THE PIPEs REPORT

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PIPE LINE

NEWS IN BRIEF

ISSUERS FACE RESTATEMENTS FROM 'DOWN ROUND' PROVISIONS

PIPE funds have been saddling issuers with millions of dollars in derivatives liabilities because of so-called "down round" provisions in structured deals, accountants say. The provisions require an issuer to reset the price of warrants and convertible securities if a secondary offering is priced lower.

For example, a company that issued a PIPE with warrants priced at $2 a share and then issued stock at $1, would have to reset the price of the warrants to the lower value and then carry the difference as a liability on its balance sheet.

The Financial Accounting Standards Board's Emerging Issues Task Force considers the down round resets as sweeteners and requires companies to carry them as liabilities rather than equity. "Companies are reporting millions of dollars in liabilities," said Neil Pinchuk, a partner at the accounting firm of Bernstein & Pinchuk LLP in New York. "Most of the PIPE contracts have these provisions. It hurts the issuers."

Fifty-one percent of PIPE deals included warrants last year, according to PrivateRaise, DealFlow Media's data service. That's down from 57% in 2008 and 60% in 2007.

Yongye International, a producer of fertilizer in China, is one company that was hurt by down round provisions, said Pinchuk. The company issued at least four PIPEs in the last two years raising $88.3 million, according to PrivateRaise, DealFlow Media's data service. This year, Yongye, a client of Bernstein & Pinchuk, has had to absorb liabilities of about $7 million on its books, he said.

"We dealt with this issue with a company we took public in March," said Greg Wahl, managing partner of Anton & Chia, an Irvine, Calif.-based accounting firm. "When you're getting warrants worth $3 for 50 cents it's a huge liability for the issuer. It is a very contentious issue."

Fund managers naturally want down round provisions to make sure their investments are protected. PIPE funds, however, are strangling the issuers, said Wahl.

"The problem is fund managers are locking these provisions in the contracts," Wahl said. "There's got to be more give and take."

PIPE funds should be taking a longer term view of their investments, but typically don't, he said. "It's pump and dump."

Down round provisions are a cost of doing business for companies issuing PIPEs, said Dennis Schall, a partner with the accounting firm Marcum LLP in New York. "PIPE transactions are expensive," he said. "Companies looking to do a PIPE are not profitable."

The controversy over down round protections has only started recently because of the financial crisis and recession, said Espen Robak, president of Pluris Valuations in New York.

"This has always been an issue but people are just discovering it now, because the economy is in the crapper," he said.

PIPE issuers will have to restate earnings because of down round protections, Robak said.

One of the reasons down round provisions are cropping up now is that they've been poorly understood by issuers and their accountants, he said.

Robak is skeptical that PIPE funds will be willing to negotiate with issuers to remove down round protections. "There may be some pushback from issuers, but I don't think it will happen very often," he said.

Going forward, PIPE funds will continue to insist on down round protections, Robak said. "It's a major value to investors."

One way of getting around the down round protections is to issue securities at a greater discount instead of warrants,

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Continued from front page

Columbus Avenue Consulting. "They're primarily dictated by volatility and the volatility assumptions funds use."

Accounting rules discourage valuing warrants at zero even though the existing values are spurious at best, Holman said.

Warrants are "particularly difficult to value" because they often convert into shares that aren't freely trading or where the underlying stock is not heavily traded, said Jeff Yager, a partner of the accounting firm McGladrey & Pullen. That can make valuations "extremely subjective," Yager said.

About 3.4 billion PIPE warrants from 585 deals will expire in the first half of this year, and 4.5 billion from 661 deals will expire in the second half, according to an estimate by SecondMarket, a provider of trading platforms for illiquid securities.

Many of those may be out of the money, however. Small cap stocks, as measured by the Russell 2000 Index, traded at higher levels from October 2005 through October 2008 than they do today. And warrants issued from 2004 through 2009 had an average premium of 115%, according to PrivateRaise, DealFlow Media's data service.

