



IR Issues Alert

Techniques to Lower the Cost of Capital in Today's Volatile Markets ^{3/4}

Or How to Complete a Successful IPO, PPE or Follow-on Offering in 2006

INTRODUCTION

If management's responsibility is to enhance shareholder value to its highest sustainable value, certainly one of the most critical management tools is access to low-cost capital. Without new capital, companies with a growth-biased business model are constrained from taking advantage of opportunities that present themselves in difficult markets. This occurs because free cash flow is consumed by financing higher levels of accounts receivable, facilities expansion, and required research and development expenditures. However, 2002 has proven to be one of the most difficult periods to raise capital, both equity and debt. In spite of a low-cost interest rate environment and a stable banking system, most commercial banks have reduced lending levels and increased payback requirements for commercial borrowers, which has reversed a trend toward higher balance-sheet leverage that began in the mid-1990s. Stung by a series of high-profile collapses such as Enron, Global Crossing and dozens of dot-com failures, commercial banks are rapidly shoring up their own net capital so as to stay in compliance with federal and state reserve and loan-loss ratio requirements. On the equity side, investment banks, battered by the same storms, have seen the number of initial public offerings (IPOs) drop in 2002 to the lowest point in 10 years.

However, the window is far from closed to companies with credible business models and skillful management seeking to access low-cost capital. In a world generally awash in financial liquidity, many companies today have the ability to raise capital through an initial public offering and, in the case of public companies, through follow-on offerings or private investments in public equities (PIPEs). Through the second quarter of 2002, 40 filings were made for companies attempting their initial public offering. This is in contrast to the total of 80 initial public offerings in all of 2001 and 333 in the 2000. In the case of small-cap public companies, PIPEs, which are transactions in which accredited investors are allowed to purchase stock in a public company, usually at below the market price, have been the most common method of equity financing. Once sold, shares are generally registered with the Securities and Exchange Commission so that they may be resold later to the public. In 2001, approximately 1,000 PIPEs were completed and initial indications suggest that 2002 may or may not match that level. So far, 417 PIPEs have been completed this year, raising \$5.4 billion in equity capital.¹

In the face of generally unfavorable market conditions, how should private companies prepare

¹ 2002 Securities Data Company, NASDAQ Issuer Services

for a successful initial public offering; and how should public companies position themselves so as to raise the greatest amount of capital at the lowest possible cost? This paper summarizes 2002's best practices with respect to responding to current market conditions, featuring greater accountability and transparency, building robust communication infrastructures to identify and communicate with key investor constituencies, and unlocking the value of significant off-balance-sheet company assets, particularly intangible assets.

PREPARING FOR AN INITIAL PUBLIC OFFERING

An initial public offering is a critical juncture in company's life, not just as it relates to capital formation but also in branding the company for investors and other investor constituencies. In addition, initial public offerings consume a considerable amount of management's time, often to the detriment of the ongoing business. Further, market conditions have rarely been as volatile as they are today. However, **successful companies begin the preparation for an initial public offering long before the company goes public.** An effective plan for an initial public offering facilitates a high-range valuation relative to the company's peers, assists in successfully navigating the SEC's "gun jumping" and "quiet period" rules, improves the company's investment thesis, which makes it more credible to the investment community, and creates the infrastructure for an effective investor communications program after the completion of the offering.

Develop The Plan

The most important goals of a pre-IPO plan would include:

1. Targeting investor audiences so that potential investor constituencies have already been identified and communicated with well before the IPO road show.
2. Train top executives and middle-level management as to how the public markets operate. The capital markets often require different forms of communication and content. Management that is skilled at this type of communication attracts greater investor interest.

3. Give management pre-IPO experience in working with analysts and portfolio managers so as to become adjusted to a post-Regulation FD environment. To the extent that management is comfortable in dealing with sophisticated investors, clearly a better job will be done in information disclosure leading to higher market valuations.
4. Have a functioning investor relations plan in place. Once the Registration Statement has been filed, a whole series of investor relations strategies and techniques are required to successfully complete an initial public offering and maintain an orderly after-market.

Anticipate Corporate Governance Issues

Corporate governance is at the very top of the list of concerns among investment professionals. Adelphia Communications, Andersen Worldwide, CMS Energy, Dynegy, Enron, Global Crossing, ImClone Systems, Qwest Communications, Tyco, WorldCom—the list continues. Investors will not reach the investment portion of the presentation until basic issues of corporate governance have been dealt with. In particular, investors will want to know that the company conforms to the new NASDAQ or New York Stock Exchange standards with respect to corporate governance. Independent directors will need to be truly independent, with clear expertise in corporate management and finance, and to understand their fiduciary duty to shareholders. The primary responsibility of the independent accounting firm should be to perform an audit, as opposed to providing consulting services. Marquee board members who sit on numerous boards will not be in favor since they may not have sufficient time to do their homework. Accounting principles must be straightforward and not include inappropriate off-balance-sheet entries. Questionable accounting policies, particularly concerning aggressive revenue recognition and stock option expense issues, must be eliminated well before the initial public offering. Stock options must be reasonable (10% or less) as a percentage of the total post-IPO capitalization.² Option plans must be voted on by the shareholders, and vesting strategies must be more clearly pegged to

² "Executive Stock Ownership and Performance: Tracking Faint Traces," C. Loderer & K. Martin, *Journal of Financial Economics*, 1997

performance. Executive compensation must be rationalized so as to eliminate extremes between the lowest-paid and highest-paid executives. Compensation must adjust upward and downward relative to corporate performance.

