Using PIPE Dreams for Hedge Funds
By Tom Taulli, Reporter | Wednesday, May 29, 2002

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NEWPORT BEACH, Calif. (HedgeWorld.com)—Private Investment in Public Equities, better known as PIPEs, are nothing new though recently they've taken on a more substantial role in the marketplace, particularly for hedge funds.

Essentially, PIPEs have evolved into traditional and non-traditional formats. Traditional PIPEs are typically structured with stock positions that have warrants attached; while the non-traditional PIPEs, on the other hand, are more progressive instruments that are structured typically as convertible preferred stock or convertible debentures with resets or other capital protection mechanisms.

No doubt, a big source of PIPE funding is from hedge funds. One such fund is Panther LLC, Newport Beach, Calif. an offshore fund that is in the process of raising US$100 million. Panther's portfolio managers, Andre Peschong and Urban Smedeby, have been involved with structuring PIPE deals since the early 1990's. "What we realized is that a PIPE investment is an ideal vehicle in the alternative asset class," said Mr. Peschong. "There is a reduction in volatility, a high capture ratio, and low correlation to the overall market."

Since a PIPE is really nothing more than a private placement (which is also known as a "Reg D" offering), it means hedge funds are in a position to move much faster. "You can literally put together a deal and move on it in 30 days," said Mr. Smedeby. "That's a lot better than waiting four to six months for a traditional investment bank's due diligence process."

Moreover, there are dramatic cost savings to the public company. "Something that is overlooked is the actual time value of money in relation to the structure," said Mr. Peschong. This means that a company that receives capital on a more timely basis is more valuable compared to the uncertainty of traditional investment banking structures. As a result, a PIPE fund has the advantage of negotiating capital protection clauses.

However, there are hurdles. Perhaps the most significant is perception. Although sounding harmless, a so-called "structured PIPE" could be devastating to a company's stock price. A fund may have a provision that grants it the right to convert at a discount to market. That is, more stock is issued as the stock price declines. This built in "discount to market" has, unfortunately, become a self-fulfilling prophecy thus giving it the nickname of a "death spiral."

"Panther Fund utilizes proprietary structures that take out the inherent arbitrage of the 'discount to market' convertibles," said Mr. Peschong. To this end, the Panther Fund managers have a different approach when it comes to investing in companies. They take it from a fundamental approach first, followed by the technical and trading side.

Panther's structures typically employ an "imbedded hedge" within the negotiated transaction with the public company.

For example, Panther will always have a maximum price (ceiling price) that it can convert the instrument into. So, let's suppose that XYZ Corp. was currently trading at $10 per share. Panther would put a ceiling price in at $12.50 per share. In this example, if XYZ Company's stock price rose to $18 per share, the maximum that Panther would convert at is $12.50 per share, giving Panther an approximate return of 30%. Now, if the stock price were to decline, then Panther would have the right to convert at a "premium" to the market at the time of conversion, never at a discount, thus negating any built in arbitrage as with the "discount to market" transactions.

Furthermore, Panther typically has anti-shorting language within the documentation so that the company knows that Panther is on the same side of the table as management. The best-case scenario for Panther is that the company utilizes the capital to grow and the stock price rises based on their performance.

For Panther, the goal is to focus on companies with strong management, cash flows and competitive advantages. So far, not only is the Panther team finding these deals, but at very attractive valuations. "It makes me feel much better doing these types of investments with the NASDAQ at 1,700 rather than at 5,000," said Mr. Peschong.

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