

Alternative capital markets for alternative energy companies

The Alternative Investment Market (AIM) of the London Stock Exchange affords smaller cap companies access to the capital markets through a more streamlined process than an IPO in the United States or even the primary trading market (“Official List”) of the London Stock Exchange.

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A recent survey by Deloitte & Touche LLP showed a strong majority of US oil and gas investors (81%) support so-called “green” energy investments. Even so, many of the energy companies looking to embrace renewable or alternative sources of energy may be stymied in their efforts as they seek a needed influx of capital.

The restrictions of Sarbanes-Oxley and other corporate governance rules have made public offerings prohibitively expensive for newer companies – the same companies who are likely to be the leading edge in alternative energy technology and development.

Thankfully for the sake of innovation, these companies are discovering they have other options.

Over the past few years, we have seen a number of our clients access the public markets through non-traditional routes. As the capital markets continue to globalize, US companies increasingly have the opportunity to locate capital abroad.

As with any cutting-edge technology, US-based alternative energy companies currently enjoy heightened interest on the global stage. The world watches as many US companies invent new ways to leverage wind,

solar radiation, and other non-fossil sources into fuel that could change the dynamics of global supply and demand for energy.

Many of our firm’s clients are working toward that goal, including one that is using cow manure to fuel an ethanol refinery. That kind of innovation will make great strides as the US tries to wean itself off foreign oil, but only if the companies find access to a solid base of investors.

As these companies face the costs of entry into the investment markets, though, they may find a need to look for options to the US markets, such as the New York Stock Exchange or Nasdaq. In particular, the London, Copenhagen, and Oslo stock exchanges afford international companies an alternative to going public in the United States.

This is particularly true of the Alternative Investment Market (AIM) of the London Stock Exchange. AIM affords smaller cap companies access to the capital markets through a more streamlined process than an IPO in the United States (or even the primary trading market, or the “Official List,” of the London Stock Exchange).

The inability of smaller companies to interest investment bankers and analysts as well as the limited liquidity of small cap companies has hurt or destroyed the US public markets for small companies. The passage of the Sarbanes-Oxley Act of 2002 and other corporate

governance requirements can make it prohibitively expensive to be a small public company in the US. Accordingly, smaller companies are looking abroad for capital.

Ten to 15 years ago, those companies would have gone public, raised \$10 million to 30 million and listed on Nasdaq. Now, many of them are looking seriously at deals in London. The AIM, in particular, and the international markets, in general, represent a significant funding source, especially for alternative energy innovators.

Here is a quick overview as to why some US companies are choosing to pursue AIM offerings:

Regulatory environment. Issuers who go public on AIM are sponsored by a Nominated Advisor (a “Nomad”) who is responsible, not only for maintaining the profile of the listed security, but also vouching for the company’s good name. Their diligence in an AIM offering is extensive because their reputation is on the line. They confirm that the company is suitable to list on AIM, and advise on the content of the offering materials. There is no regulatory body similar to the SEC passing upon AIM admissions. AIM-listed companies report financial information semi-annually (as opposed to quarterly in the US), the rules and regulations of the market are generally considerably

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less burdensome, and the overall cost of compliance is correspondingly less. In addition, a properly structured AIM listing relieves a US issuer from the compliance burdens and costs associated with Sarbanes-Oxley.

Expenses. Nomad and broker fees tend to be a bit less in the UK, compared to traditional investment banking fees in the US. Also, there are lower fees associated with audits and financial statement preparation (primarily due to the regulatory environment). Other professional fees tend to be commensurate with US offerings. However, corporate governance and reporting requirements are much lower. The average AIM offering for companies outside the UK is between \$20 million to \$80 million, although this number is increasing, and offerings in excess of \$100 million are not uncommon.

Sophisticated investors. The institutional investors active on AIM form a relatively small group. Those investors get to know the company, its management and business model. Typically, they also invest for the long term. With relatively few “retail” shareholders, a company’s securities typically are held by 15 to 40 institutional investors who comprise a sophisticated shareholder base. Many AIM-listed companies raise additional capital from their existing shareholder base over time. Generally, these investors tend to be significantly less demanding than US private equity, hedge, or VC funds.

Process. The IPO process is familiar to US issuers. Just like any offering in the US, there is an offering document, containing background and financial information on the issuer. The diligence process tends to be a bit more exhaustive than a US offering, but the Nomad and broker are taking a calculated risk in bringing any issuer to market. As such, they are very careful in preparing the

offering document and conducting appropriate diligence.

Exit strategy. As opposed to US private equity and fund deals, AIM recognizes and approves of VCs using an offering to sell some or all of their venture stock. This is a better exit strategy for the VCs and fund participants than exists in other early stage companies.

Here are a few characteristics of successful AIM offerings:

International/global focus. Foreign issuers, particularly US companies, face the initial question, “why London?” In the early years of the AIM Market (1995-2004), relatively few foreign issuers came to AIM, and many bankers and brokers encountered a bias against foreign companies listing on AIM. Since the beginning of 2005, the market opened to issues from across the globe, and now sees its future expansion primarily among non-UK issuers. For all the reasons listed above, AIM is attractive to US issuers; however, currently it is important that a US issuer demonstrates an international or global market (or market potential) for its products and services, although this is not an absolute requirement. By establishing more than a local reach, an AIM issuer not only presents a large potential market, it shows that it is an international player worthy of being traded in one of the world’s financial capitals. Typically, alternative energy companies can easily demonstrate an international angle, given the global need for their products and technology. However, a US company with a solely US-base of clients/customers/markets will raise questions in the AIM investing community. The deal may still get done if the company is strong enough, but it will be a somewhat more difficult offering.

