Market Trends 2017/18: Follow-On Offerings

A Lexis Practice Advisor® Practice Note by
Michael Blankenship, Eric Johnson and Enrique Santiago, Locke Lord LLP

Michael Blankenship

Eric Johnson

OVERVIEW

Initial public offerings (IPOs) have long been viewed as the most significant event for a business. An IPO marks the first time a company offers shares of its equity securities to the general public. Entrepreneurs and investors typically use their IPO to gain access to broad capital markets needed to expand the business and to obtain liquidity for entrepreneurs and investors. With that said, although IPOs represent the ultimate goal for entrepreneurs, for many companies, getting to the IPO is only the beginning.

Following an IPO, many companies decide to offer additional equity securities to the public. These offerings are referred to as follow-on offerings because they follow the IPO. This article discusses the market trends for follow-on offerings in 2017 as well as deal structure, process, and outlook for 2018. Like IPOs, follow-on offerings are governed by the federal securities laws and require registration with the U.S. Securities and Exchange Commission (SEC) by filing Form S-1 or Form S-3 for U.S. companies, or Form F-1 or Form F-3 for foreign private issuers. For further information on follow-on offerings, see Follow-On Offerings Resource Kit, Registered Securities Offerings Post-IPO, and Top 10 Practice Tips: Follow-on Offerings.

According to a recent study, a total of 737 follow-ons raised $142.3 billion in 2017. This marked a 21% increase in the number of follow-on offerings (up from 609 follow-on offerings in 2016), but a 3% value decrease in the amount raised (down from $146.7 billion in 2016). See the 2017 Annual U.S. Capital Markets Watch Report from PricewaterhouseCoopers (the PWC Report), which is available at https://www.pwc.com/us/en/deals/publications/us-capital-markets-watch.html.

DEAL STRUCTURE AND PROCESS

Follow-on offerings are divided into two different types of offerings:

- Primary offerings, which are offerings of securities directly by the company
- Secondary offerings, which are offerings by stockholders or other securityholders of the company

Companies conduct primary offerings in order to raise additional capital to fund new projects, acquisitions, or general operations. Secondary offerings, on the other hand, do not bring in any proceeds for the company. A company usually conducts a secondary offering because it has agreed to allow existing securityholders to sell their securities or has granted them registration rights to register their securities. Further, because secondary offerings consist of the resale of securities by existing securityholders, the offering is non-dilutive to current securityholders of the company. Follow-on offerings may consist of both a primary and a secondary offering and can involve an offer of either equity or debt securities. For further information on secondary offerings, see Issuer Considerations for Secondary Offerings and Material Agreements and Other Documents for Secondary Offerings: Document Preparation.

It is important to review the company's organizational documents, any material company agreements, governing corporate law, and listing requirements of the relevant securities exchange before executing a follow-on offering. The company will need board approval of the follow-on offering. For a form of board approval, see Board Resolutions: Follow-on Equity Offering Authorization. Stockholder approval is not required unless the company plans to issue more securities in the follow-on offering than are currently authorized by its organizational documents and the company must therefore amend its charter to authorize the follow-on offering. Stockholder approval is also required under stock exchange rules for certain issuances of more than 20% of outstanding shares. 20% Rule and Other NYSE and NASDAQ Shareholder Approval Requirements.

Registration Process Timeline of Follow-on Offerings

While the registration process for IPOs typically take about 4-6 months, the registration timeline and process for follow-on offerings is typically 1-3 months (and may be even shorter, with some follow-on offerings completed in one week or less). The shortened timeline is a result of the availability of public information and disclosures of the issuer which make it easier to conduct due diligence and prepare the documents for a follow-on offering. For further information, see Due Diligence Considerations for a Follow-On Offering. Additionally, if the follow-on offering is done within three years of the company's IPO, it is likely that the SEC will not review the registration statement and will allow it to go effective upon receipt of an acceleration request. This is because the SEC typically reviews a company's registration statements and its reports under the Securities Exchange Act of 1934, as amended (Exchange Act), only once every three years.

The process may differ depending on the structure of the follow-on offering, but generally, the process includes due diligence, preparation and filing of a registration statement, going effective, post-effective filing of the final prospectus, and the closing of the offering.

Deal Structure

Follow-on offerings can involve the issuance of securities under a variety of different structures, with the most common structure being the block trade or bought deal. For more information on various structures, see Equity Offerings Comparison Charts.

