

PIPEs: Private Equity Investments in Distressed Firms

Direct investment in the equity of distressed companies by private equity investors is a relatively recent phenomenon dating to the mid-1990s. Prior to this, private equity investments in distressed firms (sometimes referred to as vulture capital) usually resulted from purchasing the debt instruments of failing companies or the assets of bankrupt companies. The growth in direct investment has been fueled by the number of publicly traded firms in need of additional funds. The pre-mature public offerings of these firms, coupled with poor financial performance has created a new category of distressed investing called PIPEs (private investment in public entities).¹ Companies turn to PIPEs because their managers believe the financing provided by private equity or vulture investors will allow the company to first survive and then perhaps to prosper. This funding is expected to create value for the firm's existing investors and offer them a better return than would be possible in the absence of PIPE financing.

PIPE investments differ from traditional private equity investments in several ways. First, PIPE investors do not actively manage the troubled company to formulate a turnaround. Second, PIPE investors attempt to get out of their investments relatively quickly—they do not wish to be long term or controlling shareholders in the firm. Third, compared to the traditionally ill-liquid nature of venture investments, because these investments are made by firms with publicly traded equity, PIPE investments have immediate liquidity. They can also provide investors with a means to short sell the shares acquired through a PIPE and hedge some of their risk. As such, it is an open question to what extent PIPEs truly help a troubled company. One view is they may just transfer the residual value of a troubled company from existing shareholders to new investors. Another view is that PIPEs provide much needed liquidity, albeit at high cost, to firms that would otherwise fail.

PIPEs are public securities that are sold to private investors on a negotiated basis. PlacementTracker.com, the leading repository for information and prices on PIPEs, classifies PIPEs into traditional and structured PIPEs.² PIPEs include: Common Stock PIPEs, Floating Rate Convertible Preferred Stock, Convertible Resets, Common Stock Resets, and Structured

¹ Not all PIPEs involve distressed securities. Some involve small issues of equity or convertibles that are considered too small for the public markets and small offers to growing firms.

² PlacementTracker.com compiles PIPEs from SEC Regulation D offerings. Reg D offerings allow public firms to sell shares privately to a limited number of accredited investors without formal registration of the offers.

Equity Lines. As described further later, the main distinction between traditional and structured PIPEs is that structured PIPEs offer investors downside protection against declines in the issuer's stock price following completion of the deal. In contrast to private placements of equity which typically include only discounts and warrants, PIPEs can be negotiated to include additional terms, such as caps, floors, mandatory redemption provisions, and trading restrictions. Therefore, although PIPEs are either common stock or securities that will eventually convert into common stock, these customized terms allow investors to significantly alter their exposure to changes in the underlying value of a company's equity.

Between the years 1995 and 2000, a total of 1,062 firms issued 2,158 PIPEs – with some firms making as many as ten PIPE offerings (See **Exhibit 1**). The overall amount of PIPE financing has grown from less than a billion dollars in 1995 to \$12.7 billion in 2000. As testimony to the increasing importance of this market, PIPEs grew from two percent in 1995 to eight percent in 2000 of the capital raised through seasoned equity offerings. Of the five types of PIPEs, Common Stock PIPEs and Floating Rate Convertibles are the most frequently issued, with each respectively, providing 66.6 percent and 22.7 percent of the total funds raised through PIPEs over 1995 - 2000.

There are important distinctions among PIPE securities that affect the exposure an investor faces with respect to an issuer's future performance. PIPEs can be constructed such that they limit investors' downside exposure, while offering them an ability to benefit from strong post-issue stock performance. Alternatively, PIPEs can provide little downside protection but include features such as warrants that can enhance investors' upside potential in the event of strong post-issue stock performance. It all depends on what "bet" investors want to place with respect to the future of the firm.