Show up in London. It is important for a US issuer to commit to several meetings per year with the London

financial community. Some AIM companies even elect an independent director from the UK. At a minimum, a couple of annual trips to the UK by the CEO and the CFO will support interest in the stock.

\$20 million to \$100 million – the sweet spot. Deal size is important – although there are many small IPOs (i.e. \$5 million or less) and an increasing number of large issues (i.e. over \$300 million), most reputable brokers and Nomads look for deals in this mid-range. Too small, and the deal won’t justify the fees; too large, and the exchange calls to remind you that AIM is intended for small and mid-cap issuers.

A good story. Just like any US offering, investors are looking for the right story. In 2005, it was primarily natural resources. Today, technology, life science, communications and entertainment/gaming are also selling particularly well. However, AIM now covers all business sectors, and companies across the full range are flocking to the market. As always, a good management team is key.

Here are some of the mechanics of an AIM offering:

Nomads. As described above, the Nomad occupies a special financial advisory capacity with the issuer. They sponsor the company and vouch for its suitability for trading on the Exchange. They also prepare the offering document (which has the look and feel of a prospectus or offering memorandum). Any gaps in due diligence threaten the reputation of the Nomad; accordingly, their tolerance for risk is low. The Nomad relationship is long-lived. Once a company enters into a Service Agreement with their Nomad, they pay an annual retainer for their AIM sponsorship, and, while it is possible to change Nomads, it is not regularly done.

Brokers. Most Nomads also act as brokers for their clients, but an issuer may have a different Nomad and broker. As with US investment banks, brokers raise funds for the company and make a market in the listed security. They also typically provide analyst coverage. Some issuers find it advantageous to keep the Nomad and broker functions separate. We suspect that fees may ultimately determine whether an issuer splits this function.

Analyst coverage. The London investment houses create sophisticated research and reasonably comprehensive industry coverage. Of course, some houses have relative strengths, and independent coverage is available for an annual fee. For larger issues, the coverage will be better. For AIM deals, the Chinese Wall between broker and analyst is strictly observed.

Costs. Typical expenses for an AIM listing are somewhat less than an IPO in the US. Nomad and broking fees range from 3% to 5%. Accounting fees are comparable to US fees, and legal fees, while more expensive per hour in the UK, are comparable to US offerings.

What hurdles do US companies face?

UK Holdco vs. US Issuer. The UK's CREST system, which is the paperless, electronic means by which stocks trade on AIM, cannot easily accommodate legended stock. Because most US issuers rely upon Regulation S as the exemption to issue the securities outside the US, all US company stock contains a restrictive legend preventing its sale to a US person. As such, many Nomads advise US issuers to form a UK Plc as a holding company above the US subsidiaries or assets. However, for reasons ranging from tax implications to simple matters of national pride, most US issuers choose to remain domiciled in Delaware, Texas, or their states of incorporation.

Liquidity. We would describe the AIM financial community as relatively small, sophisticated and "clubby." Investors know the good Nomads and brokers; their reputation is everything; and they tend to take a longer-term view than US investment houses. The trading volume in AIM listed stocks is correspondingly low. The investment market is comprised of typically larger, institutional investors, who take the time to understand the company's business and tend to be more forgiving of an off quarter. However, given the thinner trading volumes (especially in the smaller market caps), liquidity is somewhat low.

Lock ups. As a corollary to thinner liquidity, Nomads usually seek one-year lock ups from all levels of management, directors, and holders of 5% or more of the capital stock. This is a longer period and goes deeper into the company's shareholder base than a comparable US offering.

Valuation. Pie-in-the-sky valuations will not be available for offerings in the UK. The investors operate in a sophisticated environment and will pay only for results. That being said, all of our clients doing AIM and pre-AIM offerings have been pleased with the valuations they have received. However, the Nomads feel it necessary to warn Americans that 20 times EBITDA will not fly as a method for valuing an AIM company pre-money.

UK style verification. Just as our clients find the diligence process painful in a US offering, the same holds true in London; perhaps more so. Because the Nomad's name and reputation are on the line, they require independent verification of all assertions made in the offering document, and UK securities laws support this exacting process. In the end, however, the issuer is left with an offering document that has been fully vetted, thereby limiting the risks to the company, its management, and directors.

Accounting. US issuers may prepare their admission documents using UK or US GAAP and continue reporting in either UK or US GAAP. The long-form and short-form financial reports required by an AIM listing may require an issuer to report financial information a bit differently. However, such reporting is easily adapted from US GAAP.

In summation, London is open for business and is a viable option for many US small alternative energy firms. Our clients have found AIM to be a welcome alternative to the US capital markets.

The combination of a sophisticated shareholder base in a reasonable regulatory environment represents an excellent source of capital for small and mid-cap companies, especially alternative energy companies given the heightened global interest at this time in alternative energy sources. Moreover, we have found the London Stock Exchange to be an enthusiastic and powerful ally in bringing our clients to market. **OGFJ**

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Visionaries
are usually mocked.

In 1970,
we set out to build
a new kind of
law firm.
One that challenges
how law firms
operate,
breaks away
from traditional
industry wisdom,
and places the client
at the heart of
the firm.
Pretty revolutionary
stuff.