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Alternative Public Offerings

Claire Spencer, February 2010

In the wake of the financial crisis, initial public offerings (IPOs) dwindled away to almost nothing, leaving companies with few options for raising capital, and investors with few options for exits. Alternative public offerings (APOs) were subject to a similar effect, but are on the increase now that the stock markets have begun to unfreeze. Such offerings have several advantages – the cost of a traditional IPO is well into seven figures, making them too expensive for most small-cap companies and many middle market companies as well. Furthermore, an IPO can take in excess of a year to complete, if not longer – and APOs do not have this issue. As such, it is widely held that such offerings will be increasingly popular in 2010.

A safer alternative for an uncertain recovery

Alternative public offerings (APOs) have been around for over a decade in one form or another, but their development has been particularly interesting since the financial crisis broke. Naturally, the effects on global stock markets were felt by the APO market but, since around Q3 2009, APO activity has been on the rise, particularly in China. This has occurred for a number of reasons, the general recovery in the markets being one, the reduction in the number of mid-tier underwriters being another, but also because small-cap initial public offerings are still languishing, which has created a niche among growth companies for alternative offerings. “The general need for APOs remains strong, as more and more business on a global scale expand to meet the needs of emerging domestic markets and global competition. Despite the general belief that the capital markets have dried up, deals continue to be done on a global scale,” agrees Lance Kimmel, the managing partner of SEC Law Firm. “However, what we are seeing is that investors are much more selective about the opportunities in which they are investing, and deal terms have tightened in favour of the investors during this current phase of capital market activity.” As an example, he notes that, in the US, private investment in public equity deals (PIPEs) are still being done, but for investor risk management and other considerations, registered direct offerings have increased significantly.

Indeed, the types of APO that are prominent at the moment have clearly been adapted to the current climate. “For example, a significant number of APOs over the last several years have been consummated by privately-held target companies merging or engaging in other types of business combinations with publicly-held ‘specified purpose acquisition companies’, or SPACs, whose only asset is a trust account with cash,” observes **David Alan Miller, the managing partner of Graubard Miller**. In a SPAC-merger APO, the target and the SPAC would sign an agreement, which would be put to a vote of the SPAC stockholders. The entire process can take less than half the time of a classic IPO, and there is a greater chance that shareholders of the target company can be paid a portion of the merger consideration in cash. If successful, the target company would survive as a wholly-owned subsidiary of the publicly trading holding company. “However, we expect a steep decline in 2010. This is because most of the current SPACs will be required by their charters to either liquidate or consummate transactions by the end of the first quarter of 2010. Accordingly, unless the SPAC IPO market reinvigorates so more SPACs are created, SPAC-merger APOs will become almost nonexistent by the middle of 2010,” he continues. The coming months will determine as to whether this is the case.

Richard Anslow, a managing partner at Anslow & Jaclin LLP, adds that, in China, reverse mergers into a specific type of OTC BB-quoted shell company – known as a Form 10 reverse merger – have been rising in popularity. “It is the same thing as a typical reverse merger, except that the reverse merger is with the operating company and a Form 10 shell, not an OTC BB shell. The merged company then does a direct listing on a senior exchange. Since the Form 10 shell is not a trading shell and has no free trading shares, after the Form 10 reverse merger, an offering is undertaken by the investment bank for the company. An S-1 registration statement is filed and a listing application is commenced. When they are both approved, the company commences its initial trading on a senior exchange and not the OTC BB,” he explains. This variety of APO is appealing to China-base operating companies due to the fact that many typical reverse merger transactions end up stuck on the OTC BB, and never make it to a senior exchange.

Nonetheless, both of these variations conform to the basic structure of an alternative public offering: the reverse merger, which is technically a share exchange from a legal perspective, but a reverse merger from an accounting perspective; and a (ordinarily) simultaneous financing. “In the US, the reverse merger aspect consists of an operating company entering into a share exchange with the public shell company whereby the public shell company becomes the parent company of the operating company, and the operating company becomes the wholly-owned subsidiary. Further, the shareholders of the operating company become the majority shareholders of the public company,” explains Mr Anslow. The subsequent financing can be via equity or debt, but has nearly always takes the form of a PIPE financing, mostly for reasons of speed. This is normally provided by institutional investors, although retail investors are occasionally involved. He adds that, in the US, a so-called ‘super’ 8-K must be filed with the SEC within four days of closing the reverse merger. This is basically a registration statement, and must include most of the information normally required to be included in an S-1 registration statement.

Alternatively, and perhaps more appropriately for times of market volatility, capital can be raised by a registered direct offering. “Here, the registration statement is filed first and after it is declared effective, the funding occurs, so that the investor receives freely trading securities at the closing. Registered directs add to the time before a company will have access to the new capital and that must be factored into the master strategy and budgetary requirements accordingly,” explains Mr Kimmel. Also of importance is the type of shell, as these are numerous. Fully-trading and reporting shells are the most expensive, whereas special purpose manufactured shells, which do not trade until the APO, are the least – the transaction will determine the most appropriate type of shell. Mr Kimmel adds that this is a good time to be looking for a shell, because prices for all types of have fallen dramatically since their height a couple of years ago.

