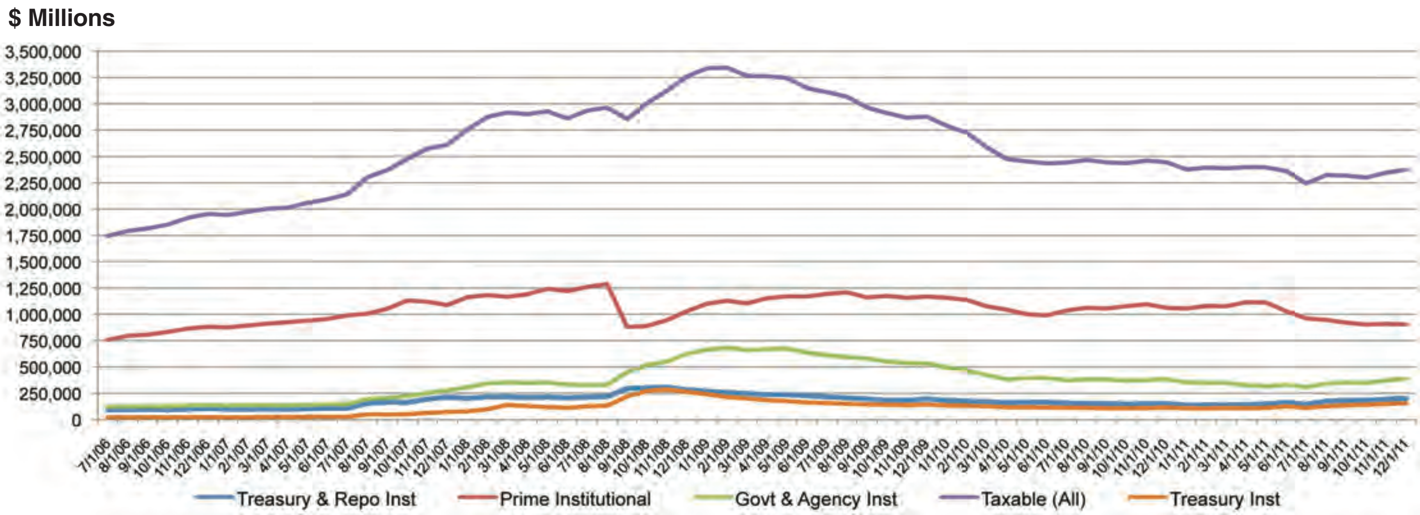
Going to MARKET

David Pritchard

M&A-style due diligence for the capital markets

Institutional Money Fund Asset Flows, July 2006 - December 2011



Source: Money Fund Analyzer™, a service of iMoneyNet, Westborough, Mass. (www.imoneynet.com)

As a rule, experienced poker players are delighted when a newbie wanders up to the table, asks for a quick rundown of the rules, then antes up for a fresh stack of chips. Similarly, public companies with all but the most experienced and sophisticated financing teams can find themselves in the uncomfortable—or, more importantly, costly—role of "mark" when seeking to access funding via banks in the capital markets. This risk stems not from a lack of financial acumen, industry expertise or vigilant oversight, but rather from conflicts of interest inherent in the capital raising process itself. (For purposes of clarity, in referencing this "process", I mean the steps by which companies with identified funding needs engage investment banks, determine financing structure and strategy and sell publicly or privately traded equity, equity-linked or debt securities into the marketplace.)

The decision to raise capital begins internally and is driven by the need to finance growth initiatives or acquisitions or refinance existing obligations. If bank financing is unavailable or deemed inappropriate for such purposes, public companies will invite investment banks to present them with financing ideas and their credentials to lead such transactions. Information garnered through the bank "pitch books" is then integrated with internal thinking and a financing strategy and deal team is settled upon. Over the ensuing weeks or months, the management team, investment bank(s) and other relevant advisors (legal, accounting, etc.) draft deal documents and marketing materials. Finally, a "go/no go" decision is made, the offering is launched and the process of book building, negotiation and final pricing is set in motion.

So, how should finance professionals who manage a broad array of exposures across the corporate platform think about risk in the context of such financings? And what potential impact do these risks represent to the long-term health and profitability of a business?

To answer these questions let's begin with an assertion—that more companies have likely gone out of business as a function of being poorly financed than all other forms of exposure combined. Managing the risks within the financing process requires experience and a keen understanding there are many components of value within the form and structure of an offering beyond the readily measurable metrics of deal fees, coupon rate or discount to last trade. Considered fully, in the context of a company's existing capital structure, debt service capability and the like, these variables combine to form a true "all-in" cost of capital. This comprehensive approach recognizes that each financing sets the stage for the next, and that preservation of financial flexibility, ease of access to capital and the right investor base may prove far more valuable than 25 basis points of up-front cost savings.

In addition to approaching the process holistically, it is also appropriate to examine the roles of the various parties to a securities offering to identify and mitigate sources of structural or pricing inefficiency. The objectives of corporate issuer (seller) and investor (buyer) are quite clear. Each wishes to consummate a transaction at the price, terms and conditions most beneficial to their respective interests.