Bought deals are sometimes referred to as "overnight" deals because such offerings are typically closed overnight. According to a recent study, overnight/bought deals accounted for one-third of the 2017 follow-on offerings. See the Q4 2017 Equity Capital Markets Update from William Blair, which is available at https://www.williamblair.com/~/media/Downloads/Insights/IB-Market-Assets/2018/ECM-Quarterly-Q4-2017.pdf?as=1&la=en.

In a traditional underwritten offering, underwriters have an opportunity to market the offering and obtain indications of interest from investors before the underwriters enter into the underwriting agreement with the issuer. However, in a bought deal, the issuer solicits bids from multiple underwriters familiar with the issuer and its business. The underwriters are given a short period of time in which to make an offer of a price at which they are willing to purchase the issuer's securities and thus the underwriters will not have an opportunity to conduct any marketing effort before they provide the bid price and agree to enter into a firm commitment to purchase the securities from the issuer. Bought deals are popular because they can be completed quickly and because they decrease execution risk for the issuer and shift market risk to the underwriter earlier in the transaction. However, due to the timing restrictions, bought deals can usually only be completed by issuers that either already have an effective shelf registration in place (as further described below) or qualify as a well-known seasoned issuer (as further described below), since WKSIs can file an immediately effective automatic shelf registration statement on Form S-3 (as further described below) without SEC review. For more information on bought deals, see Bought Deals.

Other deal structures for follow-on offerings include the following:

- **At-the-market offering (ATM).** An ATM is a follow-on offering where the company sells new shares of securities into the market at prevailing market prices. Issuers have control over the timing and size of each sale and can modify these parameters as desired. For more information, see At-the-Market Offerings and Equity Distribution Agreements for At-the-Market Offerings.
- **Equity line.** An equity line is a follow-on offering where the company enters into a purchase agreement with an investor so that the company can sell its securities to the investor for cash during a fixed period of time. Equity lines contribute to stock price volatility and are usually viewed as a last resort.
- **Medium-term note (MTN) program.** An MTM program is a follow-on offering where the company offers debt securities on a regular and/or continuous basis that usually mature in five to ten years. Issuances of securities under MTN programs can be registered with the SEC or can be conducted in reliance on an exemption from registration. For more information, see Medium-Term Note (MTN) Programs and Takedowns under a Medium-Term Note (MTN) Program.
- **Private investment in public equity (PIPE) transaction.** A PIPE is a private placement of securities of a public company where private investors take a sizable investment in publicly traded corporations. In a PIPE transaction, the issuer usually offers preferred stock at a discount and investors receive registration rights for the securities purchased. For more information, see Market Trends 2016/17: PIPEs, PIPEs: Drafting Key Documents, Raising Capital Using a PIPE, and Steps for Conducting a PIPE.
- **Direct public offering.** A direct public offering is similar to a PIPE Transaction except that investors receive registered shares which provide more favorable terms for the issuer. Direct public offerings are marketed directly by the issuer (without an underwriter) and usually targeted to a small group of investors. For more information, see Registered Direct Offerings.
- **Accelerated book build.** An accelerated book build is a follow-on offering where the underwriter determines the price range of the security being offered and sends out the draft prospectus to multiple investors. The investors bid the number of shares that they are willing to buy, given the price range. The book is open for a fixed period of time, during which the bidder can revise the price offered. After a predetermined period of time, the book is closed and the aggregate demand for the issue can be evaluated so that a value is placed on the security. The final price chosen is simply the weighted average of all the bids that have been received by the underwriter. The offer period is usually only one or two days. According to the PWC Report, bought deals and accelerated book-builds account for nearly 57% of the follow-ons in 2017.

Registration of Follow-On Offerings

Follow-on offerings are filed with the SEC using Form S-1 or Form S-3 for U.S. issuers or Form F-1 or Form F-3 for foreign private issuer. Companies typically complete a follow-on offering through a shelf registration statement. A shelf registration allows a company to file one registration statement covering several issues of the same security or different securities over a delayed or continuous period. Shelf registrations are registered by filing a shelf registration statement on Form S-3, for U.S. companies, or on Form F-3 for foreign private issuers. Each of the registration forms require a base prospectus, which includes general information about the company's business, risk factors, the securities to be registered and offered for sale, and a general plan of distribution. The information about a particular offering is then contained in a prospectus supplement. For further information, see Shelf Registration, Market Trends 2017/18: Shelf Registrations and Takedowns, Shelf Offerings, and Top 10 Practice Tips: Shelf Registration Statements and Takedowns.

