

## PIPEs – Will They Take Off in Europe?

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Private-investments-in-public-equity, or PIPEs, have been a relatively common feature in the U.S. public markets for many years. Despite much speculation, PIPEs have failed to make a significant impact in European markets. As the global economy starts to recover (or, at least, to contemplate recovering) from one of the worst financial crises ever suffered, the question is again being asked as to whether PIPEs will finally become a commonly used tool in the European investment professional's toolkit?

### *What Exactly Is a PIPE?*

The original PIPE structures involved the use of convertible securities – shares or bonds – in publicly listed companies which were taken up by private equity investors. Today, the phrase is used to cover almost any investment by private equity or private equity-style investors in public companies.

As investment professionals have become more sophisticated, so too have the investment structures. One of the common themes which is seen in PIPE transactions is an attempt by the investor to replicate in the public company the influence which it would be able to have if the company were privately owned. The first PIPE structures, which are still common in the U.S., involved convertible bonds or convertible preference stock where the holder had approval rights over certain decisions of the company or to be given input into matters such as the company's business planning (for example, through a right to appoint a director or to see early drafts of a business plan).

### *Why Use a PIPE?*

Many private equity professionals view public-listed companies as investment opportunities, perceiving them to be under-valued by the public markets and capable of producing significantly better returns in an unlisted environment. The perception, at least, is that public market investors have a much shorter investment return period of some 12 to 18 months, as opposed to the 3 to 5 year targets of most private equity investors. The theory dictates that investment and a focus on capital growth over a 3 to 5 year period is more achievable in the private environment, without the pressure of public market investors seeking consistent income streams (from dividend payments) and capital growth over the shorter 12 to 18 month timeframe.

However, a number of mainly public market investors have been quoted as saying that whenever they see a private equity investor offering to buy a public company, they believe that they are leaving value behind or they "know" that they are "leaving money on the table." Whilst the public markets may not reflect private equity valuations of listed companies, the investors in such companies recognise the higher valuations which can be obtained by private equity backed companies.

In order to try and address these issues, a number of techniques, including PIPEs, have evolved to allow public market investors to receive the value which they perceive to be in a company whilst encouraging private equity investors to invest and bring private equity techniques and strategies to the business.

### *PIPE Structures*

The basic premise behind a PIPE is that a private equity investor invests in a public listed company through injecting new money. Existing investors are generally not bought out, and instead suffer some dilution of their earnings and ownership of the company. They retain their investment and are able to participate in the future growth and performance of the company. The private equity investor will typically receive a minimum fixed return (such as an interest payment or preferred dividend) and have approval and information rights in respect of the company.

There are a wide range of structures which fall within the broad definition of PIPEs, the most common elements of which are described below.

## Ordinary Equity

At its most basic, a PIPE transaction will involve the investor acquiring a significant holding of ordinary shares in the listed company. The size of the stake may vary depending on the size of the company – for a larger company, it may represent a smaller position of around 10 percent of the company's issued shares while for smaller companies it would usually be higher. The investor would also expect to appoint at least one non-executive director of the company (usually in addition to the existing board).

## Preference Equity

Investors who are looking for a preferential return may seek to invest in preference shares in the company. Preference shares generally entitle the holder to be repaid the amount which they have invested, together with any unpaid preference dividend, before ordinary shareholders receive anything.

It would be unusual for the preference shares to be listed, though they will often be convertible into listed ordinary shares. The conversion mechanism and pricing are important factors in valuing the preference shares and should specify how the number of ordinary shares into which the preference shares convert is calculated, the circumstances in which the preference shares can be converted and whether the holder and/or the company itself can call for the conversion.

In addition, the preference shares will normally have a fixed dividend entitlement which is payable before shareholders generally can be paid any dividends. In some cases, the preference share entitlement will only be to a fixed dividend on the amount originally subscribed for the shares (equivalent to the interest payments on a loan) whilst in others, as well as an initial fixed dividend entitlement, the investor may also receive some or all of any dividend paid to the ordinary shareholders (often referred to as a participating dividend).

With any equity-linked payment it is important to remember that dividend payments and redemptions are subject to the company having generated or retained sufficient profits to be entitled to make the payment. If the company does not have the reserves to make the payment, it is simply not due, and the investor has no ability to demand or force the payment to be made.

## Debt Instruments

In some cases, a PIPE investment may simply be junior ranking debt of the investee company. The debt could take the form of loan notes, bonds or a formal loan agreement. Depending on the terms of the investment and financial condition of the company, the debt may be subordinated to all other creditors of the company (ranking just ahead of the equity holders) or may sit as a mezzanine layer, behind the senior debt but ahead of or equal with the ordinary creditors of the company. The more junior the debt, the higher the interest rate, or coupon, tends to be.

