companies are often in less control than they think.

The common assumption is that once a company draws down on an equity line facility, the investing company will quickly sell the shares. Frequently, the reality is different. Investors, under such a scheme, also have the option to hold on to some or all of the shares or sell them to a pre-arranged party. Some finance professionals believe the intention in many cases is to acquire a major stake in the company.

In the case of a standard private placement, the investor has the same wish as the client company for the stock price to go up as soon as possible. But in the case of equity line financing, once the agreement is signed, the investor actually benefits if the share price goes down in the short term, because he will be able to buy into the company at a lower price.

That's leading to worries among finance professionals and regulators alike that share manipulation may be accompanying the use of the device. In the majority of more than 40 transactions The Daily Deal examined, share prices took substantial drops soon after companies signed equity line agreements.

One company that has gone through a variety of changes after signing on for the new financing technique is Tustin, Calif.-based Techniclone Corp., a biotechnology outfit developing cancer-related drugs. In June 1998 Techniclone arranged equity line financing of $20 million with Bahamas-based Tail Wind Fund Ltd. and Resonance Ltd. of the Isle of Man through Swartz Private Equity llc of Roswell, Ga., and its associated company, Swartz Investments llc. A second equity line of $35 million was arranged in November 1999 with the same companies.

The two financing agreements came at crisis points for Techniclone. The company underwent a major restructuring in early 1998, and, over the course of the year, a number of senior executives resigned, including the CEO, CFO and a vice president. In November 1999, another round of resignations was announced, including the new president and CEO, the CFO and two directors.

According to John Bonfiglio, the company's current president, by October 1999, the company had only enough cash left for two months of operation. Bonfiglio said that Eric Swartz, a principal of Swartz Investments and Swartz Private Equity, sent out an open letter stating that he was "highly confident" that he could find money for Techniclone, but in exchange he wanted two directors to resign from the board and the two vacant seats to be given to himself and Carl Johnson, securities counsel for the Swartz affiliate, Dunwoody Brokerage Services Inc.

The resignations and new appointments duly followed, and on Nov. 19 Techniclone signed on for its new equity line with Swartz Private Equity. Techniclone's SEC filings indicate that Swartz was able to gain two seats on the Techniclone board even though no Swartz-related entities held as much as 5% of the company's stock.

But the subsequent road show failed to turn up any new investment for Techniclone. By December 1999, the company's share price had fallen below the level at which it could draw down on the equity line facility and was on the verge of being delisted from the Nasdaq. Swartz and another Techniclone director and major shareholder, Edward Legere II, provided interim funding of $500,000 to keep the company out of bankruptcy court. In return, Techniclone issued 2 million shares of common stock and warrants to purchase up to 2 million shares of common stock at $0.25 per share to Swartz Investments and Legere's Biotechnology Development Ltd.

At the beginning of this year Techniclone's price began to enjoy a major rebound, surging past $16 in March before dropping back to its present level of around $2.50.

At its current share price, Techniclone is in a position to draw on its equity line again to finance clinical trials.

Former president and CEO Larry Bymaster, who resigned when Swartz requested seats on the Techniclone board, has declined to comment. Bonfiglio, who took over after Bymaster left, said the equity line was a positive move.

"Things have turned around quite a bit, and the equity line is part of that," Bonfiglio said. "It's a tad expensive, and I can understand why some other companies don't end up using an equity line . I would prefer using it as a fallback to other types of financing. But if there aren't a lot of other options, it's a way to bring cash in."

Nonetheless, other executives worry that this type of financing too easily can be used as a takeover vehicle. One executive, who is considering an equity line despite the risks he perceives, said, "If you're given the choice between your company closing down through lack of funding or losing control to someone else, what would you do?"

One finance professional, who also requested anonymity, put it more bluntly: "It's a way to take over a company while looking like a nice guy." He said the ideal target for equity line financing is a company that's on the verge of success but has reached a point of financial crisis.

"The investor takes advantage of the company's misery. It's like offering a glass of water to someone in the desert - they're not in a position to refuse. In some cases, after the financing agreement is signed someone starts shorting the stock and sends it into a death spiral. Once that happens, the investor is in a prime position to take over the company and then pump the stock up again," he said.

