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CAPITAL MARKETS
PRIVATE INVESTMENTS IN PUBLIC EQUITIES

PIPEs unblocked, finally?

Baker McKenzie lawyers expect a resurgence of transactions involving private investments in public equities or PIPEs as they are commonly known

The effects of the coronavirus pandemic have been sudden and marked. Companies globally have been faced with an unprecedented decline in demand, supply chains have been disrupted, businesses shuttered, and workforces quarantined and/or furloughed. Across the board, companies have reacted quickly and taken steps to reduce overheads – many drawing down on their revolvers or putting in place new working capital facilities as they mobilise to preserve cash. A number of listed companies in the UK have tapped the equity markets, notably SSP, Autotrader, Hays and WHSmith and, inevitably, many more will follow. Based on the data for some of these recent issuances, companies' existing shareholders have largely been the first port of call and have stood their corners – but there will be other demand out there and now is likely to be the time for a resurgence of private investment in public equities, or PIPEs as they are commonly known.

PIPEs have traditionally not been a common feature of the UK market – principally due to the importance the UK investor community attaches to pre-emption rights – and the regulatory and customary restrictions that have been placed on listed companies, preventing the hasty issuance of shares for cash in a manner that would excessively dilute existing shareholders. Another historical reason has been limited interest from private equity investors because of the investment restrictions set out in their fund terms, i.e. restrictions that prevent the fund from making sizeable acquisitions of shares of listed companies, as well as concerns expressed about the means and timing of any exit from the investment. There have, however, been some notable PIPEs in the UK, including the investment by Warburg Pincus in Premier Foods and, more recently, the investment into Aston Martin by the Lawrence Stoll-led consortium.

While listed companies may have a range of options available for consideration, the current economic backdrop could lend itself well to companies and investors seriously considering PIPEs. A number of factors support this: record levels of dry powder globally are waiting to be deployed; traditional debt markets are facing material disruption

1 MINUTE READ

These are extraordinary times and listed companies are going to need more funding, from one source or another. In addition to drawing down on existing facilities, putting in place new debt, rights issues, open offers and cash placings, we expect to see more variation in the coming months. This will likely mean, alongside the usual secondary capital raising structures, that we start to see more PIPEs, or privately negotiated transactions in which an investor or group of investors makes a direct investment into a company whose shares are publicly listed on a stock exchange.

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as both borrowers and lenders face mounting financial pressure, which may adversely impact the availability of debt for leveraged acquisitions; valuations of listed companies are currently at a historic low point for companies in many sectors; and finally, in the UK, there are signs that the tough stance institutional investors have taken with respect to pre-emption rights (and the vocalised desire for issuers to respect these) may soften.

So what are PIPEs?

PIPEs are privately negotiated transactions in which an investor or group of investors makes a direct investment into a company whose shares are publicly listed on a stock exchange. The investment usually comprises ordinary shares, preferred shares, convertible debt, warrants, or a mixture of these. The shares are generally offered at a discount to the prevailing share price of the company. PIPEs can frequently be done in short order as they are often structured in a way that avoids the need for shareholder approval or a prospectus. The advantages for a PIPE investor are that it can acquire a significant stake in a listed company – often at a healthy discount and without having to pay a control premium – and the fact that the company is already listed means that, in principle, there is already a liquid market into which the investor can sell its shares when it wishes to exit (at least, once the lock-up expires). In the US, preferred stock or convertible instruments usually contain a liquidation preference, making them less risky than common stock. Generally speaking, PIPE investors have been hedge funds, private equity firms, sovereign wealth funds or family offices, or other private capital investor groups. On the flip side, however, a PIPE investor generally will receive more limited control rights and protections than a financial investor would typically receive in a private, unlisted company scenario, and concerns have been expressed that minority investments in listed companies are somewhat counterintuitive to many limited partners, who can get access to listed company investments through mutual funds without paying the higher relative fees associated with private equity funds.

Key issues

No shareholder approval should be needed for a PIPE investment if the existing shareholder authorities are sufficient, provided the investor is not a related party of an issuer with a premium listing. Most listed companies have shareholder authorities for cash issuances on a non-pre-emptive basis for a maximum of 10% of the issued share capital each year (and the temporary relaxation by the Pre-Emption Group to 20% will have come too late for most firms). If existing shareholder authorities are insufficient, then a special resolution requiring 75% of the votes cast will be required in order to disapply statutory pre-emption rights.

A cashbox structure, to which pre-emption rights will not apply, may also be used. In such a structure, the investor(s) pay(s) cash to a new SPV cashbox company, usually incorporated in Jersey, and the shares in the SPV cashbox company are transferred to the issuer, which then issues new shares in itself to the investor(s) in consideration for the transfer of the shares in the SPV cashbox company to it, and thereby the new shares are technically issued for non-cash consideration. The issuer then owns the SPV cashbox company and so has access to the cash.

The Listing Rules restrict issuances at a discount of more than 10% other than with shareholder approval. We may see a relaxation of this requirement from the FCA – which has been lobbying in support of the measure – in the coming weeks. The Pre-emption Group's statement of principles also limits any discount to the market price to five percent.

