PARAGON

ALTERNATIVE INVESTMENT STRATEGIES FOR BUILDING WEALTH

Investing in the PIPE Market: Paragon's Formula for Success

Since 2005, New York City-based Paragon Capital LP has been a top performing hedge fund, generating net returns greater than 70% per year.

In this Q&A Paragon's Founder and Portfolio Manager Alan P. Donenfeld discusses the PIPE market, how his hedge fund makes investment decisions and why his strategy is on such a winning streak.

Q: What is your background?

AD: For over 25 years I've been focused on investing in, advising and financing companies. Prior to starting Paragon Capital, I was a General Partner and an Investment Manager of Whalehaven Capital LP, a PIPE fund which posted an audited net return of 135% in 2004. For over 10 years, I was President of Bristol Investment Group, an SEC-registered broker-dealer and member of FINRA. I've also worked for Bear Stearns, Shearson Lehman Hutton and SG Cowen, primarily in Mergers and Acquisitions. I received my M.B.A. from the Fuqua School of Business at Duke University and a B.A. from Tufts University.

Q: What are the advantages of investing in hedge funds over other investment vehicles such as mutual funds?

AD: Hedge funds are unregulated and thus have the freedom to pursue strategies that can't be pursued by other investment vehicles, including mutual funds. For example, unlike mutual funds, hedge funds have the ability to use leverage and to short stocks. This gives hedge funds a huge advantage over mutual funds: during market upswings hedge funds can generate even larger returns and during market downswings hedge funds can protect its capital. In contrast, mutual funds are at the mercy of the market and will incur losses during a market downswing. Thus, unlike mutual funds, hedge funds can produce positive returns regardless of the performance of the market. Hedge funds also can improve an investor's diversification and increase return for the same or lower level of risk due to their low correlation with other investment classes.

Perhaps most importantly, unlike mutual fund managers, hedge fund managers have their interests highly aligned with investors' interests. Whereas mutual fund fee structures reward managers for asset-gathering, hedge fund fee structures reward managers for producing exceptional returns. In addition, hedge fund managers "put their money where their mouth is" in that they typically have significant amounts of their own capital invested in their funds. This ensures that they'll focus on producing the best performance possible for their investors.

Within the hedge fund universe, PIPE funds are among the best performing hedge funds. According to HedgeFund.net, a leading authority on hedge funds, over the 12 year period from 1995 through 2006 PIPE funds produced a compounded annual return of 27% versus 10% for the S&P 500.

Q: What are PIPEs and why are PIPE investments advantageous?

AD: PIPEs are private investments in public entities, which means that we make investments directly into publicly traded companies. PIPE investments are attractive because we purchase a company's common stock at a discount from the price that the company's stock is trading at in the public market. We may also invest in a convertible preferred or a convertible note, but the conversion price will be at a discount below the price at which the stock sells in the public market. Although we seek to make our return through the common, preferred or convertible instrument, we always receive warrants as a sweetener and these warrants have the potential to dramatically increase the rate of return on our investment.

Q: Why would companies sell their shares to your fund at a discount?

AD: For a small-cap public company, PIPEs are the only way to raise capital. They can't obtain bank financing, yet they need capital to grow. PIPE funds like ours are ready to invest on short notice and PIPE transactions are quicker and less expensive than secondary offerings.

Over the past decade PIPEs have become an institutionalized business adopted by the major firms on Wall Street as an important and flexible financial tool to finance public companies. In recent years the PIPE market has been booming: according to PrivateRaise LLC and Sagient Research Systems, in 2007 over $80 billion was raised in more than 1,400 PIPE transactions, up from $28 billion for 2006. There also are anticipated changes in securities regulations that will make it easier for small-cap public companies to pursue PIPE transactions, which should significantly increase the number of PIPE deals done. Given the huge number of companies seeking PIPE transactions, our fund can be highly selective and invest in the most advantageous PIPE deals.

Q: How do you choose which companies to invest in?

AD: We're extremely selective – we source and evaluate more than 50 PIPE deals a month, but typically only invest in 2 of them a month. Our goal is to invest in companies that have the best potential to grow as a result of our investment and that offer the most attractive terms for us to invest. As a result, we focus on market sectors that have high rates of return. We like to focus on biotech and healthcare, technology, energy and communications. We also like companies in other sectors that have strong fundamentals that are overlooked by Wall Street in general but have excellent management and simply need capital to grow their businesses. In addition, although most of our investments have North American operations, we also invest in companies with overseas operations to take advantage of rapidly growing markets such as China. Of course, we have a comprehensive due diligence process to ensure we make the best investment decisions possible.

Q: What is your due diligence process?

AD: We have an extensive checklist of things we go through. The key is conducting fundamental due diligence on the company such as the management, competitors, products, market size and growth, as well as technical market analysis on the company's stock liquidity. We seek out knowledgeable business and investment advisors, including our Investment Advisory Committee, who can give us insights into the company and whether they're going to succeed or not.

To highlight a few areas of importance, it's critical that a company's management checks out. We want to ensure that they're raising the right amount of capital, they have the knowledge and capability to execute, and their compensation is significantly tied to growth of their company's stock price so that all of our interests are aligned. It's also critical that a company's capital structure is optimal. We want to make sure that there aren't a lot of options and warrants that are struck below the price at which we're purchasing a stock. Deal terms also are important: we want to maximize our potential for returns while minimizing our risks. These risks include illiquidity, companies failing to perform, management failing to perform and just general risks associated with any investment opportunity.

Q: How do you minimize the risks of investing in small-cap public companies?