The same source noted that equity line financing agreements often include a clause forbidding the investor to short or otherwise manipulate the stock. But he said it's easy enough for a third party to short the stock without any obvious connection with the investor.

Michael McAlevey, deputy director of the SEC's corporate finance division, said the SEC has not yet come across cases of clear-cut manipulation of stock with equity line financing. "But it would not surprise me to learn that there is some manipulation going on in connection with these equity lines," he added.

(Three companies that arrange equity line financing - Swartz Private Equity llc, Landenburg Thalman & Co. and Kingsbridge Capital Ltd. - were contacted, but their executives did not return phone calls requesting interviews.)

Uncertainties about equity line financing are accentuated by the difficulty in identifying who some of the ultimate investors are: Many investments are made through offshore companies of opaque ownership. For example, the Tail Wind Fund, the Bahamas-based company that invested in Techniclone, has invested in numerous biotechnology companies, dot-coms and other development-stage companies during the past two years through equity lines and private placements. Other examples include Ireland-based Kingsbridge Capital, Liechtenstein-based Gestrow Investments Ltd. and Monaco-based Lamothe Investing Corp. A large number of overseas equity line investors are represented by the same person - Hans Gassner of a legal firm called Dr. Dr. Batliner & Partners of Liechtenstein.

Not all companies, even once they've entered into equity line agreements, are willing to accept the loss of control. Some, especially those experiencing a sudden drop in share price, have decided not to draw down on the facility. For example, Lexon, a pharmaceuticals company in Tulsa, Okla., that is developing a test for cancer, signed an equity line financing agreement with Swartz Private Equity llc for up to $30 million in May. Under the agreement, Swartz could potentially hold up to 72.8% of Lexon's shares if the facility and its related warrants were fully exercised.

That agreement was drawn up when Lexon was trading around $2.50. Since then, it has dropped to $1. Said Ray Larson, the company's public relations director, the company has been the victim of short sellers. "We won't use the facility at this time because it's not to our advantage," said Larson, explaining that the company would have to give up 60% of its shares to obtain the $5 million it currently needs.

Likewise, Alottafun Inc., a toy manufacturer based in West Bend, Wis., signed an equity line financing agreement in June 1999 with Swartz Private Equity llc but has not drawn down on it because of its low share price and trading volume. "We don't want to get diluted, so in order for both us and Swartz to benefit, we need price and volume," said Michael Porter, Alottafun's CEO.

For at least one company - with sufficient internal controls and fortuitous timing - an equity line financing arrangement worked well. Biomira Inc., a biotechnology company based in Edmonton, Alberta, signed up for a $100 million line with a group of European investors through Paul Revere Capital of New York in August 1999. (The account has since been transferred from Paul Revere to Ladenburg Thalman through a common principal.)

At the time the agreement was signed, Biomira was trading at around $4 on the Nasdaq National Market (the company is also listed on the Toronto Stock Exchange). After the equity line was arranged, the company had a series of positive press releases relating to its anti-cancer vaccine, Theratope, and its share price shot up to more than $20 between January and March, allowing the company to draw down on a third of its equity line under favorable terms before the share price dropped back down to its present levels of around $8 to $10.

"We knew there were events taking place that would strengthen the stock," said CFO Edward Taylor, "so we didn't want an equity issue at a fixed price that would have diluted the shares."

Apart from accurately anticipating its stock movement, Biomira also decided the price below which it was not prepared to sell stock during each trading period, as well as the number of shares it was prepared to sell. This information was kept confidential, protecting Biomira from short sellers. For Taylor, that is one of the most serious hazards in an equity line financing arrangement.

http://www.gcs-group.com/uploads/SampleReport3.doc

Laundering probe hangs over financier

22nd September 2000

www.thedailydeal.com

Funds alleged to have been laundered from illegal political donations in Germany and narcotics trafficking may be finding their way into U.S. companies.

At least that's the concern amid investigations into Herbert Batliner, a financial manager in the European tax haven of Liechtenstein.

The law firm of Dr. Dr. Batliner & Partner represents a significant number of investors who in the past year have signed agreements to provide equity line financing to American companies.

All of these investors are companies of unknown ownership registered in tax havens such as the British Virgin Islands.