No prospectus is required for an issuance of shares provided the issuance (when aggregated with other issues in the previous 12 months) represents less than 20% of the issued share capital. A prospectus will be required if the issuance represents 20% or more of the issued share capital looking back 12 months.

Rule 9 of the City Code on Takeovers and Mergers may be relevant, if the PIPE investor would become interested in shares carrying 30% or more of the voting rights of the company as a result of the transaction. The UK's Takeover Panel may grant a dispensation from this obligation if the investor/issuer seeks a whitewash. This will, among other things, require a vote by independent shareholders and would, if granted, permit the PIPE investor to pass through 30% as a result of the issuance without making a general offer. The PIPE investor will, however, then be restricted from acquiring further shares. To obtain such dispensation from the panel, the investor must not have acquired shares in the 12 months leading up to the proposed investment.

No shareholder aproval should be needed for a PIPE investment if the existing shareholder authorities are sufficient

While an issuer might share some limited due diligence materials with a prospective investor, as a general rule, the issuer must not share inside information with a potential PIPE investor as part of due diligence in preparation for a PIPE. However, the investor's knowledge of its own potential investment will not constitute inside information for these purposes. Potential investors with whom discussions are being conducted will be wall-crossed and prohibited from trading in the issuer's securities under the Market Abuse Regulation until the proposed PIPE and any other related inside information is announced and/or the relevant potential transactions are categorically abandoned. Additional Takeover Code obligations are engaged if the PIPE relates to a stake in excess of 30% (such as Rule 20.2 relating to equality of information).

Practice varies, but it is not uncommon for a shareholder (including a PIPE investor) to

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seek board representation if its holding reaches 15% or more. Issuers would generally require such a right to fall away if the holding were to drop to below 10-15%. Anti-dilution rights, veto-rights and rights to information are commonly requested by PIPE investors but are not common in the UK and are generally resisted by issuers. There may be more flexibility for investors if the instrument subscribed comprises convertible debt.

It would be typical for the issuer to insist that the PIPE investor be locked-up for a period of six to 12 months (i.e. be prohibited from selling any shares or derivatives linked to its shares, other than in certain limited scenarios, such as if a third party were to make a takeover offer). The issuer may also seek a standstill from the PIPE investor, i.e. an undertaking not to buy further shares in the market or launch a takeover offer (or take any steps that would trigger a mandatory bid obligation) for an agreed period of time after making the PIPE investment, whether absolutely or at a price lower than the price at which the PIPE investment was made – again, subject to limited exceptions, such as if a third party were to make a takeover offer.

Third party financing may be available to investors to add leverage to PIPEs. Depending on the structure, options may include financing which is backed by the underlying investment (e.g. a margin loan over shares) or financing which benefits from credit support from the PIPE investor itself (e.g. a fund finance facility).

If a PIPE investor were to acquire a shareholding in excess of 30% in a company listed on the Main Market, then it would become a controlling shareholder of the company, and the Listing Rules would also require the company to insist on the investor entering into a relationship agreement aimed at ensuring that the company can operate independently of the investor.

Obstacles to PIPEs

The biggest obstacle historically in the UK for companies has been the market reaction to issuances on a non-pre-emptive basis. This can be mitigated by either (a) obtaining a specific shareholder approval for the proposed investment; or (b) ensuring that key shareholders are consulted in advance of announcement (on a wall-crossed basis) and are supportive. Combining a PIPE investment with an institutional placing may assist in garnering support. Given the relaxation of the Pre-emption Group's position on this in the current economic climate, this concern – while remaining a valid one – will need to be weighed against the relative benefits of a fast cash injection into companies in need of liquidity.

Where the issuer is in a regulated industry (such as banking or insurance) there may be a need to obtain a change of controller approval. Antitrust will be a consideration in rare circumstances but should not be ignored – particularly where the stake is a significant one. In addition, the UK government has indicated that it will for the first time introduce a standalone foreign investment screening regime in the UK. However at the time of writing, it is not known when such a regime will be introduced or whether the UK government will, as a number of European countries have done, announce emergency measures to protect domestic companies that are vulnerable to opportunistic foreign takeovers.

For any investor, there will remain some uncertainty over how the investor will ultimately exit, as the larger the stake the larger the overhang – the downward pressure on a company's share price caused by the market's anticipation of an exit. This should, however, be manageable in just the same way that private equity investors sell down following the expiry of lock-ups after an initial public offering.

Following the global financial crisis, there was a notable uptick in the number of PIPEs in the US in particular, but in other countries too, such as Hong Kong SAR. Recent deal announcements portend that a surge in the number of PIPE transactions in the US will occur once again. With the demand for liquidity from UK listed companies only set to increase – particularly for the hardest hit industry sectors – and against a backdrop of implicit encouragement from bodies representing UK institutional shareholders to support UK companies' capital needs, we expect that PIPE transactions will become another useful source of financing for UK listed companies.

Nick Bryans
Partner
Baker McKenzie, London
nick.bryans@bakermckenzie.com

James Thompson
Partner
Baker McKenzie, London
james.thompson@bakermckenzie.com