The Impact of Financing

The “Derivatization” of Micro-Cap Companies

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The IP Investment Bank

Seeing Value Others Do Not . . . Creating Value Others Can Not

Overview

- As the market for financing has become more sophisticated, so have the instruments used to finance these micro-cap companies

- Today unlike years past micro-cap companies are being financed by investors that function more as stock “distributors” and arbitrageurs than investors that have a vested interest in the business prospects of the company

- In our experience, most management teams are still relatively unaware to the impact of these various forms of equity financing

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How do we define "Derivatization"

- It is when the company finances with anything other than straight common stock

- Any of the below means the financing could become "derivatized"
  - Warrants
  - Convertible Debt or Preferred
  - Non-standard "anti-dilution" provisions on warrants
  - Rights to participate in future financings
  - Equity distribution agreements

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Why does “Derivatization” matter ?

- Misaligns the interests of the other shareholders and the investors with derivative rights
- Allows the derivative investor to make money even if the stock goes down
- Allows the derivative investor to “game” the stock for profit leading to another financing

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Why does “Derivatization” matter ? (Cont.)

- Impacts “true” cost of the capital being obtained or dilution to existing shareholders
- Impacts the company’s ability to source additional capital beyond the current financing…generally makes it more difficult
- Impacts stock price that is important to all your stakeholders, including stockholders, employees, customers, etc…
- Acts as a deterrent to quality investors that have a “fundamental” approach to investing

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The Data and Impact

- The top 10 funds organized to invest in PIPES return positive returns to their investors
- Yet the company’s stocks they invested in went down an average of 20% 12 months from the date of the investment (All PIPES done since Jan 1, 2005 with 12 month price data under $200MM in market cap)
- And this doesn’t include the usual decline in the stock that occurs before the transaction

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Post Financing Performance

- **The companies the top 10 PIPE funds invested in exhibited the following performance 12 months post offering during the same period**
  - 19% traded higher
  - 81% traded lower
  - Of the ones that traded lower 62% traded down by more than 50%
  - Of the ones that traded higher….they traded significantly higher…these tended to be companies that garnered significant retail investor interest in “hot” industries

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Why do these funds make money when your other shareholders don’t ?

- Warrants are valuable – there is now an active secondary market for these warrants as never before. Black - Scholes values these warrants higher than you would imagine.

- The other rights and conversion features have value in that the fund can hedge the investment by shorting the stock

- In addition, trading desks that makes a market in your stock can short the stock and sell a put option to these funds to avoid shorting restrictions

- With future purchase rights the fund can sell before the next financing knowing they replace the stock at a lower price

- Equity distribution agreements (Equity Lines) allow the funds to sell the stock higher and the more they drive the stock lower the more money they make when they buy the stock from the company

Conclusions and Recommendations for Companies Seeking Financing

- Examine and compare the cost of every financing by valuing the derivative rights
- Examine the cost of taking the seemingly “easy” money by trying to quantify the cost to other stakeholders that might not like watching their stock trade lower
- Examine the cost of potentially making future financings more difficult

Conclusions and Recommendations for Companies Seeking Financing (cont.)

- **The top PIPE funds should be the investors of last resort**
  - In general, it is a waste of time as they will almost always try to structure the investment in their favor with derivatives or other rights
  - We generally see the stocks decline more into the financing when they think they will be an investor
  - If your company needs additional financing, it will surely be more difficult as these funds are not nice to negotiate with if you are in trouble

Conclusions and Recommendations for Companies Seeking Financing (cont.)

- **Avoid "just in time" financings - <u>financing micro-cap companies is a process not an event</u>**

  - Take the time to carefully articulate your story
  - Dedicate the time to getting out to tell the story on a regular basis…not just for financings
  - Focus on investors that invest in companies as opposed to transactions
  - Work with an investment banker that doesn't focus on transactional investors

The Bottom Line

- **The old fashioned approach to financing works best**
  - Straight common stock without other rights
  - The larger common stock discount you take will most likely be cheaper in the long run
  - Take the time to allow good investors to complete appropriate due diligence and help them as much as possible
  - Registering the stock in advance significantly widens the universe of good investors that can buy in the offering

Getting out of “Derivatization”

- <u>Get out and tell your story to get your stock into good hands before your next financing</u>

- Be careful how much you confide in the derivative investors…they can trade against you

- Be very cautious of phone calls from investors or investment bankers wanting to know if you want to do another PIPE **<u>quickly</u>**

- If you have convertible debt or redeemable preferred it is usually better to pay it off with $ from real investors than negotiate with the derivative investors

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