Price Protected PIPEs

Of the five types of PIPEs, Floating Rate Convertible Preferred Stock (FRC), Convertible Resets (CVR), and Common Stock Resets (CSR) offer significant downside protection to investors. The familiar fixed rate convertible typically has a single conversion price, at a premium to the current market price of the common stock, which is maintained throughout the term of the contract. Relative to fixed rate convertibles, the conversion price (or rate) on floating rate convertibles changes on a daily basis in accordance with movements in the issuer's stock price. Because of this feature, some have argued that floating rate convertibles are an ideal form of financing for high risk and high asymmetric information firms.³ Relative to floating convertibles, resets allow for a discrete number of changes of the conversion price at specified intervals (e.g., six months, or two years from closing). Prior to the reset points, the security is convertible only at the last fixed conversion price. The most important distinction between PIPEs and the conventional floating convertible concerns the conversion price – in the majority of PIPEs it *can only be adjusted downward*.⁴

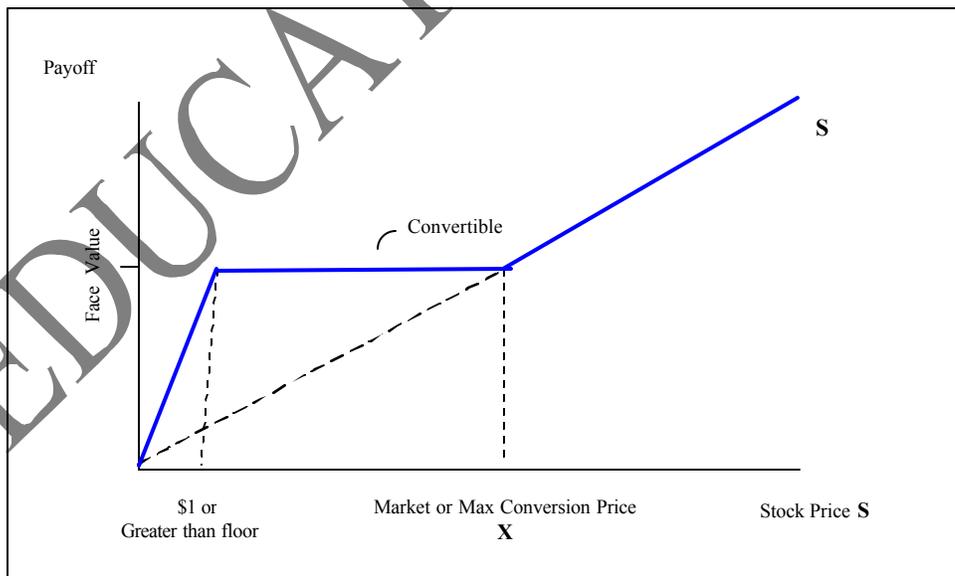
³ If management believes that the firm's equity is currently undervalued and possesses positive information that will eventually lead to a higher price, floating rate convertibles in effect allow shares to be issued at a higher price after the good news is revealed.

⁴ In some instances, PIPEs will allow for the conversion price to be set at a 10-15 percent premium over the

A structured PIPE transaction in a distressed firm typically involves a senior obligation with a conversion feature, either convertible debt or convertible preferred stock. The instrument will have priority in repayment over existing shareholders in bankruptcy or reorganization. Typically, the instrument requires regular payment of interest or preferred dividends, in cash or “in kind” (additional shares), to guarantee investors’ a return, barring default by the company.

While a number of variations to the basic contract exist, in a typical structured PIPE an investor purchases an amount (\$50 million) in newly issued convertible preferred stock from a company for a certain number of shares (5,000) at stated par value per share (\$10,000). A PIPE will call for some amount, say \$2 million, of preferred stock to be converted into common stock on a fairly rapid schedule (monthly) at a price equal to the issuer’s current stock price at the time, less a discount. Prior to the anticipated conversion, the issuer will register \$2 million in common stock with the appropriate regulatory bodies (or file a shelf registration for the entire \$50 million) for later distribution in shares to the PIPE investor. Thus, the shares that a PIPE investor receives upon conversion will be marketable. If the stock price of the issuer falls, the PIPE investor receives more shares for the \$2 million of principal converted. If the stock price of the issuer rises, conversion takes place at the originally agreed upon contract price. Therefore, issuers generally do not benefit from positive price appreciation following PIPE issuance. However, should the issuer’s stock price drops below some minimum price (floor), investors often have the right to speed up conversion of the remaining unconverted principal value without regard to the original schedule.

