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Registered Direct Offerings

Muazzin Mehrban, April 2010

Many public companies have been on the hunt for viable capital raising methods, after discovering that traditional public offerings and private investment in public equity (PIPE) deals are now less readily available. For the majority of issuers, registered direct offerings (RDOs) can be an effective alternative for raising capital, although not all companies are aware of this. RDOs can provide public companies with a fast track way to raise capital from a select group of investors, thereby avoiding the significant downward pricing pressure that typically accompanies a traditional underwritten offering. At the same time, RDOs provide investors with registered stock that is immediately tradable and far more liquid than a PIPE offering.

Experts point out that RDOs have now become a genuine capital raising alternative. "Activity in the broadly-defined RDO market has remained buoyant in recent months," says Barbara Jones, a shareholder in Greenberg Traurig LLP. "Investors have been looking for immediate liquidity, something that RDOs can more readily offer in comparison to more traditional offerings such as PIPEs. And public company issuers and investments banks have now become more aware of the benefits they provide." The expanding base of issuers has been a direct result of greater acceptance of the product by brokerage firms and corporate treasurers.

Figures published by Dealogic reflect this rise in the number of RDOs. In the US, in terms of deal value, there has been a general upward trend in the value of RDOs registered since 2007, albeit with peaks and troughs along the way. From the second quarter of 2009 up until Q1 2010, the total quarterly value of RDOs remained consistently high, exceeding the $500m mark. This has been a direct consequence of the sheer volume of RDOs, particularly in the third quarter of 2009 when 62 were registered, representing a five-year high.

Of the 10 largest US SEC-registered RDOs of 2009, the top two both came in at $100m. CB Richard Ellis, a commercial real estate adviser, priced its RDO on 10 June, while environmental equipment maker RINO International's took place on 2 December. The RINO deal was agented by investment bank Rodman and Renshaw, which performed the role of agent for three of the 10 biggest deals last year. The remaining major deals were made up of businesses from various backgrounds, including the financial, energy and pharmaceutical sectors.

Experts have documented the extensive advantages RDOs can provide beyond liquidity, including a pricing discount for investors as shares are registered. There are also significant cost and time savings compared to traditional underwritten secondary offerings. "The confidential marketing and short timeline of a well executed RDO also means there is less market risk and potential downward pressure on the issuer's stock price during the marketing of an RDO, as the offer is made to a small target of buyers whom the placement agent believes are well suited for the potential investment. Buyers also agree to maintain confidentiality of the offering, ensuring that privacy related to deal making is maintained," explains John J. Borer III, a senior managing director and head of investment banking at Rodman & Renshaw LLC. Furthermore, the public announcement of an RDO is not made until the transaction is priced, allowing the issuer to determine the level of market interest without having to disclose that it is conducting a public offering.

Crossing the wall

Confidential transactions, known as wall-crossing deals, are something that issuers have become more reliant upon. The recent amplification in the number of wall-crossing deals is mainly the result of financial distress in 2008, when capital markets were closed and market volatility was at a peak. According to experts, deals of this nature began in earnest in the aftermath of the collapse of Lehman Brothers, when several major offerings, all over $250m, were confidentially pre-marketed by issuers. Analysts also assert that such a move is not only aimed at building capital but also reassuring investors that the company will have capital in reserve. RDOs essentially act as vehicles, bringing together entities in need of capital with those that can provide it, in a quick and rather discrete manner. Some within the industry have described this process as a vital way of thinking outside the box in times of distress for capital markets, such as now.