For issuers, this means selling high with no conditions, while investors look to buy low with expansive covenants and protections. Absent the presence of an additional party to the transaction, these differing interests would find resolution through the time-tested laws of supply and demand. But there is another party in the mix—the investment bank managing the process.

While not nearly as storied as the forces of supply and demand, the role of investment banks in the capital raising process is also quite well established. It is also complex and inherently conflicted. And while the form and nature of these conflicts by no means puts the interests of investment banks at odds with their corporate clients, acknowledgement and understanding of them is incumbent upon management teams seeking to serve shareholder interests by optimize financing efficiency. Let's examine this role, and the imbedded conflicts, in more detail

When companies identify a capital need and invite banks to pitch for the mandate, they initiate a highly competitive process. (It should be noted that financing fees combine with M&A advisory revenue to form the bulk of Wall Street's investment banking revenue.) Banks invited into this "bake off" typically have longstanding relationships with the company and may even provide direct commercial lending. They seek to leverage these relationships at all levels (management, board, etc.), as well as provide compelling ideas at competitive terms, to secure a role in the offering. At this point in the process, companies benefit enormously from the considerable financial and intellectual resources within the investment banks.

But once companies select their deal team, these competitive dynamics fall away. And the underwriting agreements they are required to execute define not only the role the banks will play, but, in the form of expansive indemnification language, the role they will not. Companies assuming their banks owe them a specific legal obligation and are working exclusively on their behalf because they 1) initiate the process, 2) select the deal managers and 3) will pay the financing fee would be well served reviewing this language closely.

To be more specific, companies engaging investment banks for securities offerings assent that the banks are not serving them in a financial advisory capacity and owe them no fiduciary or agency obligation. They also agree all terms and conditions of the offering will be considered to have been reached following "arm's length" negotiations, without reliance upon (read: recourse to) the banks, and that they are capable of independently evaluating and understanding all facets of it. This despite the fact the banks have great expertise in the structure and placement of securities and were likely hired for this very reason in the first place! Add further that banks are under no obligation to disclose conflicts of interest related to the offering.

Banks require this broad indemnification because of the complex role they play working for the corporate client as securities issuer and selling these securities to buy-side clients through internal sales channels. The obligation to balance client interests on both sides of capital market financings fundamentally define the bank's role as conflicted. And companies recognizing this, rather than simply relying on their deal managers for guidance, should seek to proactively identify and monitor points of risk and structural or pricing inefficiency throughout the process.

Interestingly, the conflict of interest issues that go largely unchecked within capital markets financings are addressed directly by the "best practices" framework applied to M&A transactions. Consider, for example, the use of separate buyside and sellside counsel and advisors and the requirement of independently derived fairness opinions. These now commonly employed devices combat the risk of inequitable outcomes between parties by providing both with knowledgeable and unambiguously committed advisors. Until similar protections evolve in the capital markets arena, it is incumbent on management teams to recognize the conflicts at work in the financing process and act as their own and, by extension, their shareholders advocates.

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A Corporate's Perspective on M&A

Going to the capital markets isn't easy for first-timers. Michael F. Biehl, Executive Vice President, Chief Financial Officer and Treasurer of Chart Industries, discussed his experiences with *Exchange*:

Exchange: What was your challenge?
Biehl: We had never done a convertible notes offering, which can be quite complex, especially if a call-spread option is used in connection with the offering. In addition, while I have prior experience working with the investment banks on debt and equity offerings, I had no prior experience with a convertible notes offering. Therefore, it was in my company's best interest to get solid advice to insure the fees were competitive, the terms of the offering were competitive and well understood and we ended up with as strong a convertible notes execution as possible.

Exchange: Because you probably had other options, what led you to make this particular financing decision?
Biehl: We were looking to refinance our high-yield senior subordinated notes and the high-yield market was very unstable. Our stock also trades with significant volatility, which can be used reduce borrowing costs within a convertible notes structure. We didn't want to add more traditional bank or mezzanine debt, and were looking to put in a low cost, long-term debt instrument into our capital structure that gave us the greatest flexibility as we expect to grow organically and inorganically over the next five years. Chart's stock price tends to be very volatile and the analysts' price targets are well above the current market price, with significant growth projected and a very solid balance sheet in place.

Exchange: What were the results?
Biehl: We closed on a $250 million convertible notes offering in early August 2011 in a very volatile market. The notes have a seven-year term, no payments due, until 2017, except for a 2 percent semi-annual interest, and will result in an annual cash savings of approximately $10 million. The reference price on our offering was $53.10 with an up 30 percent conversion price of $69.03. We also utilized a call-spread mechanism, increasing the effective conversion price to $84.96. The offering was oversubscribed by approximately 3 1/2 times.

Exchange: What advice do you have for Exchange readers?
Biehl: If a company is considering a structured securities offering, I would highly recommend bringing in outside advisors, such as Aequitas, as the details and process can be quite complex, especially when conversion features or derivatives are involved. I believe there are many companies who have done convertible offerings, for example, that really don't understand everything in the agreements, including potential adverse provisions. Don't assume your investment bankers are going to do what may be in the best interests of your company, regardless of how good a relationship you may have with them.