Filings with the U.S. Securities and Exchange Commission identify at least 33 equity line agreements in which investing companies are represented by Han Grass, a partner in the firm. The firm has also represented investors in at least five convertible debenture agreements. Most of the investment agreements were signed this year, with a handful arranged in 1999.

Recent events raise questions about some of the funds managed by the Batliner firm. Although few of the U.S. companies that have signed investment agreements through the Liechtenstein firm have actually received any funds to date, the lack of information available on the ultimate investors has raised some concerns.

While Grass and Batliner are largely unknown in the U.S., they have achieved some notoriety in Europe for alleged money laundering of illegal political donations and drug cartel funds.

The firm's head, Herbert Batliner, is a former supreme court judge referred to in the European press as the doyen of financial managers in Liechtenstein. As a tax haven with strong bank secrecy rules, the principality has gained a reputation for maximum discretion in financial affairs. Liechtenstein is one of 35 countries, most of them islands in the Caribbean or Pacific, that the Organization for Economic Cooperation and Development blacklisted in June for failing to cooperate in the fight against money laundering.

Liechtenstein appoints independent investigator

Batliner's clientele includes Germany's Christian Democratic Union. Investigations are under way in Germany into allegations that the CDU employed Batliner's services in hiding illegal slush funds through a network of offshore trusts. Grass, Batliner's partner, has been implicated in the CDU scandal but has publicly denied any involvement.

At the end of last year a leaked report by Germany's secret service accused Liechtenstein of widespread corruption and money laundering. Disturbed by the allegations, the Liechtenstein government appointed an Austrian prosecutor, Kurt Spitzer, to carry out an independent investigation.

Following raids on banks, legal firms and civil service offices, Spitzer presented a report at the end of August that exculpated Liechtenstein as a money laundering center. Spitzer said that most of the funds passing through Liechtenstein for the purpose of being laundered had already been "pre-washed" in other countries, including the United States. Spitzer, however, criticized Liechtenstein's lax record on criminal prosecutions against money laundering and reported incriminating findings against several individuals. Eight people, including judges and senior government officials, have been arrested. Batliner, who was named as a money launderer in the German secret service report, is now being investigated by Liechtenstein authorities. Spitzer said assistance has been requested from American authorities in the Batliner investigation.

According to news wires and the German press, a spokesman for Batliner's firm confirmed that a Liechtenstein court has already initiated preliminary proceedings against him. A spokesman declined to comment further on the case when contacted earlier this week.

Ties to Ecuadorian drug trafficker revealed

Spitzer has not confirmed a report in the Swiss newsmagazine Facts that Batliner is suspected of laundering $17 million for an Ecuadorian drug trafficker, Jorge Hugo Reyes Torres. However, court documents in the U.S. indicate that Batliner has handled funds for Reyes Torres in the past.

Reyes Torres's 14,000-acre hacienda was seized in Ecuador's largest-ever drug raid in June 1992 on allegations that the ranch was financed by sales of cocaine to American users. Reyes Torres and his two brothers were arrested in the raids, and Reyes Torres and his wife were imprisoned. Court records indicate that the Batliner firm withdrew from its representation of the trafficker's accounts immediately after the arrests.

In a lengthy interview with the German weekly Der Spiegel in February, Batliner confirmed that CDU party officials established a foundation in his trust agency in 1982, but denied knowledge that party funds were involved.

Regarding general allegations of money laundering and tax evasion, Batliner said he never accepts cash accounts and that fully 80% of his clients are referred to him by banks. While he did not rule out the possibility of illegal funds passing through his accounts, he laid the responsibility at the feet of banks and attorneys. "We have a special relationship of trust with the major banks," Batliner was quoted as saying. "When they send us clients, we naturally assume that the banks have taken care to ascertain the identities of the persons and the source of their funds.... I'm not a Father Confessor who has to ask his clients if they have obeyed the laws of their homelands."

Batliner also said he was taking legal action against Germany's secret service, claiming that he was defamed by allegations that he laundered Russian mafia funds through accounts in the Cayman Islands.

Many companies unaware of controversy

Court proceedings in Spain determined that the Batliner firm, through Grass, established a trust company called the Levis Foundation in Liechtenstein that received funds illegally funneled from one of Spain's largest banks, Banco Español de Crédito - now a part of Banco Santander Central Hispano - through a Swiss lawyer. Grass was called as a witness during the 27-month trial, the longest in Spain's history, but he declined to appear.