Form S-1

Form S-1 is the default form of registration statement. The disclosure requirements for a follow-on public offering of common stock on Form S-1 are substantially the same as for an IPO, while a debt offering has additional disclosure requirements. Regulation S-K governs disclosures required to be made by the issuer on Form S-1, which include disclosures regarding the transaction and the issuer itself.

While the disclosure requirements on Form S-1 can be lengthy, some issuers are eligible to incorporate by reference certain information from prior filings of the issuer if such issuer:

A. Is a public company subject to the requirement to file reports pursuant to the Exchange Act

B. Has filed all reports and other materials required to be filed by the Exchange Act during the preceding 12 months (or for such shorter period that the issuer was required to file such reports and materials)

C. Has filed an annual report required under Section 13(a) (15 U.S.C.S. § 78m) or Section 15(d) (15 U.S.C.S. § 78o) of the Exchange Act for its most recently completed fiscal year

D. Is not a blank check company or shell company and is not offering penny stock

For further information on Form S-1, see Form S-1 Registration Statements and Form S-1 Checklist.

If a company decides to incorporate certain disclosures by reference into its Form S-1, only those Exchange Act reports that have been filed on or before the date of the Form S-1 may be incorporated. Thus, once the registration statement becomes effective, the company would need to either make a post-effective amendment to include any Exchange Act reports filed after the effective date or file and distribute a prospectus supplement that contains the information from the later Exchange Act reports. The registration statement will not be continuously updated every time the company files a new Exchange Act report unless the company is an eligible smaller reporting company (SRC). SRCs may elect to incorporate by reference into a registration statement on Form S-1 any Exchange Act reports that are filed after the effective date of that registration statement. To be eligible to use this forward incorporation by reference, the SRC must (i) be current in its Exchange Act reporting requirements, (ii) disclose in the prospectus all reports and other information filed by the company with the SEC, and (iii) make its incorporated Exchange Act reports and other documents readily available and accessible to the public. Additionally, in order to use the forward incorporation by reference, the disclosing SRC cannot be considered a blank check company, shell company (except to the extent the SRC is related to business combinations), or an issuer offering penny stock.

Form S-3

Form S-3 is a registration form which can be used by companies that have been subject to the requirements of the Exchange Act for at least 12 months and have filed their periodic reports and proxy statements in a timely fashion. To use Form S-3, a company must satisfy rigorous eligibility requirements. Most of the information required by Form S-3 can be incorporated by reference from past and future periodic reports and proxy statements. Form S-3 allows the incorporation by reference of future filings, so the registration statement is automatically updated every time the company files a new Exchange Act report or other filing that has been incorporated by reference. Form S-3 cannot be used for offerings of asset-backed securities.

Because less information is required, Form S-3 is the most cost-effective and efficient registration statement for eligible issuers. In addition, a company that qualifies as a WKSI can file Form S-3 for certain types of offerings. In this case, Form S-3 becomes effective automatically and includes reduced information requirements for the base prospectus in the registration statement.

Registrant Eligibility Requirements for Form S-3

To use Form S-3, a company must satisfy the below registrant eligibility requirements, in addition to transaction eligibility requirements. The company must:

A. Be organized in the United States and have its principal business operations within the United States

B. Have a class of securities registered under Section 12(b) (15 U.S.C.S. § 78l) or equity securities registered under Section 12(g) of the Exchange Act, or be required to file reports under Section 15(d)

C. Have filed in a timely manner all Exchange Act reports required during the past 12 months, excluding certain specified Form 8-K reports (which will not deprive a company of S-3 eligibility if not filed)

D. Not have failed to pay any dividend or sinking fund installment on preferred stock, nor have defaulted on any debt payment or long-term lease, since the end of the most recent fiscal year (also applies to consolidated and unconsolidated subsidiaries of the company)

E. Have filed with the SEC and posted on its corporate website all electronic filings and Interactive Data Files required during the past 12 months

Transaction Eligibility Requirements for Form S-3

Once a company satisfies the above registrant eligibility requirements, it must then verify that a particular offering complies with Form S-3's transaction requirements in order to use Form S-3 for the offering.