PIPE investors using debt instruments may also demand a right to share in any upside profit if the company is sold, usually through the grant of an equity warrant allowing the investor to buy shares in the company at a pre-agreed price in the event of a sale or other relevant corporate transaction. Equity warrants (often referred to as "equity-kickers") are more common where the PIPE investment is subordinated to the company's other creditors.

## Convertible Debt Instruments

Convertible bonds (or convertible loan notes) were one of the original PIPE structures and are still common in U.S. transactions. For the investor, they give a preferential right to a return of capital ahead of the equity holders, usually ranking alongside the company's ordinary creditors. In addition, they provide a regular yield and upside protection in the form of the ability to convert into equity and participate in any increase in the company's share price.

The interest rate, or coupon, on the convertible bonds will be a matter of negotiation and is often tied in with the negotiation of the price at which the convertible bonds can convert into equity: the higher the coupon, the higher the price per share at which the bonds convert will usually be. Depending on

the company's financial position and cash flow forecasts, the coupon may either be paid in cash on an annual or semi-annual basis or take the form of pay-in-kind (or "PIK") notes where the coupon is satisfied by the issue of additional bonds (having the same terms as the original ones) and is only paid when the bonds are redeemed.

### Combinations

Where PIPEs are concerned, a large degree of creative and lateral thinking can be required to address the commercial, legal and regulatory issues as PIPE transactions often combine a number of the elements described above. For example, when 3i Group plc and Arclight invested in FTSE 250 constituent, Venture Productions, both investors invested in a combination of listed ordinary shares and convertible bonds. Warburg Pincus, on the other hand, recently invested solely in ordinary shares in FTSE 250 constituent, Premier Foods.

### *Issues to Be Considered*

Aside from the commercial considerations in structuring the investment to achieve the desired returns and liquidity, there are a number of legal, market and other restrictions which prospective PIPE investors need to consider, particularly where the investment is in the company's listed shares or other instruments which are convertible into the company's listed shares.

### Price Sensitive Information and Making the Investment

Private company investors are used to enjoying a relatively free flow of information from their investee companies following a detailed due diligence exercise before making the initial investment. During that process, investors will usually have had the opportunity to probe the company's future plans and forecasts in great detail.

In the listed company environment, companies are restricted in the information which they are entitled to make available to existing and prospective investors. In the UK, the market abuse regime implements Directive 2004/109/EC (Transparency Directive). There are two market abuse offences which are of particular relevance in a PIPE context:

- insider dealing, where an investor invests in the knowledge of unpublished price sensitive information (PSI); and
- improper disclosure, where a company discloses PSI to one or more but not all of its shareholders.

The definition of PSI is deliberately vague and generally covers information which, if made public, would have a material effect on the company's share price (be that upwards or downwards). Although the judgement has to be made at the time, transactions are ultimately reviewed by a regulator with the benefit of hindsight, meaning that most investors will tend to take a conservative view over what is or is not PSI. The issue for a prospective PIPE investor is that if the company discloses PSI to the investor, the investor cannot make its investment without committing the insider dealing offence unless that PSI is released to the market at large.

As the only way to cure the PSI issue is for the information to be publicly disclosed, companies need to be careful not to disclose information to a prospective investor which they are not prepared to make publicly available. Business plans containing detailed budgets and profit forecasts generally cause the most angst with PIPE investments as investors will typically want to have an opportunity to review these in detail. Understandably, the companies do not want to have to make these publicly available where they could be seen by customers, suppliers and competitors.

However, if a company (taking appropriate advice from its brokers and other professional advisers) can conclude that information is not PSI, then disclosure to the prospective investor may not require subsequent public disclosure. The company may be able to reach this conclusion where, for example, the company's business plan forecasts are in line with market expectations and publication by the company would be unlikely to cause a movement in the company's share price. As it would be the investor who commits the insider dealing offence, the investor also needs to reach the same conclusion.

## Information Flows Following the Investment

Once the investment has been made, PIPE investors will want to be able to monitor their investment and work with the company on its future plans in the same way as it would with a private company investment. However, the improper disclosure offence referred to above restricts listed companies from giving PSI to one investor which is not made available to all investors, restricting the information which would normally be available from a private company.