Given the modest coverage of these European scandals in the American press, it's not surprising that the officers of several companies that have signed up for equity lines with companies represented by the Batliner firm said they were unaware of the recent controversies involving the double-doktor. Most of the officers, in fact, were not even aware of the Batliner firm's involvement in their financing arrangements.

Rainer Poertner, the chairman Media X Corp., based in Culver City, Calif., said he found the information about the Batliner investigations "somewhat disturbing." Media X, a broadband and Internet multimedia content producer, signed up for an equity line with the British Virgin Islands company Villabeach Investment Ltd. in April, with Grass representing the Batliner firm as the company's trustee.

Poertner was nevertheless confident that no drug money or other unsavory money was involved in the Media X equity line and was certain that the fund arranging the deal, Triton West Group Inc., had carried out thorough due diligence.

"Typically the fund [Triton] has a number of possible investors, and they choose one as practically the last step of the financing process," Poertner said. "European funds normally do not identify their individual investors." Nevertheless, Poertner said he might make further inquiries about the Villabeach investors in light of recent events surrounding the Batliner firm.

Another company CEO involved in an equity line expressed concern on learning of the Batliner allegations, but declined to go on the record.

Business as usual continues

Barry Siegel, CEO of First Priority Group Ltd. of Plainview, N.Y., said his investment bank, Ladenburg Thalman & Co., told him that his equity line investor, Suerez Enterprises Ltd., involved a group of European investors, including institutions and "very large individual players," but he was not given any names.

Siegel said that before he signed up for his equity line in May, he researched several companies that had dealt with Suerez before and found the deals had gone very well. Siegel was told that Suerez manages $1 billion worth of investments, but it appears that the company maintains a very low profile. The only record found in any corporate or media database was that of the First Priority filing with the Securities and Exchange Commission in relation to the equity line. Although Suerez maintains an office in New York, the company is not listed in the telephone directory.

Likewise, Rose Perri, COO of Toronto-based Generex Biotechnology Corp., said Ladenburg Thalman told her that "a group of investors" was behind the firm Tradersbloom Ltd., which signed an equity line agreement with Generex in August.

Perri said she was not bothered by the lack of information about the identities or even the nationalities of the investors. "Ladenburg has a good reputation," she said

Ladenburg Thalman, which arranged at least 18 equity lines with the Batliner firm, was contacted for comment on the investigations in Europe. Robert Kropp, Ladenburg's head of investment banking, said only, "We're satisfied with our diligence."

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Daily Deal/The Deal
October 4, 2001 Thursday

PIPEs financings draw critical eye on Batliner

BYLINE: by Stacy Mosher
SECTION: PRIVATE EQUITY
LENGTH: 479 words
HIGHLIGHT: New report citing offshore law firm in equity line financings sent to U.S. authorities.

A report calling for an investigation into private investments in public entities, or so-called PIPEs financing, involving an offshore law firm suspected of money laundering has been submitted to the U.S. Senate''s permanent subcommittee on investigations on Capitol Hill.

The equity-line financings examined in the report -- compiled by an anonymous market professional and based in part on investigative reporting by The Daily Deal -- were all provided by trustee companies of a Liechtenstein law firm, Dr. Dr. Batliner & Partner.

Herbert Batliner, head of the Batliner law firm, is the subject of money laundering and tax evasion investigations in Germany and in his native Liechtenstein, which has recently taken measures to clean up its reputation as a money laundering center in Europe.

The ultimate ownership of the Batliner companies investing in PIPEs with U.S. companies is unknown. But Batliner is known to have handled funds for a number of questionable individuals.

Most recently, a federal court in Florida in June granted a request for judicial assistance from authorities in Liechtenstein in relation to an investigation into trust companies the Batliner firm handled for an alleged Ecuadorian drug trafficker, Jorge Hugo Reyes Torres.

The 300-page report was sent to Sen. Carl Levin, D-Mich., chairman of the subcommittee, which has been investigating money laundering in the U.S. financial industry. Copies of the report have also been sent to the U.S. Securities and Exchange Commission, the U.S. attorney general and a variety of other government agencies, including the Federal Bureau of Investigation, the Drug Enforcement Administration and U.S. attorneys in New York and Florida.