Benchmark Intangible Assets and Intellectual Property

The basic principle under which companies are valued, either from the perspective of an initial public offering or follow-on financing, is market valuation relative to comparable peers. This assumes that the risk premium applied to a reasonable population of similar companies will provide a valuation matrix that can be applied against a particular company in a similar industry. In a difficult market such as the one we are in now, the valuation matrix can unfavorably impact the company attempting to go public, or an existing public company with strong management and a novel business plan. In this case, management should take note that there is a strong correlation between consistent, high-quality corporate disclosure practices and achieving premium equity valuations relative to peers.³ High-quality communications reduce investors' uncertainty about the accuracy and adequacy of information being disseminated and thereby lower the cost of capital and improve liquidity.

In recent years, one of the most significant drivers of growth and shareholder value has been intangible assets. However, the lack of reliable information about intangible assets, and the recent accounting collapse of intangible assets driven by lower market valuations and new FASB rules, has put the credibility of such assets at risk. Therefore, astute management should develop novel disclosure practices to reflect the economic evolution of intangible assets. Baruch Lev, an award-winning researcher and author of numerous studies on intangible assets in accounting, finance and economic journals, has proposed an information system that is now being adopted by numerous public companies.⁴ The goal of this information system is to extract and disclose strategic

information most relative to the enterprise value chain or business model. The value chain usually begins with the *discovery* of new ideas for products, services or processes. The next phase deals with the *technological feasibility* of the products or services under development. The third stage describes the successful *commercialization* of the economic value of the innovation process. Once this is done, companies can develop a useful and credible information scheme to communicate progress and evolution within these three broad intangible information categories. For example, investment in research and development can be classified by type and matched to the introduction of new products and services, as well as to the contribution of such products and services to revenues and margin. Workforce training can be matched to productivity increases, increases in revenue per employee, reduced employee turnover, and improved morale. Supplier and customer integration can be linked to lower cost of goods, reduced inventory levels, measurable customer satisfaction, innovation in products or services, and expansion in channels of distribution. This is not to say that companies should ignore such fundamental corporate finance principles as free cash flow, a sound balance sheet and conservative accounting practices. However, superior corporate growth over the last 25 years has generally been driven by people and ideas rather than bricks and mortar.

“QUIET PERIOD” DISCLOSURE PRACTICES

So as to avoid the possibility of market manipulation or stock promotion during an initial public offering or follow-on offering, the Securities and Exchange Commission has promulgated certain disclosure rules governing the type and style of disclosure for private and public companies during a capital formation process.⁵ These rules have been further complicated by advances in technology, which today include the use of the Internet and company web sites to transmit information through cyberspace, and the proliferation of electronic publications and market commentators.⁶ The quiet period generally starts at the time the issuer has

³ “Liquidity and the Cost of Capital,” Yakov Amihud and Haim Mendelsen, *Journal of Applied Corporate Finance*, 1998

⁴ “Intangibles: Management, Measurement and Reporting,” Baruch Lev, Brookings Institution Press, 2001

⁵ Securities & Exchange Commission Releases 5009, 4697 and 5180, Publication of Information Prior to and After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933

⁶ “The Internet and Securities Law with a Focus on an Initial Public Offering,” Equity Analytics, Ltd., 2001

reached an understanding with a broker/dealer who is to act as the managing underwriter prior to the filing of a Registration Statement, and continues through the period in which dealers must deliver a prospectus. During this quiet period, both public and private companies that have not developed a pattern of communication to trade and financial constituencies are prohibited from commencing such a program during this period. However, companies that have established a general policy of product and corporate communications can continue to follow the same general pattern and distribution of factual information as before. Among other types of activities, a company with an established communications pattern may:

1. Continue to advertise products and services
2. Continue to send out customary quarterly, annual and other periodic reports
3. Continue to make announcements to the press with respect to factual business and financial developments.
4. Answer telephone inquiries from shareholders, financial analysts and others.
5. Observe an open-door policy in responding to inquiries regarding factual matters from security analysts and other security holders.

However, the Securities and Exchange Commission has noted that companies must not issue forecasts, projections or predictions with respect to revenue, income or earnings per share, nor publish opinions concerning valuation. Therefore companies entering a quiet period should, at a minimum:

1. Review the company's existing communication program so as to eliminate potential "gun jumping" issues;
2. Reinforce the company's disclosure policy to all employees and appoint one principal spokesperson to manage external disclosure to trade and financial media;
3. Assign to a significant company officer the task of monitoring the marketplace for publicity on the company or its peers and for rumors;
4. Incorporate into the approval procedure securities counsel review of all information being disseminated to trade and investor audiences; and,
5. Eliminate forecasts from all communications, including projections with respect to market size, the company's targets for market

penetration, or new-product introductions and other forms of forecasts in applied valuations.

CONCLUSION

Significant growth opportunities do not always wait for favorable capital formation windows. In fact, often the greatest opportunities present themselves in market downturns when potential acquisition valuations decline and smaller competitors are squeezed out of the marketplace.

Capital is always available in both up and down markets—the question is its cost. In this paper we have suggested that management can lower the cost of capital in down markets by implementing best practices with respect to:

1. Advance planning to identify potential investors and implement management training regarding today's capital market issues;
2. Anticipate current corporate governance themes;
3. Reposition intangible assets to differentiate against peers; and,
4. Review the "quiet period" rules and regulations.



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