

## PRACTITIONER'S POINT: INVESTING IN PIPES



Mitch Hull has over a decade of experience, is founder of Hull Capital Management, LLC, and shares his insights on private investments in public equities (PIPEs)...

**"In a PIPE offering there are less regulatory issues with the SEC" ... then why is investing in them perceived with such notoriety?**

The "notoriety" in a PIPE transaction is really a function of historical biases created in the early days of PIPE investing. In the mid to late 90's PIPEs, known at the time as Reg. D Private Placements, were new to the capital markets and the dominant transaction structure was the floorless floating convertible bond. It was embraced by a vast majority (at present it constitutes 5% of the market). This structure is known more pejoratively as the "toxic convertible" or "death spiral" as a number of dot com companies that had used this structure experienced negative outcomes when the Internet "bubble burst". Many of those issuers' business models proved to be failures – and some erroneously continue to blame the PIPE structure for the same. Today, very few transactions are completed with floating conversion features.

**What is peculiar to PIPEs - can you elaborate on the traditional and structured variations.**

Traditional PIPEs are simple common stock transactions (usually priced at a slight discount to market) with warrants (usually struck at a slight premium with a 5-year life). Structured deals can have collateral, conversion features, straight debt, re-set provisions and lots of other bells or whistles. They are more complex and often take longer to complete. This market is unique owing to its fragmentation. It is a relationship business. There are over 400 agents marketing transactions, most of whom will do less than 5 transactions a year. A fund's deal flow is a function of its relationships. Every fund has its own deal flow. This is not like the IPO market where every major institution sees every transaction. More than it follows money; deal flow follows relationships in the PIPEs market.

**Who and why should somebody consider investing in PIPEs?**

Institutions, high net worth individual or other investors seeking exposure to publicly traded companies with a market capitalisation of under USD250 mn should consider investing in PIPEs. The micro cap market is volatile and choosing the PIPE route with its structure offer advantages such as better access to information, better pricing and deal sweeteners (such as warrants, anti-dilution rights, re-set provisions, etc.).

**What amount and time horizon do you believe optimises returns in PIPEs?**

Time horizon is a function of the investor's strategy. There are some trading oriented strategies that have an optimal holding period of less than six months. At the other end of the spectrum, are others that are effectively like public venture capital for which the optimal holding periods can be 18-36 months. The wide range of holding periods is a good indication of the numerous investment strategies and structures in the PIPE market.

**Based on your experience how do you identify, monitor, mitigate and successfully: exploit the risk associated with investing in PIPEs? Which of the above is the hardest to achieve and why?**

As a fund of funds, we are invested in 20 different PIPE fund managers. Our job is to know all the managers including both the funds in which we are invested as well as those with which we have not allocated capital. Deal flow and experience in the space are two of the most critical factors. Since it is such a relationship driven business that simply understanding the product is not enough.

We monitor the funds' investment activities using databases that compile the data from publicly filed documents. One of the great advantages of PIPE investing is that all the deals can be tracked and as investors we have full transparency into the investment sizes and terms. We keep overlaps to a minimum and undertake regular correlation analysis to check this on a quantitative basis. Another advantage of the PIPEs space is that two funds can invest in the same deal but they can generate different performance because their investment strategies vary. This feature helps us mitigate some of the risk posed by overlaps.

The biggest risk that requires the strictest monitoring is style drift. We have to understand the allocation (type, size) of investments that a fund makes. We need to make sure that a fund does not deviate from implementing its core strategy. Sometimes a fund will try and change its strategy to follow a hot market or deploy assets that are disproportionate to the transaction size. We believe a fund has to know what it does best and do it. If we sense that the fund is doing something different ... there is a problem.

**What do you look for and what do you intentionally avoid, when you consider investing in a PIPE fund?**

We look for those with extensive experience in the PIPEs space. They must be articulate, have a sound strategy and possess the required skills to execute it. If any of the above is missing then we avoid the fund. We are vigilant in identifying mismatches - for eg. a fund comprising managers with trading experience should not be focusing on a long only strategy that requires deep fundamental due diligence. We are extremely wary of managers who when asked about their strategy respond by asking us what we are looking for. We insist and strongly believe that a manager's interest needs to be aligned with ours.

**Going forward, what is the scope and what according to you are the challenges?**

The challenges are never ending but revolve around staying on top of the developments in the market. The PIPEs market is constantly evolving as it responds to regulatory changes, shifts in the overall stock market and general economic conditions. The market is incredibly fragmented and we need to talk to as many funds, agents, lawyers, accountants, reporters, investor relations professionals and others associated with the PIPEs business. It is our job to make sure we have a full understanding of the issues and the market so that we continue to effectively manage our fund.

**Remarks/comments...**

There are many advantages associated with PIPE transactions versus follow-on public offerings. These include time to market, lower cost, fewer regulatory filings and hurdles and no effect on the stock's price during confidential marketing. While the PIPE has traditionally been and will continue to be primarily a micro cap financing vehicle, larger cap companies see the advantage and are now beginning to opt for the PIPE transaction instead of the public offering. The average deal size continues to rise and we continue to see more billion dollar companies in the PIPE space.