The analysis, focusing on equity-line financings and convertible debentures, raises questions about whether private placement financings for small U.S. public companies may have been used for money laundering, tax evasion and stock manipulation to the detriment of the companies involved.

Equity-line financing and certain types of convertible debentures have been tagged "toxic financing" because they offer the potential for stock manipulation to the alleged benefit of the lender. Proponents of equity lines and convertibles, however, maintain that a well-formulated agreement will protect companies from shorting and other manipulation. Properly constructed PIPEs instead allow investing companies to hedge their risk in financially vulnerable companies.

The report identified PIPE financings provided by Batliner-linked companies between 1997 and the beginning of 2001 through SEC filings. The 60 companies identified included 18 receiving convertible debentures and 42 receiving equity lines, sometimes coupled with convertibles.

Calls to the Batliner law firm were not returned by press time.

Daily Deal (New York, NY)
October 7, 2001 Sunday

Sedona challenges PIPE financiers

BYLINE: by Stacy Mosher
SECTION: M AND A
LENGTH: 977 words
HIGHLIGHT: The customer-relations management software provider requested investigations by the U.S. SEC and the National Association of Securities Dealers regarding alleged improprieties in the trading of its stock.

Hundreds of publicly listed small-to-medium-sized companies in the United States have been obliged over the past four years to turn to expensive equity line financing and convertible debentures to keep themselves afloat. Some of those companies, however, have discovered why these financings, known as PIPEs - for private investment in public entities - are also sometimes referred to as "toxic financings."

Sixty companies identified in a report submitted recently to U.S. government authorities were all recipients of so called PIPE fundings via trustee companies of a Liechtenstein law firm, Dr. Dr. Batliner & Partners, and a Monaco- and Panama-based investment fund called Amro International S.A. Many of these companies saw their share prices drop precipitously after the financings were closed. Now, one of the 60 is fighting back.

Customer-relations management software provider Sedona Corp. last week announced it had requested investigations by the U.S. Securities and Exchange Commission and the National Association of Securities Dealers regarding alleged improprieties in the trading of its stock. The King of Prussia, Pa.-based company said that pending such investigations it would not honor requests for conversion of its outstanding convertible debenture.

Sedona Chairman Laurence Osterwise said that unexpected downward trading patterns had early on raised concern and suspicion among company management, and Sedona brought those concerns to the attention of the NASD at the end of last year. After learning recently that a report mentioning Sedona and other companies had been submitted to the authorities, the company felt compelled to take further action.

Indeed, Sedona is not alone. Further research by The Daily Deal suggests that companies identified in the market professional's report performed on average less well than companies that received financings from other investment funds at the same time.

This stock performance was traced on PlacementTracker.com, a popular Web site for PIPE investment operated by DirectPlacement Inc., a subsidiary of PPI Capital Group Inc. Data on the Web site for 149 equity line financings closed between Jan. 1, 2000 and Dec. 31, 2000 show that the 25 companies identified by The Daily Deal which closed financings with Batliner trusts during this period lost an average of 74.58% of their stock price value since that time. In comparison, the average drop in share price for the other 123 companies closing equity lines during this time was only 59.53%. Losses for the periods one month, three months, six months and 12 months after closing on Batliner financings were also higher than the average for those periods.

According to information provided on PlacementTracker, most of the financings for these 60 companies were arranged by Rhino Advisors, a New York hedge fund that is one of the major players in the equity line finance field. Rhino manages two families of private funds, Creon Management and Amro International, whose investors are described as "European high net worth individuals." An SEC filing in April 2000 states of Rhino that "in three years of operation its investment strategies have nearly quadrupled the base capital deposited into Amro and Creon."

Rhino's name seldom appears on any filings in connection with the deals, which is a common practice among hedge funds. But Brian Overstreet, the president of DirectPlacement, said filings patterns established through known Rhino deals suggested that Rhino regularly had set up investment funds through the Batliner firm and a few other overseas firms. Overstreet says his company has repeatedly asked Rhino to confirm or deny the information on the Web site, but Rhino has declined to assist. "A lot of the hedge funds enjoy doing things this way," Overstreet said.

