THE DEALFLOW REPORT
NEWS, INFORMATION, AND ANALYSIS OF SMALL CAP EQUITY FINANCE
VOLUME II, NO. 13 REPORT.DEALFLOWMEDIA.COM APRIL 8, 2013

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- Small cap financings declined last quarter as investors avoided illiquid investments.
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SMALL CAP FINANCING MARKET DECLINES IN 1Q AS INVESTORS ESCHEW ILLIQUID INVESTMENTS

by Dan Lonkevich

The small cap and microcap equity financing market contracted more than expected in the first quarter as concern about the illiquidity of the smallest companies kept investors focused on large cap names that drove the broader market to record levels.

The number of PIPE transactions declined by 3.1%, while initial public offerings slid 10%. Venture capital deals declined 31%. Reverse mergers fell 44% and alternative public offerings declined by 81%. The IPO market for special purpose acquisition companies also fell 66.7%. Follow-on offerings, which were dominated by larger companies, were the only outlier, rising 14.7%.

The declines contrasted sharply to a larger than expected 10% rise in the Standard & Poor's 500 Index, which set a record close of 1569.19 on March 28, above its previous high of 1565.15 in October 2007.

"We're moving toward a market that's completely dominated by the large cap space," said Mark Wood, a partner with the law firm **Katten Muchin Rosenman** in Chicago, who advises small cap and microcap companies on capital raising. "The liquidity's there. The values are going up there more consistently. That's where the institutional investors are playing and they drive the market."

The small cap equity financing space is pretty tough right now and I don't see that changing," Wood said. "Things like the JOBS Act aren't helping. I hope not, but the glory days of the small cap equity financing market may be gone for good."

Wood cited a host of reasons that contributed to the absence of liquidity in the small cap equity financing market: the decimalization of stock prices, the absence of small cap investment banks, the lack of profitability in underwriting.

The Jumpstart Our Business Startups Act was meant to solve some of these problems by

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SEC ISSUES 'NO-ACTION' LETTERS TO EQUITY CROWDFUNDERS ANGELLIST, FUNDERSCLUB

by Bill Meagher

Securities and Exchange Commission officials have sent "no-action" letters to equity crowdfunding platforms **AngelList** and **FundersClub** indicating that SEC staff doesn't plan to prosecute either company under the law that bans securities offerings by those who aren't licensed as broker-dealers.

The letters, dated March 26, may give market players more confidence in the legality in the nascent industry of equity crowdfunding, where stock in private companies is sold through online platforms.

Neither AngelList nor FundersClub are registered as broker-dealers, although

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making it easier for companies to go public by relaxing disclosure requirements, ending the ban on general solicitation and advertising of private placements and even allowing crowdfunding. The Securities and Exchange Commission, however, has been slow to finish the rule making that many observers are hoping will resuscitate the market.

Wishful Thinking?

"It's a cycle and there's plenty of liquidity," said John Borer, the head of investment banking at **The Benchmark Co.** in New York. "It's just that institutional investors think there's more money to be made right now in larger cap companies."

Small to medium sized companies aren't getting many deals done, Borer said.

"I don't remember a time when we had this few deals getting done," he said. "I've been in this business for more than 15 years and usually when it feels this bad it means things are about to get better."

Borer previously worked at Rodman & Renshaw, the small cap investment bank that declared bankruptcy last September after a failed attempt to transform into a financial technology company with an electronic platform for executing private placements.

In the first quarter, Benchmark helped arrange a $6 million confidentially marketed public offering of common stock for **Chembio Diagnostics (CEMI)**, a $5.5 million registered direct offering of common stock for **Novelos Therapeutics (NVLT)**, and a $1.77 million convertible debt placement for **CopyTele Inc. (COPY)**.

"It's a tale of two markets," said David Weild, chairman and chief executive officer of **Weild & Co.**, an investment banking and advisory firm. "You've got large cap companies setting records and performing well and the bottom of the market grounding to a halt."

During the first quarter, Weild & Co. acquired some of the investment banking assets of ThinkEquity out of bankruptcy. At one time, San Francisco-based ThinkEquity had been an active PIPE placement agent and underwriter of IPOs.

"It is precisely because there are no more incentives being committed to the small cap and microcap market," Weild said. "This is a marketing and distribution problem and it's a progressive disease. It doesn't mean you won't get cyclical upturns, but the new cyclical upturns may start to look lower than the old cyclical downturns."

Weild noted that many provisions of the JOBS Act – ending the ban on general solicitation and advertising, easing restrictions on offerings under Regulation A of the Securities Act, allowing companies to experiment with tick sizes larger than a penny and crowdfunding – have not been implemented yet.