SecondMarket recently launched a warrant management program because so many warrants will be expiring soon.

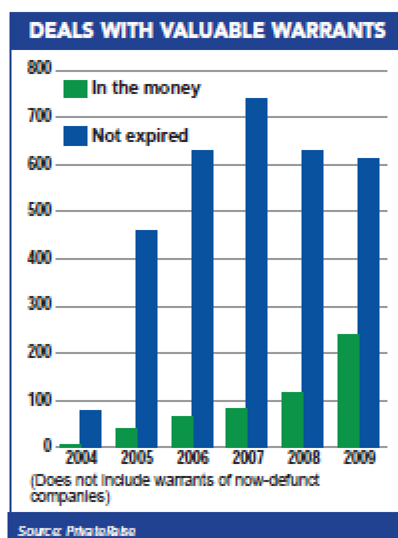
Matt Norton, SecondMarket's head of market intelligence, said many firms are unaware of the value of their warrants.

"A lot of folks we talk to are a little embarrassed" about not know how much their warrants are worth, he said. It can get messy "to a point where [funds] have hundreds of different warrant positions."

Hilary Bergman, president of the New York boutique brokerage **Pelion Securities**, has signed up to use SecondMarket's service. He believes investors with potentially profitable warrant portfolios might not get their full value, or any at all, because of lack of attention. Many smaller firms don't have a person dedicated to tracking the warrants, he said.

"Unless you've got an administrator managing warrants for you, you've got these warrants piling up in the drawer and you might have a significant corporate event happen and you'll be totally clueless," Bergman said. Many small investors holding warrants "probably had a lot of money that could have been exploited."

Bergman has warrants from many transactions from both personal capital investments made as chief operating officer of **Pali Capital**, a fund that invested in PIPEs, and from placing deals as a broker.



(Does not include warrants of now-defunct companies)

Source: PrivateRaise

The typical duration for a PIPE warrant is five years and the median warrant coverage has been 50%, consistently since 2004, PrivateRaise data shows. Meanwhile, the percentage of deals that contain warrants has decreased from a high of 65% in 2006 to 51% in 2009.

Most of the deals where warrants that were issued that are still in the money took place in 2009. At least 237 PIPEs were issued last year that included warrants that remain in the money. That's partly because of the run-up in the stock market last year and partly because relatively few of the warrants issued last year have expired.

The valuations of warrants are generally calculated using the Black-Scholes pricing model, the dominant method of valuing options, according to several valuation experts. Importantly, the more life a warrant has left, the more it is worth. Other factors that determine a warrant's worth include the stock price, strike price volatility, and the underlying liquidity.

Espen Robak, the president of Pluris Valuation Advisors in New York, says that if a warrant falls just slightly out of the money, it loses a tremendous amount of its value because of the risk, even if it has plenty of time before it expires. "These are highly illiquid instruments," Robak said.

FAS 157's Shadow Envelopes Warrants

Despite the difficulty valuing warrants, it is important to value them in a way that is compliant with the accounting rule FAS 157, according to Yager.

"Valuing warrants at zero would not be acceptable in my book," he said.

FAS 157, implemented by the Financial Accounting Standards Board, took effect in 2008. The rule encourages strict valuation of securities and assets using current comparables in similar markets.

When FAS 157 first took effect, many investors, including **Blackstone Group** founder Stephen Schwarzman, complained that it skewed valuations downward, especially during times when markets were illiquid. Critics argued that this caused huge write-downs and exacerbated the financial crisis.

Now, however, firms have accepted FAS 157 and are taking extra steps to comply.

Columbus's Holman, who has several PIPE funds as clients, said the accounting standard is leading some firms to sell warrants just to price them accurately.

"There's a heightened awareness of the FAS 157 because of what happened last year," Holman said. FAS 157 requires that firms price most securities at what others are willing to pay for them and not just what holders think they're worth. This frustrated some funds that had to go through an involved and costly process to value their securities.