Investors often consider that appointing a director of the company will give them access to all of the information needed about the company's affairs. However, the improper disclosure restrictions apply to the company and also to any director of the company, and therefore, a nominee director would commit the improper disclosure offence if he were to disclose PSI to his appointing investor.

If a "Chinese wall" can be established between the person responsible for taking decisions to buy, sell or hold the investment in question and the investment team which will work with the company to help develop its business, the company may engage the investor in a consultancy or advisory capacity. This would allow the team members working with the company at a business level to have access to the company's confidential information and, in particular, PSI, though they would not be able to share that information outside the team working on that particular investment or with the person(s) responsible for deciding on the investment strategy for the company in question.

Provided the investor is not investing in the existing listed shares, it may be possible to require the company to make certain information available to the investor either in the original investment documents or in the terms of the investment instrument itself. In the PIPE context, the information requirements should be restricted to what is normal market practice for the type of instrument used. It would be unlikely to be appropriate, for example, to include detailed information rights of the sort usually found in a private equity investment agreement in the terms of a convertible bond issued by a listed company. It would also not be appropriate to change the structure of the investment from listed shares to another type of instrument solely to avoid the improper disclosure restrictions.

## Veto Rights

Private company investors are used to requiring their investee companies to seek their approval of material decisions, such as acquisitions and disposals and entering into significant contracts. Such rights are rarely held by shareholders in listed companies, who have to rely on the approval and corporate governance requirements of the market on which the shares are traded. Where an investor seeks unusual control rights in the listed company context, this may make the company less attractive to other institutional investors, reducing the potential demand for the company's shares (and therefore also the share price and liquidity).

As with information rights, it may be possible to include some control rights where the investment is not for listed shares, provided that the rights broadly accord with investor perception over what is appropriate for that sort of investment.

## Regulatory Issues

The rules applying to the market on which the company's shares are traded may also include restrictions which will impact the structure of a PIPE investment. For example, companies listed on regulated markets, such as London Stock Exchange's main market or Euronext's main market, are subject to Directive 2003/71/EC (Prospectus Directive) and Transparency Directive (which are implemented in the UK in the Prospectus Rules and Listing Rules published by the Financial Services Authority).

The Listing Rules require shareholders to approve the issue of shares at greater than a 10 percent discount to the market price. In addition, the Listing Rules require companies to have a minimum 25 percent of the listed shares which are deemed to be in "public hands" (referred to as the "free float") at all times. Holdings of 5 percent or greater (as well as directors' holdings) do not count towards the free float requirement.

Separately, the Prospectus Directive requires a company which issues new shares representing 10 percent or more of its existing issued shares over a rolling 12 month period to publish a prospectus, which is usually a time-consuming and expensive process.

Companies listed on London's AIM market are subject to a more subjective test that they continue to be considered appropriate to be listed on that market. If an investor seeks to impose restrictions or behavioural requirements which the nominated adviser considers excessive, the nominated adviser may argue that the company is no longer appropriate to be listed. In addition, AIM-listed companies must consult with their nominated adviser before appointing any directors, including investor appointed directors.

### Compulsory Takeover Offers

Under the UK's City Code on Takeovers and Mergers (Takeover Code), any person or persons acting in concert who acquire 30 percent or more of the issued shares of a company to which the Takeover Code applies are required to make a takeover offer for the company. It is possible to waive the requirement with shareholder approval in respect of new issues of shares (but rarely, if ever, market purchases). Investors seeking to take co-ordinated action with other shareholders accordingly need to be extremely careful not to inadvertently trigger the compulsory offer requirement through their actions.

### Market Indices

The qualification rules for inclusion in any particular market index may also need to be considered. For example, the existence of a shareholder holding more than 50 percent of a company may result in a company not qualifying for inclusion in a particular index. Inclusion within an index can be important in attracting investment funds with strategies calling for exposure to that index's constituents.

### Shareholder Approvals

Shareholder approval of the initial PIPE investment will often be required, whether simply to create and/or approve the issue of new shares to the PIPE investor or to approve a waiver of a requirement to make a takeover offer. Considering the likely views of the company's existing shareholders is therefore important in agreeing the terms of the proposed investment. In addition, as the PIPE investor is unlikely to have voting control over the company, actions requiring shareholder approval generally may still be blocked by the other shareholders, even if the PIPE investor and the company's management approve them.

### Conclusion

Public listed companies offer private equity investors attractive investment opportunities. The issue of matching the pricing expectations of new and existing shareholders remain as relevant today as ever. PIPE structures offer a compromise to both parties, allowing them to share in the company's future potential – is it finally time for PIPEs to become common investment structures for European companies?

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