"We need to get on with it and set about repairing capital formation for small cap and microcap companies," he said. "It's not going to be an overnight fix."

To be sure, not everyone believes that the pullback in the small cap and microcap equity finance market is unwarranted.

"The market is smarter than it's been in the past," said Bryant Riley, chairman of boutique investment banking, advisory and research firm **B. Riley & Co.** in Los Angeles. "PIPEs, reverse mergers and SPACs are all highly speculative. Investors are being more careful. I think it's good. I hope we don't go through another fad like reverse mergers in China, clean tech or the dot-com bubble. Wall Street makes a lot of money when that happens, but it's better for investors when there's more caution."

PIPEs

PIPE activity declined in the first quarter to 249 deals from 257 deals in the year-ago period. The 249 deals were the fewest in a first quarter since the same period in 2009. Then, during the height of the financial crisis, only 166 PIPEs were issued.

Fewer companies raised more money in the latest quarter, $9.63 billion compared with $8.37 billion a year earlier. The larger dollar volumes reflected an increase in the average dollar amount raised: $39.8 million compared with $32.6 million.

It also reflected an increase in the size of the companies issuing PIPEs. Forty PIPE issuers had market values greater than $500 million and accounted for $6.94 billion of the total dollars raised.

The number of unregistered PIPEs fell to 143 worth $2.17 billion from 168 worth $4.88 billion, a year ago. Registered deals increased to 102 worth $7.46 billion from 89 worth $3.5 billion.

The dollar volume figures also were exaggerated by the relatively large number of at-the-market offerings, which increased the total but seldom if ever are fully taken down. The first quarter included 40 ATMs pledging to raise as much as $5.43 billion, compared with 27 committing $1.45 billion, a year earlier.

Indeed, eight of the 10 largest PIPEs were ATM deals including a $750 million deal for **Ventas Inc. (VTR)**, and $500 million ATMs for **Westar Energy (WR)**, **American Campus Communities (ACC)** and **El Paso Pipeline Partners (EPB)**.

The largest non-ATM PIPEs were by **Cheniere Energy Partners (CQP)** with a $365 million common stock placement, and **ARIAD Pharmaceuticals (ARIA)** with a $323.2 million common stock placement.

Of the 249 first-quarter PIPEs, 133 involved the issuance of common stock, 25 the issuance of convertible preferred stock, and only 23 the issuance of convertible debt. In comparison, the first quarter of 2012 included 142 common stock deals, 21 convertible preferred deals, and 25 convertible debt deals.

As usual, health care issuers dominated the PIPE market with 85 deals worth $1.83 billion, followed by technology, telecom and media issuers with 39 deals worth $1.17 billion.

Hedge funds accounted for almost half of the total PIPE investments in the first quarter with 123 investments worth $461.7 million, followed by private equity and venture capital with 32 investments worth $605.2 million. Corporate insiders and affiliates accounted for 30 investments worth $50.1 million.

The top 10 PIPE investors were led by **Sabby Management**, **Hudson Bay Capital Management** and **Downsview Capital**, which each had six investments worth $8.85 million, $5.62 million and $3.88 million respectively.

The placement agent rankings were led by **RBC Capital Markets**, which arranged 12 deals including six ATMs and six PIPEs worth $2.02 billion. ATM-specialist **Cantor Fitzgerald** and more traditional microcap

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PIPE specialist **Dawson James Securities** tied for second with 11 deals each. Dawson James is led by Michael Vasinkevich, the former vice chairman of the defunct Rodman & Renshaw.

New York-based Cantor Fitzgerald arranged 10 ATMs and one PIPE to raise as much as $673 million. In contrast, Dawson James, in Boca Raton, Fla., arranged 11 PIPEs worth $70.9 million.

Excluding the large ATM deals to large energy partnerships and real estate investment trusts, "the deals getting done were minute," Benchmark's Borer said. And even on the smallest deals there were often two or three banks helping to arrange them, he said. Even on ATMs, deals often have three or four banks on them.

Investment banks that used to specialize in PIPEs have had to change their focus, Borer said.

"We're focusing on M&A advisory and private company financings," he said. "There's a need to fill and it's much less competitive."

Competition for an ever shrinking piece of the small cap equity financing market accelerated the demise of Rodman, ThinkEquity and other investment banks in recent years.

IPOs

IPO activity also cooled off in the first quarter with only 35 deals raising $8.8 billion, compared with 39 deals worth $5.8 billion, a year ago, according to Dealogic.

