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All of the discussion has focused on the tightness of the credit markets, but the credit environment is also having an impact on the equity markets.

The trickle down

Impact on equity in a tight credit market

There has been no small amount of discussion, and hand wringing, related to the current conditions in the credit markets. Not as much has been said about equity markets in our industry. There is certainly a trickle-down effect in the equity markets, given that lower loan-to-value underwriting standards lead to higher equity requirements.

I recently asked our resident securities lawyer, Andy Hall, about his thoughts on the current equity markets. Being a "glass is always at least half full" person, Andy provided some interesting insights into what is happening in the equity markets. Following is a summary of some of his observations:

1. The tight credit markets have increased overall cost of capital. Operators and promoters naturally love debt—at least reasonably priced debt. The higher the leverage, the lower the cost of capital. If Andy's optimism has any tarnish, it would be that operators and promoters are finding it harder to put together capital structures that provide expected equity returns for investors and the payoff the operators and promoters desire. This is particularly true in M&A activity, where sellers have maintained high prices. If a seller wants 6x EBITDA, the deals now require 2x EBITDA in equity to accompany 3x in senior debt and 1x in mezzanine. Before the credit crunch, buyers could often find 5x in debt; hard to do today. In our industry, where margins are rarely exceptional, operators and promoters are paying more for the capital required to get deals done. With the higher cost of capital and lower returns for operators, this results in fewer transactions getting done.

2. How then is the glass half full? There remains a lot of equity available and the equity providers (funds and angels alike) have moderated their target returns a bit. Where equity providers used to insist on returns in the 25 to 30 percent plus range, we are seeing some softening to less than 25 percent. In addition, new funds have entered the marketplace, such as CapitalSpring, which is making equity available to an underserved portion of the industry: the smaller operator buying one to three units. We have also seen "old school" private equity enter the market, which brings needed capital, but also creates interesting challenges for us as we tend to "educate" these providers and their counsel on what is customary and reasonable in the market.

3. Proposed new SEC private offering rules will make private equity markets more efficient. Probably the main reason Andy is optimistic in the current environment is that the SEC last year proposed new rules related to private offerings that will liberalize Regulation D and make private equity markets more efficient:

- The new rules would create a new exemption available to issuers if sales are made exclusively to "large accredited investors," a new category of investors that includes entities with $10 million in investments and individuals with either $2.5 million in investments (a new measurement standard) or $400,000 in annual income/$600,000 with the investor's spouse.
- The new exemption permits limited tombstone advertising (a departure from the general solicitation prohibitions of Regulation D) and subjects the issuer to minimal, if any, state regulation.
- The new rules would revise the definition of "accredited investor" to broaden the pool of potential investors. In particular, they

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add a new measurement standard for "investments owned" which is more clearly defined than net worth.

• The new rules would shorten the integration safe harbor for Regulation D offerings from six months to 90 days. As a result, an issuer would face shorter "dark periods" in fund raising advisable to avoid violations in one offering from poisoning a second offering.

• The new rules would require Form Ds, the form required to be filed with the SEC and states in which the issuer sells securities, to be filed via the SEC's EDGAR electronic filing system, which will eliminate duplicative and time-consuming paper filing with the SEC and state regulators.

It is unclear when the SEC will revise the proposed rules or issue new rules. There has been substantial commentary, which the SEC is digesting. Most practitioners and capital market participants feel the new rules do not go far enough. For example, practitioners question why the new exemption should have any limitation on general solicitations (indiscriminate communications with an unknown group of investors—think advertising) when the exemption is available if sales determine the availability of the exemption, and not offers like other rules in Regulation D. Academics and state regulators, on the other hand, remain concerned that even some large accredited investors, for example retirees who have all of their investments in retirement accounts, lack the sophistication to evaluate the merits of an investment and cannot afford the risks. Andy is hopeful that the practitioners' views will prevail, as the stated goal of the proposed rules is to make private capital markets more efficient.

He is very excited about the following opportunities the new rules would present:

• Access to a larger investor pool. With Rule 507 Offerings and the permitted tombstone advertising, issuers have the opportunity to attract a deeper and broader pool of potential investors without the need to use finders and placement agents. No longer tied to the common exclusivity of a placement agent or to a limited number of potential investors known to the issuer and its agents, issuers may be able to be more aggressive in pricing the offered securities. A larger pool of potential investors creates a more efficient capital market. The safe harbor is available for tombstone publication on the internet.

• Ability to engage in more offerings. The shortened dark periods should allow for more efficient capital formation, as issuers relying on Regulation D exemptions will be able to engage in more frequent offerings. Issuers will be able to consider shorter time horizons for the uses of funds, particularly related to working capital needs.

• Offerings should be less expensive. The elimination of paper filing for Form Ds will result in overall cost savings for the issuer, in terms of lower fees to law firms or other outside agencies and in terms of lower internal costs and lost opportunity costs. The limited advertising, to the extent it replaces or lowers fees charged by finders and placement agents, will result in lower transaction costs. In addition, the larger pool of prospective investors in Rule 507 Offerings could have the effect of increasing the price per unit of the securities offered.

4. Finders—use with caution. One area the proposed rules did not address is the use of "Finders," or unregistered broker/dealers, in connection with private placements. This has become a particularly acute issue since last summer, when the SEC declined to issue a no action letter to a finder requesting no action from the SEC if it assisted companies in raising private equity or if it facilitated stock-based M&A transactions. The letter (Hallmark Capital Corporation, June 11, 2007) appeared to reverse prior SEC views on the use of finders. Basically, finders who take a success fee or "cut of the deal" risk (a) enforcement by the SEC for failure to register as a broker/dealer and (b) unenforceable engagement agreements under Section 29 of the Exchange Act of 1934. The risk for the issuers is that the use of an unregistered finder can result in a deemed general solicitation and loss of exemption. The risk for issuers is lower than the risk for finders, but issuers need to proceed with caution.

Many practitioners and the ABA have been lobbying for "broker/dealer lite" registration for finders who only act in private placements, eliminating burdensome net capital requirements and other inapplicable registration requirements and having lower NASD testing requirements. However, the SEC has stated that it does not view this as much of a problem. It is an area we will be keeping our eye on.

It is clear the equity market in the franchise world is here to stay. There still is significant interest in investing in our space. It is clear the SEC and other regulatory bodies are trying to assist in making equity more available. Please keep these thoughts in mind as you are planning your growth plans for 2008-2009. FT

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