

Equity Lines Emerge as Attractive Financing Alternative for Public Companies

By Brad Wilhite

Beginning with the collapse of the financial markets in the latter part of 2008 and continuing through 2009, investment capital has been scarce for public companies and, in particular, smaller micro-cap issuers. During this time, while public companies have found it extremely challenging to raise investment capital, a financing instrument that has been in the market and available to issuers for over a decade – the Equity Line – has emerged as an attractive alternative for public companies as well as institutional investors.

Collapse of the Capital Markets and Emergence of the Equity Line

Leading up to the financial markets collapse, there were several years during which capital was flowing at an increasing rate into hedge funds and institutional investment funds, giving micro-cap public companies the ability to raise capital from a variety of sources while selecting terms and structures that best fit their needs. Hundreds of hedge funds were formed during that time, and capital was deployed aggressively. PIPE (private investment in public equity) became the term commonly used to describe the market that developed around investment transactions involving private investors and public companies.

As the PIPE market flourished, public companies had many options for raising equity capital from institutional investors. Issuers could sell common stock and warrants, known as unit offerings, and they could issue convertible preferred stock and convertible debt. Some companies also utilized Equity Lines, but the availability of large sums of capital in single transactions without the need for a Registration Statement to be deemed effective in advance of receiving funds – as required by Equity Lines, made other forms of PIPE transactions more attractive to issuers.

With the breakdown of the financial markets in the latter part of 2008, a chain reaction occurred. Equity values dropped by over 50% in a very short period of time, triggering hedge fund losses and investor redemptions. As hedge funds retreated, and in some cases shut down, the number of investors in the PIPE market decreased as did the tolerance for risk. Investors, needing liquidity in their transactions, became less willing to invest in large amounts of restricted stock or debt that could not be converted into registered shares. While terms offers were still being made to public companies for these structures, and some transactions were completed, the cost of capital was often very expensive with aggressive covenants and restrictions that made the financing unappealing or unacceptable to issuers.

As a result, during the past eighteen months, the Equity Line has become increasingly accepted as an attractive and viable solution that meets the financing needs of public companies and the portfolio requirements of institutional investors.

Equity Line – Pros and Cons

Equity Lines have several positive attributes for both issuers and investors.

First, an interesting point of clarification about the term “Equity Line”. Within the securities industry, the Equity Line has been known for years as an “Equity Line of Credit”, however, that is a confusing misnomer as there is no “credit” involved and the Equity Line is not a debt instrument. Unlike debt, an Equity Line does not charge interest and the funds received through

the Equity Line do not have to be repaid. However, much like a traditional line of credit provided by a bank or asset-based lender allows a company to carry accounts receivable and inventory, an Equity Line allows a public company to “draw” against its equity on a periodic basis by selling registered shares of common stock to an investor for cash. For this reason, just as every company should consider a bank line of credit to support its operations and working capital needs, every public company should consider an Equity Line as a potential source of funding that can be accessed if and when needed.

For issuers, an Equity Line can provide a reasonably reliable, steady stream of cash that can be used to fund ongoing working capital needs. Equity Lines usually offer less dilution and a lower cost of capital to issuers than other forms of investment. And, unlike secured debt instruments such as convertible debentures, Equity Lines do not have any security interests in the assets of the issuing company so there are no lien filings. Additionally, Equity Lines often are structured in a manner that give issuers the control over the timing and amount of shares that are sold to the investor, allowing issuers to determine when capital is raised and at what price.

For investors, an Equity Line provides a lower risk approach to investing, as registered shares are purchased in tranches over time at a pre-determined discount to market. This gives investors the ability to dollar cost average their investments over time rather than gambling on the purchase price associated with a one-time investment.

For all of the positive factors associated with Equity Lines, there are a few negative considerations for issuers. First, issuers do not receive all of the capital at once, therefore, an equity line typically is not a viable source of financing for an acquisition or other use of capital that requires a large one-time infusion. Second, the shares to be sold to the investor must be registered by filing and going effective with an S-1 registration statement (S-3 if the issuer is exchange-listed), which involves additional legal fees and a time delay in receiving the capital.

In years past, some providers of Equity Lines earned a tarnished reputation, casting a negative view toward Equity Lines that still exists today. These investors, often formed as off-shore entities, were known for mandating usage and taking the control of the instrument away from issuers. They also did not allow issuers to establish a mechanism for price protection via a threshold or floor price. In some cases, Equity Lines were set up for issuers that had minimal operations and little to no trading volume, giving the market the impression that Equity Line structures were a “financing of last resort.” This perspective has changed as exchange-listed companies – ranging from NYSE to Nasdaq and NYSE Amex – have established Equity Lines as a viable source of capital, as have substantial companies that trade on the OTC Bulletin Board.

Equity Line Mechanics

An issuer’s first step in implementing an Equity Line – following negotiations with an investor and execution of a term sheet and definitive agreements – is to have qualified and experienced securities counsel (such as The Lebrecht Group!) prepare and file an S-1 Registration Statement (or S-3 Registration Statement if the issuer is exchange-listed) on the issuer’s behalf. In addition to providing the issuer’s current financial information and other disclosures, the Registration Statement will outline the terms and structure of the Equity Line agreement, and register the common stock underlying the Equity Line.

Upon filing of the Registration Statement, the Securities and Exchange Commission can either pass on review and allow the Registration Statement to go effective, or respond with comments within 30 days of filing. If comments are received by the SEC, the Registration Statement will be

amended and re-filed, and the process will continue until the SEC is satisfied with the disclosures and the Registration Statement is declared effective.

At this point, most Equity Lines allow issuers to “put” an initial tranche of registered shares to the investor for cash at a pre-determined discount to market. A formula based on the current price of the stock, as measured by closing bid prices or volume weighted average prices, is used to calculate the number of shares that are issued. Properly structured Equity Lines allow the issuer to set a threshold or “floor” price with each tranche which can provide protection to both the issuer and the investor should the market price of the issuer’s stock decline that period.

Following the initial transaction, the issuer then has the ability – typically every five to ten trading days – to repeat the process, selling a tranche of registered shares to the investor for cash at the pre-determined discount to market. This continues through the term of the Equity Line, usually structured as up to 24 to 36 months following the date the Registration Statement is deemed effective. Periodically, during the term of the Equity Line, the issuer’s counsel will make additional filings to incorporate current financial information to keep the Registration Statement effective.

Selecting an Equity Line

For issuers seeking capital, an Equity Line can play an important role in the overall capital solution. However, while, as the saying goes, “all money is green”, not all Equity Lines or investors offering Equity Lines are the same. When selecting an Equity Line and an investor, issuers should look for these general characteristics:

- An on-shore rather than off-shore investor may be preferred to aid in due diligence on the investor entity; issuers may take additional comfort in doing background checks on the principals of the investment firm by using FINRA’s BrokerCheck resource (www.finra.org/brokercheck) if applicable;
- An Equity Line offering the ability for the issuer to determine the timing and amount of each tranche;
- An Equity Line allowing for a threshold or “floor” price that the issuer can set with each tranche to assist with price protection;
- An Equity Line with a pricing formula based on volume-weighted average prices, ideally on a daily basis, as opposed to closing bid prices or the lowest prices of a period; and
- An Equity Line that does not put restrictions on other forms of equity and debt financing, giving the issuer freedom to raise additional capital to meet its needs.

With these characteristics in an Equity Line, efforts by the issuer to build and maintain a market for its stock, achievement of some key business milestones, and a little bit of luck along the way, an issuer can utilize an Equity Line to provide capital to meet its operational objectives and execute on the strategic vision!

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