The Evolving Nature of The PIPEs Marketplace

by Ira Zadikow

The general public perception of PIPEs among many investors, the media and even academics is that of a financing tool that is primarily used by desperate, struggling companies in order to just survive. However, the reality of the marketplace is not only quite different, but is also evolving as the use of PIPEs are becoming increasingly more widely accepted among larger corporate issuers, placement agents and investors.

The recent high-profile deal between Sun Microsystems (SUNW) and Kohlberg Kravis Roberts ("KKR") is just one example of PIPEs being issued by well-known and financially strong companies, generally to pursue a variety of strategic objectives and not as a funding tool to just maintain operations. The strategic corporate objectives being facilitated or pursued are designed for both short and longer-term timeframes. They generally fall into the category of acquisitions or partial investments, partnerships and other means of accelerating growth and expansion. We would also importantly note that the greater acceptance and issuance of PIPEs by larger and more well-capitalized companies are increasing the confidence level not only among both placement agents and investors, but among potential PIPE issuers as well.

We will readily acknowledge that there are many instances of PIPEs being issued to aid financially weak companies, being sponsored by less than high-profile names and invested in by less than scrupulous parties with only short-term profits as their goal. However, we would suggest that to a growing extent the PIPEs market is actually a growing and vibrant marketplace, becoming much more widely accepted by established names and with what we believe is a bright future. We would also suggest that for many reasons PIPEs are increasingly being seen as a viable alternative to "standard" equity and debt offering choices. In addition, the funding size of PIPEs has been growing, with deals of $500 million to $1 billion and above becoming commonplace.

The aforementioned Sun-KKR deal is an obvious flash-point in the evolving marketplace. It generated a great deal of media attention and brings together an extremely well-known technology company with an extremely well-known and opportunistic buy-out and investing partnership (here executed through their KKR Private Equity Investors, L.P. entity). What's extremely interesting is that $700 million was raised for a co. which exited their second quarter with approx. $3.4 billion in cash and marketable securities (and an additional $1.4 billion in longer term debt securities), who earned $0.05 a share in EPS (excluding charges) and who literally said that they didn't need the money. One potential use for the cash going forward will be for corporate acquisitions, which again highlights the strategic nature of PIPEs being executed by larger, financially viable companies which are not seeking funding in order to just survive.

(If not specifically mentioned, all of the following funding deals were done via PIPEs.)

Several months ago Grupo Santander (STD) acquired approximately 20% of Sovereign Bancorp (SOV) for $2.4 billion. Sovereign in turn then used those funds (in addition to others) to acquire Independence Community Bank Corp. Sovereign has positive EPS.

EXCO Resources (XCO) will be raising $2 billion. The proceeds will partly be used to buy oil and gas properties from Anadarko Petroleum (APC). EXCO has positive EPS.

Itron (ITRI) issued a $235 million PIPE, the proceeds being used (with additional funds) to acquire Actaris Metering Systems. Itron has positive EPS. (Itron and their acquisition plans generated a positive note in this week's Barron's.)

Shire PLC (SHPGY) issued an $800 million PIPE, to be used (with additional funds) for their acquisition of New River Pharmaceuticals. Shire has positive EPS.

Gold Fields (GFI) recently issued a $1.2 billion PIPE, the proceeds being used to repay debt that was incurred in the acquisition of Barrick Gold's 50% ownership stake in South Deep and the other 50% owner, Western Areas. Gold Fields has positive EPS.

Williams Partners (WPZ) recently issued a $600 million PIPE, the proceeds used (with additional funds) for its acquisition of the balance of Williams Four Corners from Williams Companies (WMB). Williams Partners has positive EPS (EPU).

TC PipeLines, LP (TCLP) recently issued a $600 million PIPE, the proceeds used (with additional funds) to acquire a 46% interest in Great Lakes Gas Transmission LP from El Paso (EP). This follows their recent acquisitions of interests in Northern Border and Tuscorara. The company has positive EPS.

Skyworks Solutions (SWKS) recently issued a $200 million PIPE, the proceeds to be used for general corporate purposes, a stock repurchase, and for potential future acquisitions. The company has positive EPS.

Comverse Technology (CMVT) recently invested $293 million in a PIPE issued by their subsidiary Verint Systems (VRNT). The proceeds were used (with additional funds) to acquire Witness Systems. Verint has positive EPS.

Halozyme Therapeutics (HTI) recently entered into separate partnership agreements with two major pharmaceutical companies, with each co. also investing via PIPEs in Halozyme. Baxter International (BAX) invested $20 million and Roche $11 million, with these funds separate from additional funds paid to Halozyme for upfront and licensing fees for their drug and delivery systems. Halozyme is a small co. in terms of revenues and is losing money on the bottom line, but these transactions are illustrative of the very common type of PIPEs pursued in the pharmaceutical and biotech industries.

In a similar vein, Genentech (DNA) recently invested $15 million in Altus Pharmaceuticals (ALTU) as part of a drug partnership.

Approximately one year ago Abbott Laboratories (ABT) bought 64 million shares of Boston Scientific (BSX) for $1.4 billion. This was part of a deal whereby Boston Scientific bought Guidant Corporation and Abbott in turn bought the vascular business of Guidant.

A little over one year ago Gastar (GST) entered into a partnership with Chesapeake Energy (CHK). Chesapeake invested approx. $76 million through a PIPE, acquiring approx. 17% of the company. Recently Gastar issued a $50 million PIPE in which Chesapeake invested an additional $10 million. The funds are being used primarily to fund an active oil & gas exploration & production program. The co. currently is generating negative EPS and is not expected to turn bottom-line positive in the near-term.

Most of these transactions are examples of companies, in a variety of industries, issuing PIPEs in order to facilitate various types of acquisitions or investments, or partnerships. Most of these companies are also EPS positive. Both of these elements in our opinion are very important as far as being indicative of the true nature of a large number of current PIPE transactions.

The evolution of the PIPEs market can be seen in other areas as well. The changing nature of the placement agent sponsors of PIPEs can be seen in the increasing presence of well-known names such as UBS, Lehman Brothers, Citigroup, JP Morgan, Bank of America, Deutsche Bank and Goldman Sachs. The changing nature of investors in PIPEs can be seen in the increasing interest from mutual funds and private equity. This is again most probably due to the increasing number and size of PIPEs being issued by larger and more well-established companies as well as excess liquidity needing to find a home. We won't overly focus here on the reasons for these latter changes, possibly that will be a topic for a future discussion. Suffice it to say that we believe all these changes are combining to create a healthily growing and evolving market, which we feel is a positive for all participants involved.