The basic features of floating rate and reset convertibles are depicted in the diagram.



current price but unlimited upsides are rarely observed.

A floating rate or convertible reset can be viewed as being long stock (S) at the price at which the PIPE was issued, assuming this is the maximum conversion price of the security, and long a put option at this price.⁵ The put option feature derives from the fact that the number of shares that investors receive upon conversion, increases as the value of the company's underlying stock decreases. Therefore, the number of shares increases to offset declines in price, preserving the original value of the investor's principal. However, as the stock price approaches zero, the protection offered by this put option ceases. At that point, no amount of shares can maintain the investor's original principal (i.e., "a million times zero is still zero.") Further, because PIPE investors rely on the market rather than the firm to redeem the shares for cash, at prices below \$1 per share delisting of the shares poses a major risk. This is depicted on the diagram as being short a put at \$1 per share.

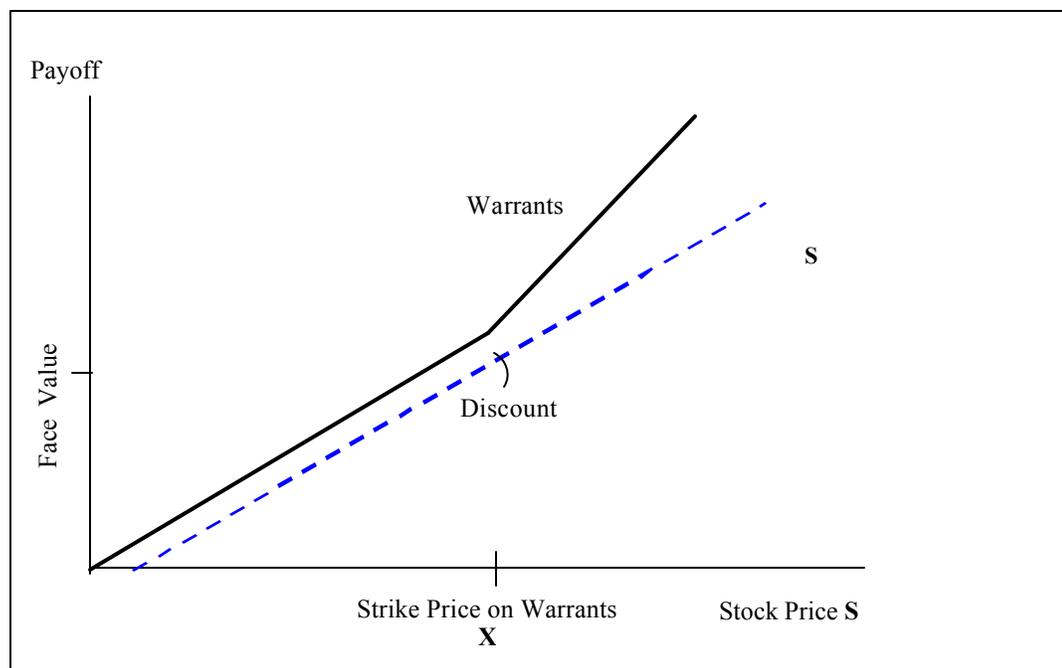
A common stock reset (CSR) is similar to the floating rate and convertible resets in its payoffs. The common stock reset allows investors to buy common stock at a set price less a discount. The reset, which can occur once or several times over the contract term, adjusts the purchase price downward in the event an issuer's stock declines following issuance. Most CSR, however, allow for the reset to occur only once within a relatively short time, 30 – 60 days, after closing. Thus, the main difference between CSR and floating rate convertibles and resets is that the period of price protection is of shorter duration.

Unprotected PIPEs

Common Stock PIPEs (CS) do not provide downside protection but often offer investors enhanced upside potential. CS enable investors to purchase the company's stock at a discount to the current market price. In addition to a discount, CS investors usually receive warrants to purchase the company's stock at a price generally at or above the current market price of the stock.

The basic features of a common stock PIPE with warrants are depicted in the diagram below.

⁵ Conceptually, one can also view the FRC as Long a "Bond" plus a call option at the conversion price. The "Bond" serves to provide investors with downside protection. But I prefer to view it as S + P, because most FRCs are convertible preferred stock and therefore investors hold equity positions in the firm.



