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PERSPECTIVE

CMPOs: An opportunity for both companies and investors

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There has been so much talk in 2019 about initial public offerings, with the likes of Levi's, Lyft, Uber and Pinterest making their way into the world of being public companies. Going public is certainly a major milestone for a company and given the number of unicorns who have finally made their way to the public markets in 2019, this has further fueled the focus and investors are quick to jump in and contribute to the frenzy.

But existing public companies who go back to the public markets for a follow-on offering rarely get the same warm reception from investors. In fact, stock prices tend to deflate upon announcement of a follow-on, predominately because of concerns around dilution. There can also be concerns for those companies who repeatedly access the public markets for more capital, that such companies are having difficulties sustaining and growing revenues.

Despite these concerns, investors who are looking for value and growth may be overlooking great companies by focusing solely on IPO investment opportunities. In 2018, 214 IPOs raised $54 billion but nine of these 214 IPOs accounted for over 25 percent of the total value. In this same year, 685 follow-ons by existing public companies raised $143 billion. Further, follow-ons provide investors with discounts to public pricing. In 2018, the average discount to investors was 7.3 percent. With so many more investment opportunities, investors can pick and choose those companies where the management team is strong and the growth story most attractive.

From a company's perspective, a follow-on can have many benefits even in light of a slightly depressed stock price. It can provide a company with much needed capital to finance company growth, invest in research and development, expand key areas of the business or fund acquisitions that will be accretive to their bottom line. The key for the company is to be prepared to take advantage of market dynamics by timing the launch of a follow-on and structuring it in such a way to maximize the likelihood of its success, while trying to avoid any negative impact.

One structure that can provide companies with this opportunity is the CMPO, or confidentially marketed public offering. The CMPO is a particularly effective tool for small to medium-cap companies. A CMPO is an offering that has two components, a confidential roadshow marketed to institutional investors and a "public flip" shortly before pricing to market the offering publicly to both institutional and retail investors. It is very similar to a typical underwritten public offering but with a twist that provides companies with the most potential to maximize transaction success. To get the most benefit from a CMPO, companies need to focus on two things: preparation and execution.

Preparation: Lining up the Necessary Components for a CMPO

Effective Shelf Registration Statement: The first thing a company needs to execute a CMPO is an effective shelf registration statement on Form S-3. Form S-3 is the shorter-form registration statement (compared to Form S-1) which allows eligible issuers to register securities and take advantage of incorporation by reference. The principal requirements for being eligible to file a Form S-3 include (but are not limited to):

• Being organized under the laws of the United States;

• Having a class of securities registered pursuant to the Securities Exchange Act of 1934; and

• Filing all required SEC reports during the past 12 months in a timely manner.

In the past, the use of Form S-3 was limited to companies with public float of at least $75 million, but now issuers with a lower public float can still use Form S-3 but the amount they can issue within a year is capped at one-third of the market value from the trailing 12-month period. This is known as the "baby shelf rule." Such a company must also not have been a shell company during the prior 12 months and must have a class of common stock listed on a national securities exchange. If a company is S-3 eligible (and even if they are subject to the baby shelf rule), they should file one. This allows a company to prepare the foundation necessary for a CMPO (a base prospectus), address comments from the SEC (as necessary) and get the S-3 effective before or as they start preparing for a transaction.

Diligence: With an S-3 on file, a company should consider organizing their diligence materials. A CMPO due diligence process is very similar to a traditional underwritten public offering. Underwriters and their counsel will review documents that are not publicly filed, conduct business diligence calls with management and legal and auditor diligence calls. Customer calls are also often required. Since the diligence process in a CMPO can be more compressed, a company should prepare as much as possible in advance.

Underwriters: Finally, a company should speak to several underwriters and select a lead underwriter who can drive the CMPO process. Some companies even involve an underwriter before a base S-3 is filed although this is not required. It is important that a small or midcap company chooses an underwriter who is more specialized and focused on their size of company as they will have a more appropriate investor base to tap into and will be more experienced in refining the company's story to maximize the marketing process.

Executing a CMPO

The three key items that are necessary to kick off a CMPO, other than the effective S-3 registration statement, include:

Wall-Crossing Procedures: It is important during a CMPO to avoid insider trading issues and maintain offering confidentiality. This can be difficult to do when a company and their underwriters are speaking to so many investors during the confidential road show. The most effective way to do this is through the use of confidentiality agreements but that can be time consuming and burdensome. Wall-cross procedures help to bridge the gap. During this process, underwriters reach out to potential investors and provide very high level information about the company (without disclosing the company's name), industry, approximate deal size and use of proceeds. The investor must agree to keep the information confidential, typically for a limited period of time. Upon receiving verbal agreement, the underwriters will then send a one-way email revealing the identity of the issuer and affirming the investors' agreement to maintain the confidentiality of the information. This one-way email does not require an investor to confirm but does provide the desirable paper trail for documenting confidentiality. Once an investor has been "brought over the wall", they will then often participate in a management presentation or learn more about the issuer so that the underwriters can gauge the investor's interest in participating in the transaction.

Roadshow Deck: This will be the key marketing tool and is effectively a company presentation outlining the company's story, key financials and other information pertinent to an investor. Communication with potential investors is done orally as any written communication (such as sending a roadshow deck via email) can be an issuer free writing prospectus and will thus be required to be filed with the SEC. Once the underwriters have received sufficient interest from investors and identified a handful of anchor investors for the transaction, the preliminary prospectus supplement is "flipped to public".

Preliminary Prospectus Supplement: The "flip to public" means it is time to file the preliminary prospectus supplement with the SEC and make the offering known publicly. This can be done before or after market closes and then the offering is typically priced that same day, often in the evening. Pricing terms are then announced before market opens on the following day. This "flip to public" allows a company to meet the public offering requirements of the exchange avoiding the need to obtain shareholder approval in those instance when they are selling 20 percent or more of outstanding common stock priced at a discount to market.

The other aspects of a CMPO are very similar to a typical underwritten public offering. The auditors will deliver comfort letters and a series of closing documents are delivered, including opinions, officers certificates and transfer agent documentation. This is in addition to the extensive diligence process conducted by the underwriters and their counsel as described above. The company will also need to obtain NASDAQ approval and the underwriters will get FINRA approval for those companies who are not exempt. Counsel for the company and underwriters quite often work through all of the documentation and closing deliverables while the underwriters and company are focused on the confidential marketing phase. This dual-track process ensures that once pricing occurs, both the company and underwriters will be prepared to close after pricing, which occurs within 2 business days after the trade date.

CMPOs: Maximizing Success and Minimizing Downside

While investing in IPOs offers investors the opportunity to invest in a new company at the beginning of its public company journey, follow-ons are much more prevalent and despite their often cited drawbacks, provide companies with much needed capital. The CMPO structure offers companies the greatest advantage by providing a confidentially pre-marketed phase of the transaction to determine investor interest and pricing. This allows the company the opportunity to decide whether or not to proceed with the offering before a public announcement that would cause unnecessary pressure on the stock. The CMPO is also a win-win for investors who have the opportunity to get in on a company's next phase of growth, most often at a price discount.

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