The number of companies that elected to go public as emerging growth companies under the JOBS Act rose to 28 that raised $3.6 billion. That was up from the 24 EGCs that raised $4.1 billion in the fourth quarter. The JOBS Act, which created the new EGC category, was signed into law April 5, 2012.

The top 10 first quarter IPOs were by **Zoetis Inc. (ZTS)**, which raised $2.24 billion; **CVR Refining (CVRR)**, which raised $600 million; **Pinnacle Foods (PF)**, which raised $580 million; **Norwegian Cruise Line (NCLH)**, which raised $447 million; **West Corp. (WSTC)**, which raised $426 million; **Artisan Partners Asset Management (APAM)**, which raised $332 million; **CyrusOne Inc. (CONE)**, which raised $314 million; **Aviv REIT (AVIV)**, which raised $264 million; **SunCoke Energy Partners (SXCP)**, which raised $257 million; and **Boise Cascade Co. (BCC)**, which raised $247 million.

The IPO market continues to be "moribund" for small cap and microcap companies with IPOs under $100 million, said Borer.

Steve Maletzky, director of equity capital markets at **William Blair & Co.** in Chicago, blamed the decline in IPOs "on poor sentiment at the end of 2012," which is starting to diminish.

"It's going to pick up and we're already seeing the IPO backlog trending higher," he said. "Issuers and selling shareholders were caught off guard by the strong market performance to start the year. Those that pushed to get deals out experienced good price performance.

"Liquidity concerns are here to stay for the time being in the microcap space," Maletzky said. "Investors have a clear alternative to illiquid microcaps with larger more liquid small and mid-cap companies that are performing well. Investors do not want capital tied up in illiquid microcap investments in a market where they can get outsized returns in larger, more stable opportunities."

As the public markets continue to improve and valuations increase, private equity and venture capital firms "will be enticed back to the IPO market seeking exits for their earlier-stage portfolio companies," he said.

"We will see more smaller IPOs but I do not see a significant increase in IPOs below $50 million," Maletzky said. "We are consistently hearing that post-deal liquidity and float are important to investors."

IPOs of less than $50 million have a limited buyer universe and most institutional investors need larger deals to put meaningful dollars to work, he said.

Part of the reason for the lower number of IPOs may have to do with continued "repercussions from Facebook's failed IPO" last May, said Mitchell Littman, a partner with the law firm of **Littman Krooks** in New York. "People are saying if that never popped nothing else will. The Facebook effect is still there and holding things back."

Follow-ons

Follow-on offerings increased to 187 deals worth $48.7 billion from 163 worth $43.8 billion, according to Dealogic. Of those follow-ons, 114 were accelerated book-builds with volume totaling $27.2 billion.

"Follow-on activity is up because valuations are up and companies are able to access the capital markets quickly off an available shelf registration," William Blair's Maletzky said. "We're seeing IPO-like oversubscriptions in follow-ons. They're performing very well."

The follow-on market is performing so well, however, that one banker suggested it might be getting a little ahead of itself.

"People are chasing yield in the secondary market," B. Riley's Riley said. Wall Street "is selling these yield plays because retail investors would rather have yield than equity. It's getting a little crazy. Everybody's refinancing their debt. It feels a little frothy. But it's a way higher class of problem than spinning reverse mergers in China."

During the quarter, B. Riley helped arranged a $112.5 million public offering for real estate investment company **Kennedy-Wilson Holdings (KW)** and a $77.2 million offering of American depository shares for Chinese semiconductor maker **RDA Microelectronics (RDA)**.

Venture Capital

Venture capital activity also cooled off in the first quarter with private companies raising only $6.36 billion from 753 venture equity deals, according to data from PitchBook. In last year's first quarter, 1,095 venture capital equity deals raised $7.95 billion. The results also were lower than in the fourth quarter when 811 deals raised $6.37 billion.

Barry Kramer, a partner with the law firm of **Fenwick & West** in Menlo Park, Calif., said the decline in venture capital deals reflects the trend over the last two years of limited partners being less enamored of venture capital in general.

"Venture capital is a funnel," he said. "What you have at the top is limited partners putting money into venture capital funds and at the bottom you have venture capital

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funds putting money into companies."

For much of the past two years, the money venture funds have been putting into companies has exceeded the amount coming in from LPs, he said.

"It's not like there aren't good entrepreneurial companies out there looking for money," Kramer said.

The venture capital spigot won't open up until the IPO market and merger and acquisition activity start to pick up again, Kramer said.

"Last month, we did three venture-backed tech IPOs in one week," Kramer said, citing deals for **Silver Spring Networks (SSNI)**, **Model N (MODN)** and **Marin Software (MRIN)**. "If the IPO market for tech companies starts to pick up and big tech companies start making acquisitions again it will help venture capital sentiment."