Successful offerings

Like transactions of all kinds, the road to a successful APO begins with thorough due diligence, which should be performed on both the shell company and the operating company. “The shell company is obvious,” asserts Mr Anslow. “If it has a history, you want to make sure that all negative issues are disclosed, and an informed decision based on this due diligence is made. If the shell company has a very bad history that can cause problems for the company in the future, then a new shell company should be used.” He adds that with regards to the operating company, it is generally the case that the principals do not have experience operating a public company. As such, unless they are guided properly, they may not disclose everything that is required for SEC filings. But generally, the process is the same, notes **Mr Miller**. “A company engaging in an APO should take the same steps as a company engaging in an IPO – fly-specking its books and records, making sure everything is in order, ensuring that all informal and oral arrangements are documented by written agreements, etc. From a strategic perspective, a company wanting to ensure a successful APO must be realistic about its valuation. The most successful APOs are a result of target companies agreeing to valuations low enough to attract fundamental, long-term investors,” he says. Mutually agreed and realistic valuations dramatically increase the chances of success.

It is also necessary to have the right legal advice, adds Mr Anslow. “The professionals that are retained should have experience in this specialty practice area. We have had situations where law firms that do not practice in this area apply other concepts to the reverse merger and require things, such as shareholder approval. An audit firm that has not undertaken work on these types of transactions may not understand how to treat the reverse merger – actually a share exchange – as a ‘deemed’ reverse merger,” he explains. Further, when operating in an unfamiliar jurisdiction, local legal advisors should be hired to advise on everything, from laws and regulations to documentation and the hiring of other local experts such as auditors and accountants. Investment bankers should also be well-versed in APOs, as they will be ultimately tasked with selling the deal to the syndicate or book of investors. “Furthermore, while APOs are faster, less expensive, and more certain of successful completion than traditional IPO, they generally have a lower profile, thereby requiring the company to build its own investor awareness to create an orderly liquid market for its securities,” explains Amir Heshmatpour, founder and managing director of AFH Holding & Advisory LLC.

These measures take time, and APO transactions are unlikely to be successful if conducted at speed, even though they are generally much faster than traditional offerings. Clear, frank and regular communication is also vital – this means that expectations on both sides are realistic and achievable. This should continue after the transaction has been completed, with the possibility of an investor relations program to provide after-market support. However, this is not to suggest that APOs are new or unfamiliar. Indeed, regulators in countries such as the US, the UK and Canada are well-accustomed to the process, and can ensure that it moves along efficiently. Of course, from a regulatory standpoint, it is helpful that APOs require less oversight – for example, in the US, approval from the Financial Industry Regulatory Authority (FINRA) is not required.

Ultimately, the biggest risk in the APO process is that the capital may not be available on favourable terms, or at all. This has the potential to cripple the company's business model and its sub-standard operational performance until the capital can be raised and deployed. This is particularly difficult when the company has been saddled with the increased costs of public company reporting. Nonetheless, it is likely that APOs in their current (and indeed future) form will continue to increase, particularly from China, the BRIC nations, and other strongly emerging economies such as Vietnam, Indonesia and certain Eastern European countries. “Investor capital needs to be deployed and redeployed constantly as part of its raison d’être, so fund managers will always be looking for good investments wherever in the world returns can be maximised and risk can be managed,” asserts Mr Kimmel. “Whether the goal of maximising returns on investments leads one to look farther afield from just traditional well-run businesses, focus on tax-advantage industries that can increase the bottom line, or embrace socially relevant innovations and imperatives, smart money will always be looking and ready to act,” he says.

While APOs were hit by the global economic downturn, all signs indicate that their use is on the increase among small and medium-sized companies, and this is likely to continue for the foreseeable future. It is also likely that they will also be of use in emerging nations as means of going public in the US, explains Mr Heshmatpour. “In the new market environment, I expect the APO to be more widely accepted as a viable alternative to traditional IPOs, especially among small to mid-tier companies seeking access to US capital markets and companies from foreign emerging markets that need to establish a Western presence and Western style practices before being positioned to attract more traditional institutional investors,” he confirms. However, **Mr Miller** suggests that now the traditional IPO market has picked up slightly, APOs may begin to decline. “Notably, SPAC-merger APOs will definitely decline dramatically after the first quarter of 2010, unless the SPAC IPO market heats up in the immediate future and more SPACs are quickly created. The first SPAC IPO in over a year was consummated in November 2009, which is a great sign for the SPAC IPO marketplace. If this leads to more of these listings being consummated in early 2010, then the market will pick up again,” he says.

It is hard to say exactly how things will proceed in 2010 and, as more IPOs are performed, there is a chance that the increases seen in the APO market will begin to flatten out. However, the efficiency and general nature of APOs makes them eminently suited to small and medium-cap companies and, further, the structure of APOs can be adapted by need, size and even location. As a result, it is more likely that 2010 will be a successful year for the APO market.