If the company meets the registrant requirements of Form S-3, it may use the form for the following transactions:

A. Primary offerings for cash if the public float of the issuer is at least $75 million.

1. Public float is calculated by multiplying the number of the company's common shares held by non-affiliates by the market price.

2. The public float is tested at the time of sale of securities. A company with a public float in excess of $75 million at the time the Form S-3 is filed that suffers a decrease in the market value of the equity to below $75 million after the effective date will not be subject to the one-third cap discussed below with respect to so-called baby shelves.

B. Primary offerings of non-convertible securities other than common equity, if the company has done or is one of the following:

1. Has issued at least $1 billion in primary offerings for cash of non-convertible securities other than common equity, within the past three years

2. Has at least $750 million outstanding of non-convertible securities other than common equity, where the non-convertible securities were issued in primary offerings for cash

3. Is a wholly owned subsidiary of a WKSI

4. Is a majority-owned operating partnership of a WKSI real estate investment trust

C. Other limited primary offerings (known as baby shelves) if the company meets the following additional requirements:

1. Has not sold securities during the past 12 months exceeding one-third of the market value of the non-affiliate equity (including for this purpose the securities to be sold in the offering)

2. Is not a shell company and has not been a shell company for the past 12 months

3. Has a class of common equity securities listed and registered on a national securities exchange

D. Secondary offerings of securities of a class already listed and registered on a national securities exchange

E. If the company has sent to relevant record holders, plan participants, right holders, and securities holders the information required by Rule 14a-3(b) (15 U.S.C.S. § 78n) in the past 12 months, then any securities to be offered:

1. On the exercise of outstanding rights, on a pro rata basis to all security holders of that class of securities

2. Under a dividend or interest reinvestment plan

3. Upon the conversion of outstanding convertible securities

4. Upon the exercise of outstanding warrants or options

If a company does not meet the minimum market value of the public float requirement for (A) above (Primary offerings for cash) at the time a Form S-3 is filed but increases its market value over $75 million after the effective date of the registration statement, the one-third cap on securities listed above under (C) (for baby shelves) will be removed. If the company's public float then falls back below $75 million when its next Form 10-K is filed, the one-third cap will be reinstated. The one-third cap on securities sales in the past 12 months only applies when the market value of the equity that the company has publicly available totals less than $75 million.

For more information on Form S-3, see Form S-3 Registration Forms, Form S-3 Registration Statements, and Form S-3 Checklist. For a comparison of Form S-1 and Form S-3, see Comparison of Form S-1 and Form S-3 Registration Statements Checklist.

Emerging Growth Companies

Companies that qualify as emerging growth companies (EGCs) enjoy more relaxed disclosure requirements than other companies. See Section 2(a)(19) (15 U.S.C.S. § 77b) of the Securities Act of 1933, as amended; Jumpstart Our Business Startups Act of 2012 (112 P.L. 106, 126 Stat. 306). To qualify as an EGC, a company must have had total annual gross revenues of less than $1.07 billion in the last fiscal year and cannot have sold common equity securities under a registration statement. For further information, see Emerging Growth Company Practice Guide, Top 10 Practice Tips: Emerging Growth Companies, and IPO Requirements for Emerging Growth Companies Checklist.

There are many benefits to qualifying as an EGC. For example, an EGC can:

- Provide less detailed disclosures than most companies
- Provide audited financial statements for only two fiscal years, whereas most companies must cover three fiscal years
- Be excluded from providing an auditor attestation of internal control over financial reporting (Sarbanes-Oxley Act Section 404(b))
- Avoid executive compensation restrictions such as “say-on-pay,” “say-when,” and “say-on-golden-parachute” provisions
- Defer compliance with changes in accounting standards
- Engage in test-the-waters communications with potential investors to gauge investor interest

A company can maintain its EGC status for five fiscal years unless any of the following conditions occurs:

A. The company’s total annual gross revenues exceed $1.07 billion.

B. The company issues more than $1 billion in non-convertible debt in a three-year period.

C. The company becomes a large accelerated filer.

LEGAL AND REGULATORY TRENDS

Smaller Reporting Company

As mentioned above, SRCs have the benefit of being able to use forward incorporation in a Form S-1. They are also eligible to take advantage of certain other relaxed disclosure and reporting requirements. For further information, see Emerging Growth Company versus Smaller Reporting Company Comparison Chart. On June 27, 2016, the SEC proposed amendments to the definition of smaller reporting company in order to expand the number of companies that qualify as SRCs. See SEC Proposes Amendments to Smaller Reporting Company Definition (June 27, 2016), available at https://www.sec.gov/news/pressrelease/2016-131.html.. On November 30, 2017, SEC Chairman Jay Clayton at the annual Government-Business Forum on Small Business Capital Formation stated that “In the coming months I anticipate that the Commission will consider adopting rules to expand the definition of ‘smaller reporting company’ to permit additional companies to avail themselves of scaled disclosure requirements.” See Remarks to the Annual Government-Business Forum on Small Business Capital Formation (November 30, 2017), available at See https://www.sec.gov/news/public-statement/annual-government-business-forum-small-business-capital-formation.

The proposed rules would expand the definition of smaller reporting company to allow a company with less than $250 million of public float to provide scaled disclosures as an SRC, as compared to the $75 million threshold under the current definition. Furthermore, if a company does not have a public float, it would be permitted to provide scaled disclosures if its annual revenues are less than $100 million, as compared to the current threshold of less than $50 million in annual revenues. Lastly, under the current rules, once a company exceeds either of the $75 million or $50 million thresholds (as applicable), it will not qualify as an SRC again until public float or revenues decrease below a lower threshold. Whereas, under the proposed amendments, a company would qualify only if its public float is less than $200 million or, if it has no public float, its annual revenues are less than $80 million.

T+2 Settlement Cycle

On March 22, 2017, the SEC adopted an amendment to shorten by one business day the standard settlement cycle for most broker-dealer securities transactions, which became effective in September 2017. See SEC Adopts T+2 Settlement Cycle for Securities Transactions (March 22, 2017), available at https://www.sec.gov/news/press-release/2017-68-0. Previously, the standard settlement cycle for these transactions was three business days, known as T+3. Although the shortened settlement cycle compressed the period between pricing and closing and added pressure to deal teams, due to the general timeline of follow-on offerings, the change has been smooth and well received.

FAST Act

On October 11, 2017, the SEC proposed amendments designed to modernize and simplify disclosure requirements for public companies, investment advisors, and investment companies and to implement a mandate under the Fixing America's Surface Transportation (FAST) Act. The proposed amendments would make adjustments to update, streamline, or otherwise improve the SEC's disclosure framework, including, among other things, the following: improve the SEC's disclosure framework by eliminating the risk factor examples listed in the disclosure requirement; eliminate certain requirements for undertakings in registration statements; simplify disclosure or the disclosure process (including proposed changes to exhibit filing requirements); and incorporate technology to improve access to information by requiring data tagging for items on the cover page of certain filings and the use of hyperlinks for information that is incorporated by reference and available on EDGAR. See SEC Proposes Rules to Implement FAST Act Mandate to Modernize and Simplify Disclosure (October 11, 2017), available at https://www.sec.gov/news/press-release/2017-192.

MARKET OUTLOOK

Follow-on offerings are a vital tool for companies to raise additional capital following their IPO. Many times, follow-on offerings are put together quickly in order to fund an acquisition or a new line of business, and 2018 could be viewed as a challenging year for follow- offerings due to enhanced market volatility. Evolving trade policies, regulatory changes, tax reform, and increases in the interest rate make 2018 a very complex environment for raising capital. Tax reform and interest rate increases in particular may make it much more expensive for companies to acquire necessary capital through follow-on offerings.

Michael Blankenship
Partner, Locke Lord LLP

Mike Blankenship is a Partner in the Houston office of Locke Lord LLP and a member of the firm's Capital Markets group. He focuses his practice on corporate finance and securities law, including securities offerings, special purpose acquisition companies (SPACs) offerings and transactions, private equity, mergers and acquisitions, and general corporate representation. He regularly counsels public companies on strategic transactions, capital markets offerings and general corporate and securities law matters. Mike represents both issuers and underwriters in U.S. and international capital markets transactions, including initial public offerings, and advises on corporate governance and securities market regulation. He is widely recognized as a go-to expert for a variety of securities law matters, including the Sarbanes-Oxley Act, Dodd-Frank Act and related rulemakings.

Eric Johnson
Partner, Locke Lord LLP

Eric Johnson is a partner in Locke Lord's Houston office. Eric has extensive experience representing private and public energy companies, including master limited partnerships, in a broad range of corporate and securities matters. For 19 years, Eric has focused his practice on mergers and acquisitions, capital markets transactions, and corporate governance matters.