The president of Rhino Advisors, Thomas Badian, confirmed that Rhino had dealt with the Batliner firm in the past. But after becoming aware of The Daily Deal's article last September on investigations being carried out on Batliner in Europe, he said Rhino moved its accounts to another service provider. "We had no way of knowing what was going on over there, but we take our reputation and our investors' reputations very seriously," Badian said.

Among the 60 companies mentioned in the report which were PIPE-financed by Batliner and Amro International, 29 of them also involved Ladenburg Thalmann & Co. Inc., a New York investment bank, according to separate research by The Daily Deal. Available records at the SEC also indicate that Ladenburg arranged PIPEs for public companies very frequently through Batliner and Amro in 1999 and 2000.

The majority shareholder of Ladenburg Thalmann is New Valley Corp., a company controlled by corporate raiders Bennett Lebow and Carl Icahn. Ladenburg's minority shareholder is Berliner Effektengesellschaft AG, a German group that controls the largest market maker on the Berlin Stock Exchange.

SEC filings indicate that Ladenburg first began arranging investments from the Batliner trust companies in late 1999, around the time that Berliner Effektengesellschaft acquired its stake in Ladenburg. Epstein Becker & Green, P.C., a New York law firm, served as escrow agent for 46 Batliner and Amro PIPEs.

Ladenburg Thalmann's current managing director for its Structured Finance Group is Joseph A. Smith, previously a partner with Epstein Becker who was signatory for a large number of the Batliner and Amro PIPEs.

A spokesman for Epstein Becker, Jim Haggerty, said all of the escrow accounts referred to were closed or transferred after Smith left the firm. When first contacted by The Daily Deal, Joseph Smith said that Ladenburg Thalmann "never dealt with the Batliner firm directly."

Later he added that Ladenburg "remains absolutely comfortable with its due diligence."

Daily Deal (New York, NY)
October 19, 2001 Friday

PIPEs move towards the mainstream of finance

BYLINE: by Stacy Mosher
SECTION: PRIVATE EQUITY
LENGTH: 720 words
HIGHLIGHT: As struggling technology companies look for other financing, they may soon discover that more staid private equity players may be offering PIPEs financings.

Struggling technology companies in search of alternative financing may soon discover that more staid private equity players could join the crowd of hedge funds and mid-tier investment banks that now offer expensive PIPEs financings.

At a jam-packed PIPEs (private investments in public equities) conference in New York last week, representatives from GE Capital and UBS Warburg, AG Edwards and Dain Rauscher Wessels were seen rubbing shoulders with the usual PIPEs players such as Promethean Investment Group and Rhino Advisors, Ladenburg Thalman & Co. and Swartz Investments.

The reason, explained keynote speaker James O'Brien, is that PIPEs are coming of age as a respectable investment vehicle. "Virtually every investment bank has been in our office over the last 12 months looking for an education," said O'Brien, founder and managing member of Promethean, one of the larger players in the PIPEs arena. "Even pension funds are borrowing ideas from hedge funds. Convergence is coming."

This is a sea change from as recently as a year ago when short selling associated with PIPEs, in particular convertible debentures and equity lines of finance, tarred companies and financiers alike. Short selling continues to haunt some companies that have turned to PIPEs as secondary financing opportunities dry up. And O'Brien made it clear to the conference attendees that this sort of hedging will remain endemic to the PIPEs marketplace.

"Hedging, or short-selling, is often regarded as a cost to the company when in fact it's a benefit," said O'Brien, who estimates that about 60% of PIPEs investment involves hedging through arbitrage. "As a fund manager, I need a position where the risk outlook is acceptable. If I can reduce the downside, the cost of capital to the issuer will be much lower. If I want to reduce the hedge I'll have to pass on the expense to the issuer."

O'Brien also warned new entrants to expect to learn some hard lessons. "The risks are unlike any other sector apart from possibly venture capital," O'Brien said. "Private equity shops moved into telecom and got their faces ripped off. The venture capital arms of certain large banks want to get into PIPEs now because they see PIPEs as where it's at, and they're right. But some will get their faces ripped off."

One investment banker at the conference, organized by Wall Street Reporter Magazine, argued that the future of PIPEs would improve as soon as healthy companies began choosing PIPEs over secondary offerings.

"When I talk to issuers about PIPEs, the biggest concern is the downward pressure they tend to create on share price," he told the audience from the floor of the conference. "The hedge funds have to take responsibility for that."