AD: We mitigate much of our risk by the way we invest. We're not necessarily buying common stock as a common investor would in the stock market, but rather we're trying to structure instruments that provide us downside protection while maintaining upside return. The fact that we're buying stock or a convertible note at a price that's at a discount to the market price is one way to mitigate risk. We also have the option to lock-in the gain created by the purchase of securities at a discount. In addition, we protect our investment and enhance its returns through warrants, conversion rights, repricing milestones, full ratchet anti-dilution provisions and rights of first refusal. We keep our portfolio diversified as well, and limit how much of our assets we invest in any one company.

Q: What's your typical holding time?

AD: When we make an investment decision, we're basing that decision on numerous factors. We're looking to invest in undervalued companies given their market sector, projected growth rate and the timing of that growth, the quality of management to execute their plan and the competition in their market. When these companies start hitting milestones we're more likely to become longer-term investors. Conversely, though, if companies fail to perform and don't hit the projections and milestones they set out, we may take a shorter-term view of the companies.

Q: Is there a particular sector you favor?

AD: Healthcare is a sector that we currently like a lot. If we invest at the right stage of development, with the right technology niche and management, the company can exhibit exponential growth in valuation. It's one of the few areas where we can achieve very high rates of return by doing our due diligence and understanding where these companies are headed and what their growth cycles are. Biotech companies in Phase II moving to Phase III can really reward us if we're invested in the right ones. When they hit their milestones, it can bring tremendous growth and stock appreciation.

Of course, we'll look at any sector or company that is experiencing or expected to experience tremendous growth. We also don't rule out sectors that are out of favor because when a sector is out of favor it may be very undervalued. Investing in the most promising companies in these sectors can pay off big when those sectors come back into favor.

Q: Are PIPEs something individuals could simply invest in on their own?

AD: No, PIPEs are far too technical and there are obvious barriers. For example, you have to qualify as an accredited investor or be a qualified institutional buyer to even be permitted to invest in PIPE transactions. Even if you're eligible to invest, you still have to access and analyze a hundred attractive deals, know how to evaluate them and their complex terms, and handle execution, which includes documentation, closing, monitoring investments and realizing on investment. There's a tremendous amount of work that goes into every facet of what we do. Fortunately, our team has extensive legal experience that enhances our process.

Q: Why did you choose to start a PIPE fund?

AD: I've been financing companies for over 25 years. I've been involved in LBOs, management buyouts, bridge financings, IPOs, secured debt financings, but the one type of investment that has the most consistent absolute return with reduced risk is a PIPE investment. According to HedgeFund.net, from 1995 through 2006 PIPE funds have produced compounded annual returns of 26.9%, as compared to 10% for the S&P 500. In addition, PIPE funds have significantly outperformed the S&P 500 and other investment strategies in terms of return and risk/volatility, as measured by the Sharpe Ratio. The higher the Sharpe Ratio the more consistent and less volatile the returns. Since 2001, PIPE funds have returned an average annual compounded return of 21.78% with an annual Sharpe Ratio of 3.47 versus a 3.78% average annual compounded return and 0.48 annual Sharpe Ratio for the S&P 500. If you know how to source, evaluate and structure PIPE investments, it's a tremendous strategy to be in.

Q: How has your PIPE fund performed?

AD: We have had tremendous results and generated a cumulative return of over 235% since inception in 2005. We strive to achieve consistent and above average rates of return in any market environment. We still believe based on our investment philosophy and approach that we have the ability to achieve a higher rate of return with limited downside risk, uncorrelated to anything that goes on within the market or the general economic picture.

Q: Are there advantages to investing in your PIPE fund instead of larger PIPE funds?

AD: Yes, in addition to producing very strong returns our fund is relatively small, which offers several advantages over larger PIPE funds. First, we can invest in PIPE deals that are too small for larger funds to focus on. These deals often offer better terms and a significantly higher potential for tremendous gains. Second, larger funds may have so much capital to put to work that they're compelled to invest in many of the deals that they see, including the less attractive ones. In contrast, we can be very selective in deciding which PIPE deals to invest in. Third, as a smaller investor in PIPE deals, it's far easier for us to exit our investments. In contrast, larger funds may end up "stuck" in investments given the larger size of their investments and limited liquidity. Fourth, in addition to investing in PIPE deals, we can invest in very appealing transactions called alternative public offerings. Alternative public offerings are an inexpensive IPO substitute for attractive private companies seeking to become publicly traded. These transactions, which can produce significant returns, typically are too small for larger PIPE funds to focus on. For these reasons, we have far more flexibility and potential for higher returns than do larger PIPE funds.

Q: Why do you invest in alternative public offerings?

AD: Publicly traded companies have substantial advantages over private companies. These advantages include a higher valuation, an increased liquidity of company stock, a greater access to capital markets, an ability to acquire other companies through stock transactions and an ability to use stock incentive plans to attract and retain employees. These benefits create an arbitrage between the value of a private company and the value of that company when it becomes publicly traded. We can capture this arbitrage by sponsoring and participating in reverse mergers and alternative public offerings, which are an increasingly popular method for private companies to become publicly traded. In an alternative public offering, an attractive company is merged into a public shell, often with a simultaneous or subsequent PIPE financing. We can produce attractive returns by investing in the public shells into which attractive private companies are merged to become more highly valued publicly traded companies. Our team's expertise in alternative public offerings provides us with a huge edge over other funds that can't capitalize on these lucrative deals.

Q: What is the overall goal of your fund?

AD: Our overall goal is to generate high returns regardless of the performance of the market. Given our tremendous track record, solid team, strong access to deal flow and proven ability to execute we're poised to continue producing excellent results for our investors with limited downside risk.

FOR FURTHER INFORMATION PLEASE CONTACT:

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