Structured Equity Lines (SEL) are similar to Common Stock PIPEs. An investor in a SEL agrees to purchase a given dollar amount of the company's common stock within a given time period. The company selects when during this period that it will sell shares to the investor through a draw down or put notice. Like CS, SEL investors purchase the stock at a discount to the then current market price and often receive warrants. Because the shares are issued over time, investors pay less for the shares if the price declines.⁶ Therefore the payoff diagram to a SEL looks similar to a CS. The main difference between them is that the firm receives all of the funds upfront with a CS PIPE and in potentially several installments with a SEL.

Because of the high risk associated with investing in distressed companies, PIPE investors use a variety of structures and hedging techniques to reduce their risk and to lock in attractive returns. For example, if the terms of the contract permit it *and* the shares are available to borrow, PIPE investors will sell short the shares of the PIPE issuer.⁷ Since the PIPE investors' contract promises delivery of the shares, they do not fear short covering should the issuer's stock price unexpectedly increase. And they profit on the short position if the price decreases. PIPE investors typically seek stable returns of 20 percent over a time frame of 18 to 24 months. The lower but stable returns in a short time frame leads investors to approach their investments from a technical viewpoint rather than from a long-term value perspective.

⁶ In this sense, one can view SELs as offering investors downside protection against price decreases after the closing of the deal. However, the same downside protection can be achieved by issuing a series of CS PIPEs over the same horizon.

⁷ Although PIPE investors can alter the payoffs from these securities by shorting the underlying common stock, the shares of companies issuing PIPEs are usually "on special" - very difficult to borrow.

eToys: A Structured PIPE Investment

On June 12, 2000, eToys, Inc. entered into a floating rate convertible investment with Promethean Asset Management. In this transaction, Promethean was the lead investor, along with Citadel Investment Group and Angelo, Gordon & Co, that together purchased a \$100 million in newly issued convertible preferred stock from eToys.

Although eToys was a public company, at the time it was unable to sell new common stock to the public on favorable terms. Founded in 1996, eToys had gone public in May 1999 at \$20.00 a share. Subsequently, its stock rose to a high of \$84.50 a share before falling to \$6.00 a share in June 2000. New debt was also unavailable. The company had \$170 million in existing debt but less than \$60 million in tangible non-current assets. Most of that debt had been raised six months earlier, in December 1999, when eToys had issued \$150 million of five-year, 6.25 percent convertible bonds underwritten by Goldman Sachs. The bonds, which had been sold at 100 percent of par then, were trading at 38 percent of par in June 2000. The company experienced net operating losses in the first quarter of 2000, and it needed more cash to take advantage of the upcoming Christmas season to reach critical breakeven sales.

The investors purchased 10,000 shares of the convertible preferred at \$10,000 stated value per share. The shares were to be redeemed by eToys in three years unless converted or redeemed earlier. They carried an annual dividend of 7 percent payable in cash or stock semiannually for the first year and quarterly thereafter. Half the company's new preferred stock had to be converted into common *by* December 31, 2000 (six months after the offering). The balance could be converted without restrictions at anytime *after* January 30, 2001. The balance of the preferred stock, however, *could* be converted into common *before* the January 30, 2001, date *if* the common-stock price fell below \$3.00 per share for 15 consecutive trading days or fell below \$2.30 per share for any three consecutive trading days.

These provisions attempted to ensure that the investors would receive half of their money back within six months if eToy's stock performance held stable, and more than that, if the stock fell below the floor of \$3.00 per share. The number of common shares investors would receive upon conversion of the preferred stock was determined by a formula that tied the conversion price to the current price but built in a growing discount. The company could also redeem the preferred stock at any time by paying the stated value plus accrued dividends multiplied by a percentage that began at 101 percent as of July 1, 2000 (the time of the investment), and increased by 1 percent per month. The rising redemption rate ensured that unless the company's performance improved considerably, the firm would be unable to remove the investors' claims over the term of the PIPE arrangement. One observes from these highly customized terms the lengths investors go to protect their returns.