However, Amir Heshmatpour, founder and managing director of AFH Holding & Advisory LLC, explains that since an RDO is conducted in a targeted manner, the offering is not as widely distributed as other public offering issuances and may encounter problems under the relevant securities and exchange rules. "If an issuer anticipates offering and selling a number of shares that exceeds 20 percent of the total shares outstanding, prior to the offering, and if those shares are sold at a discount, the offering may not be considered as a 'public offering' under the rules of the applicable exchange," he asserts. "If the RDO is not considered a 'public offering', the issuer would then need shareholder approval before completing a 'private placement' at a price below the book, or market, value and that may result in the issuance of shares that equal 20 percent or more of the number of total shares outstanding prior to the offering." Unless the latter can be satisfied, an RDO will not be considered a public offering on key markets, such as the Nasdaq and NYSE. But transactions can be "flipped" from confidential placement to a publicly-announced public offering if the market conditions are suitable for a wider distribution.

Experts also point out that small public companies are only allowed to use primary-shelf registration statements to sell, over a period of one year, the number of shares equal to a third of the total shares they are floating. This could considerably limit the amount of money raised in an RDO. Companies have been discussing such offerings largely because of the financial crisis, which caused their stock prices and market capitalizations to slide and made it difficult for them to raise capital.

Not only do RDOs result in more liquid offerings, they also signal to the market that the issuer is capable of raising fresh capital. Ms Jones suggests that, as part of the issuance process, a company must have an effective shelf registration statement (S-3) on file. "Listed companies will get greater attention for this structure because of the interest of the investor in having a liquid security. These structures have been around for many years and more traditionally used by large cap companies. However, with changes to the shelf offering process in 2005, the mid and small cap markets have become comfortable with this financing tool in recent years." The changes mean that almost all public companies can consider undertaking an RDO. However, businesses should bear in mind the limitations regarding the number of shares which can be legally sold this way.

Any company considering an RDO, whether a bought deal or one marketed overnight, must ensure it has filed all its reports in a timely manner. All due diligence and documentation should be prepared well in advance. If a company is in possession of relevant information that has not been disclosed to the market, it will not be able to undertake a material offering until the information has been made public. The company will also need to work in tandem with the stock exchange to ensure that all advance notices have been acknowledged. "In addition, it is important to ensure you have good advisers in the form of counsel and placement agent or underwriter," says Mr Borer. "Maintaining strict confidentiality and proper 'wall crossing' procedures while considering an offering or exploring terms to prevent gun jumping and potential erosion in stock price is also essential," he adds.

Role of the agent

Key to the success of an RDO is the performance of the placement agent. The agent is essentially responsible for managing the placement process, advising on the best approach to market, the most suitable structure for the offering and the timing of its exposure to investors. It is the agent's duty to narrow down the investor audience, ensuring that they are appropriate in terms of the transaction size and time to market. David Alan Miller, the managing partner at Graubard Miller, points out that unlike underwriters, placement agents do not actually purchase any of the issuer's shares and act more as intermediaries. However, agents still have underwriter liability. "Accordingly, agents must do the same due diligence they would do in connection with a typical underwritten offering. This also means that the placement agreement the issuer must execute will look very much like an underwriting agreement and contain the typical reps, warranties and covenants found in an underwriting agreement," he says. "The placement agreement would also require the issuer to provide legal opinions including negative assurance, and cold comfort letters from the auditors at the closing of the RDO." In addition, the placement agent will also be able to advise issuers after the placement has occurred, on matters such as post deal communication and road shows. However, it should be noted that a placement agent cannot engage in market stabilising activity and can only be involved in passive market making transactions.

The majority of experts concur that due to the strong advantages RDOs hold over traditional PIPEs, they should play an increasing role throughout 2010. The market may see more transactions with long-terms warrants, particularly with micro and nano-cap companies. "With fewer active PIPE funds, continuing concerns over illiquidity and depressed stock prices, many companies and investors alike will find RDOs the best and most viable financing option. Moreover, given the speed to market and lower costs as compared to other financing alternatives, there is a higher likelihood for an issuer of a successfully completed transaction," says Mr Heshmatpour. Furthermore, given the sheer volume of companies making use of the expanded S-3 eligibility, the number of potential registered direct issuers will continue growing. While senior debt and high-yield markets remain unreliable sources of capital for many mid- and small-cap companies, registered direct transactions are likely to be utilised more often as an effective corporate finance tool.