"I couldn't disagree more," O'Brien responded. "Why would a healthy company want to come to the

PIPEs market?"

O'Brien was equally straightforward about the dangers of PIPEs financings themselves. "If you don't want a hedge, don't go to the PIPEs market - it's dominated by people who are relying on hedging."

Equity line financings offer particular risks to an issuer, he explained. "Mainly it's a trading vehicle for the investor," he said. "It could be useful, but neither you nor the investor controls it - the market does. You can't build your business around it."

Convertible debentures, too, can be dangerous, he warned. "On the downside, it's debt. If your company is spending money and may not be able to pay it back, stay away from debt. Companies are not always aware of the risk they're taking on," O'Brien noted. "Hedge funds are."

Other speakers at the conference took a different view. Keith Rosenbloom of Commonwealth Associates and Jonathan Silverstein of OrbiMed Advisors llc, made a point of saying they never short their PIPEs investments.

Richard Gormley of SG Cowen added: "We believe many new entrants into the PIPEs market like Fidelity Putnam will make it an appropriate alternative vehicle for other than financings of last resort."

Still, many attendees acknowledged the risk O'Brien spoke about. "There's nothing in this conference that sounds good for issuers," sighed an executive of a public company. Added an asset manager from a tony investment management house: "I wouldn't want our investors to be at this conference!"

Daily Deal (New York, NY)
December 6, 2001 Thursday

New heyday for small public companies

BYLINE: by Stacy Mosher
SECTION: PRIVATE EQUITY
LENGTH: 610 words
HIGHLIGHT: Reverse mergers and PIPEs are drawing investors to both old-economy companies and new-economy companies.

Small and mid-cap public companies that have been holding out their begging bowls are gradually returning to favor, according to executives of investment bankers and private equity firms speaking at a corporate finance conference Dec. 6.

Both old-economy value companies, which fell out of favor during the dot-com rush, and new-economy companies such as biotechnology outfits are attracting investor interest, said the speakers at the New York City conference sponsored by Richard A. Eisner & Co. llp.

For some struggling companies, however, hard choices remain. Keith Rosenbloom, director of merchant banking for New York investment bank Commonwealth Associates, believes that while small companies have options, their greatest problem can be ignorance of the full range of those options and their consequences.

One of the newer investment trends is towards reverse mergers, in which a private company seeking quick access to the public market takes over a public company. In the past, reverse mergers were often carried out between a moribund public shell and a private company in a completely unrelated line of business. The newest twist is for a struggling but operational public company to be taken over by a stronger private company in the same industry.

Mark Simon, managing director and head of the Life Sciences Group of New York investment bank Robertson Stephens Inc., says this is a particularly attractive option in the biotechnology field, where a company that has gone public prematurely may find it advantageous to merge with a private company with similar products in a more advanced stage of development.

"We have four discussions now in progress involving public companies likely to merge with high-quality private companies," Simon said.

The major roadblock to these deals is usually the management of the public company, which may be reluctant to relinquish control of their company under terms that appear an admission of defeat. "It's easier to get deals for companies with a market cap over $500 million, because it's easier for management to leave in glory," Simon said. "For companies with a market cap under $100 million, it's more difficult to convince the CEO, who usually wants to cling to his dream until the cash runs out."

With speed the main advantage of reverse mergers, Simon finds that reluctance on the part of even a single corporate officer can be enough to scuttle a deal.

In the PIPEs market, too, choices can be difficult. The most benign forms of PIPE investment are straight common stock purchases and fixed convertible debentures. Because these are long-term investments, a public company often gives up a certain amount of management control to the investors.

More toxic forms of PIPEs, such as floating convertibles and equity lines, offer many small and struggling public companies a large field of hedge fund investors who typically have no interest in running the company. And under the structure of these deals, if the company's stock price goes up, the company ends up with less dilution of its share base.

The problem comes when the stock is shorted, which is almost inevitable - the result is enormous dilution and possibly even a death spiral into bankruptcy.

Rosenbloom believes almost any alternative is preferable to a toxic PIPE.

"If you're the director of a public company considering a toxic financing, you must truly exhaust all other options. Large liquid companies can do structured financings without any big problems because they're aware of the limitations. But for a small company, the director must really evaluate what the business is worth."