The investors also received warrants to purchase a total of 4,907,574 shares of common stock at an exercise price of \$7.17. The terms of the warrants included a potential reset of the exercise price in June 2001 based on the average stock price at that time. To prevent the investors from putting additional short-term pressure on the stock price, the agreement limited the investors' short selling of eToys' stock only to the extent of the shares they received through conversion.

At the time of the investment, eToys had approximately 120 million shares of common stock outstanding and a stock price of \$6.58. If the preferred shares were converted in a reasonable range around this price, it was anticipated that the investors would own between 4 percent and 13 percent of the company. According to eToys' chief financial officer, this was less dilution than if the company had issued common stock at the current market price. The CFO estimated eToys would have had to sell 16.7 million shares of common to raise \$100 million, assuming market conditions permitted.

Under the terms of the agreement, the rapid conversion of the preferred stock and the ability to sell the resulting common stock in the market gave the vulture funds the possibility of a high return from the quick turnaround of their money. The existing shareholders accepted this dilution in return for the infusion of needed cash. The day the investment closed, eToys filed a shelf registration statement with the SEC covering the expected common shares to be converted over time. This action gave the new investors the ability to rapidly unload their common shares.

By early November 2000, the investors had already recovered about \$40 million of their original \$100 million investment by converting about 40 percent of their preferred shares into approximately 10 million shares of common stock and selling them. This activity increased the number of common shares outstanding to 132.3 million as of November 3, 2000. If the remaining 6,000 preferred shares were converted at eToys' then current price of \$1.81, the investors would have received an additional 30 million common shares. The investors had the right in early November to seek conversion of all their shares, but agreed to defer conversion of some until December 31, 2000, to avoid pushing the stock price down further. While the investors refrained from selling all of their remaining shares, they did convert and sell another portion of the preferred stock. By end of November 2000, they had recovered approximately \$70 million of their original \$100 million investment and had sold over 27 million shares ? substantially more than the 16.7 million shares of common stock the CFO had been pleased to avoid selling. EToys filed for bankruptcy in early 2001. What is not clear is what role, if any, the PIPE played in eToys' demise.

The Future of PIPE Investing

The outlook for PIPE and vulture investing looks especially promising in the near term for investors. The U.S. enjoyed the longest peacetime expansion in history in the 1990s, but that expansion came to an abrupt end in 2000. In 2000, the number of public companies filing for bankruptcy reached a record fifteen-year high. This development suggests an opportunity-rich environment for PIPE investors. However, whether these arrangements work equally well to further the interests of public shareholders in the firms issuing PIPEs remains to be seen.

Exhibit 1

Private Placements of Public Equity and Seasoned Equity Offerings 1995 – 2000

The sample includes all security offerings that are identified by *Placementtracker* as a private placement of public equity (PIPE) and that have *CRSP* data available. The data on seasoned equity offerings are from *Security Data Corporation*. The amount raised is in millions of dollars.

<u>Type of Issue</u>		<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
Floating Rate Convertibles	No. of issues	30	149	233	194	116	90
	Amount Raised	\$232.4	\$1,307.0	\$1,822.5	\$1,059.3	\$869.4	\$794.7
Common Stock Resets	No. of issues	5	2	6	13	21	34
	Amount Raised	\$28.3	\$7.4	\$24.2	\$75.0	\$145.1	\$338.1
Convertible Resets	No. of issues	3	10	9	10	17	41
	Amount Raised	\$14.2	\$186.2	\$145.8	\$107.0	\$175.1	\$1,125.8
Structured Equity Lines	No. of issues	0	1	10	12	10	69
	Amount Raised	\$0.0	\$7.5	\$41.3	\$28.2	\$46.1	\$368.6
Common Stock Pipes	No. of issues	58	99	119	127	284	386
	Amount Raised	\$624.3	\$1,425.9	\$1,545.3	\$1,007.5	\$3,238.1	\$10,040.2
Seasoned Offerings	No. of issues	467	548	502	362	371	344
	Amount Raised	\$38,518	\$45,175	\$47,620	\$45,363	\$72,076	\$86,775

Source: S. Chaplinsky and D. Haushalter, "Financing under Extreme Uncertainty: Evidence from PIPEs," University of Virginia, Darden School working paper, 2003.