SPACs

Only one special purpose acquisition company completed an IPO in the first quarter. **HF2 Financial Management (HTWU)** raised $153 million in its March 27 IPO and intends to purchase a financial services business. That compares with three SPAC IPOs in the first quarter of 2012.

HF2 is only the second SPAC to go public with a financial structure that doesn't include stock-purchase warrants. **Hyde Park Acquisition Corp. II (HPAC)** became the first warrantless SPAC when it raised $75 million last August. The warrantless structure can make a SPAC more attractive to acquisition candidates, since its stock won't be diluted as warrants are exercised.

Only one SPAC, **Capitol Acquisition Corp. II (CLAQU)**, filed to go public in the first quarter. The SPAC, which is sponsored by **Venturehouse Group**, filed its S-1 on March 26 and is planning a $150 million IPO, which will be underwritten by **Citigroup** and **Deutsche Bank Securities**.

Another SPAC, **Chardan Metropol Acquisition Corp.**, sponsored by **Chardan Capital Markets** and **The Metropol Group of Companies**, has been in registration since April 2012. Chardan is underwriting.

The decline in SPACs reflects investor concern about their performance after they make their first business acquisition, said Kerry Propper, the chief executive officer of Chardan Capital.

"Some of the deals announced I think are going to perform well, and as you see deals getting done and performing well it will re-energize the entrepreneurs who sponsor SPACs," he said.

Propper said he has decided to postpone the Chardan Metropol IPO until another Russian-focused SPAC, **CIS Acquisition (CISAA)**, completes its first acquisition and he can see how the market reacts to it. CIS Acquisition raised $40 million in its initial offering in December and has up to two years to complete its first business combination.

During the quarter, a number of SPACs announced business combinations.

Blue Wolf Mongolia Holdings Corp. (MNGL), a SPAC that raised $70 million in an IPO in July 2011, agreed to merge with **Li3 Energy (LIEG)**, a South American lithium miner.

SCG Financial Acquisition Corp. (SCGQ) on March 4 said it will merge with **Symon Communications**, a provider of digital signage, in a $45 million deal. In February, Chicago-based SCG said it would pay about $27.5 million in stock and assumed debt to merge with **RMG Networks**, which provides digital signage and advertising in airplanes.

Prime Acquisition Corp. (PACQ) agreed to buy **BHN LLC**, an Italian financial advisory firm with a portfolio of real estate in southern Europe, for about $200 million in stock and assumed debt.

ROI Acquisition Corp. (ROIQ) agreed to merge with **EveryWare Global**, the maker of Oneida and Anchor Hocking brand dishes and flatware, in a cash and stock deal valued at $420 million.

Selway Capital Acquisition Corp. (SWCA) agreed to pay at least $62 million in stock and debt to acquire **Healthcare Corp. of America**, the holding company for a pharmacy benefit manager.

China VantagePoint Acquisition Co. (CHVPF) called off its $20 million acquisition of **Black Diamond Holdings** and said it will return cash to shareholders.

Reverse Mergers

Reverse merger activity was off 44% in the first quarter with the number of deals dropping to 25 from 45, a year ago.

The decrease in reverse mergers "is attributable to an increase in self-filings, the restrictive nature of the seasoning regulations and the bad press and the bad feelings around some of the Chinese reverse mergers," said David Feldman, a partner with the law firm **Richardson & Patel**.

While it was clear that reverse mergers were down, there are no shortage of companies that want to go public, Feldman said.

"There is still interest in reverse mergers, but the timing has to be right," he said. "We are working on several reverse mergers right now."

The wave of Chinese frauds has taken its toll on the market. Just one China-based company, **Xunna Information Technology (XUNA)**, completed a reverse merger in the first quarter. This compares to three deals a year ago and two Chinese reverse mergers in the fourth quarter.

APOs also were down year-over-year in the first quarter. Four reverse mergers were completed with financing totaling $15.76 million. Those numbers represented a decline of almost 81% from 21 transactions worth $41 million, a year ago. The average deal size doubled to $3.94 million in the latest quarter from $1.97 million a year ago.

Forty percent of the reverse mergers completed were by foreign companies. Companies from Germany, Brazil, Mexico, China, the U.K., and Canada closed reverse mergers in the first quarter. And 30% of those deals included PIPE financing.

"I would guess that a need for financing in a timely manner is what drove the foreign deals," Feldman said. "For foreign companies, it is easier for them to do a reverse merger than a self-filing. We have done a couple of deals with Brazilian companies and we are working on something with a German company now."

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