

Reverse Mergers

The Ins and Outs of a Complicated Alternative to IPO's

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OVERVIEW

The capital markets offer a broad and complex array of funding alternatives. No single approach can be said to be best because every company faces its own circumstances, needs and challenges. While the entire world is familiar with the most visible and highly publicized avenue for raising capital, the *Initial Public Offering* (IPO), there exist many alternatives that offer distinct advantages worth considering. One of these alternatives is the so-called “reverse merger” or “back door approach to going public”.

Reverse mergers have variously been touted or maligned depending upon the point of view of the observer and the sophistication level of the audience. As a strategic approach to “going public”, small to middle market companies should give definite consideration to reverse mergers. There are tangible benefits to this approach if well conceived and well executed. But as in all financial dealings, there are also significant pitfalls.

This paper discusses the ins and outs of this complicated alternative to the IPO.

SIMPLIFIED REVERSE MERGER

In its simplest form, a reverse merger works like this: a private company that desires access to the public markets finds a public company, usually called a “shell company”, and through mutual agreement of the management of the two companies, a merger is negotiated. The shareholders of the shell company usually receive a cash inducement from the private company to purchase sufficient new shares in the public company to end up owning a majority share of the public entity.

Thus, with relatively simple paper work, few regulatory obstacles, and a considerable saving in time and cash versus an IPO, the private company assumes the public shell, the name of the company and its ticker symbol. The surviving company then can change its name, change its ticker symbol, promote itself in the public financial market place, sell its stock via Pink Sheets, Over the Counter Bulletin Boards, or, if qualified, on the major stock exchanges.

This entire procedure can be executed within 30 to 60 days from finding the shell versus 6 months to 12 months for an IPO. It also can be executed for significantly less (several hundred thousand dollars) versus the millions that are expended during the IPO process. But it is not right

for every situation and care must be taken to execute the transaction with long term goals and realistic expectations in mind.

FINDING AN APPROPRIATE SHELL COMPANY

The process of a.) finding and b.) selecting a shell company can be very time consuming. It is not difficult to find candidates. The real issue is finding “appropriate” candidates. This is a job for true experts in financial analysis and deal structure.

In general, shell companies available for reverse merger are, by definition, troubled companies. A healthy, thriving public company seldom exhibits the conditions requiring consideration of a reverse merger. A shell usually has no assets, typically following a sale or bankruptcy. In some cases, the shell may even have significant liabilities such as previous or pending litigation, debt that needs to be paid off, patent litigation and or angry employees that are waiting for a new entity to sue, and creditors that later decide to demand payment from the new entity.

Many times the shell company has an image problem in the capital markets that survives far beyond the point of the reverse merger. This may be an anchor the new management does not anticipate as a future liability.

If the company has an operating business that appears to be valuable on a Going Forward basis for the new management, full disclosure and due diligence are needed to verify that the business is worth salvaging. This requires a Business Plan from the existing management team that shows a clear turn-around strategy; it also requires a financial plan and a recommended capital structure that would put the operating division on solid footing.

There are also companies called “blank check companies or blind pools” that are created solely for the purpose of serving as a reverse merger candidate. They have no operating framework or corporate history but are simply selling their “public status” as a way of making money for the shareholders. These “blank check companies” deserve special caution as they may be worthless at the end of the day.

The ideal circumstance would be to search out and target a company with a semblance of good reputation, some residual asset and customer base, untapped potential due to previous operating problems which can be remedied, and a management team that is willing to stay with the company, even if it is only an operating division of a new holding company that may have several disparate operating units. In some case, the company also has tax loss carry forwards that can immediately accrue to the best interests of the merged companies, by applying an existing NOL against future income streams of the joined company.

As stated in an article by John Nidecker, *Weekly Corporate Growth Report*, December 17, 2001, “You’re buying someone else’s failure and there is often more due diligence required than in a typical merger.” In order to avoid this problem from becoming a major issue, it is most often preferable to hire a professional investment banking firm to do the search for you in order to minimize risk all around.

ADVANTAGES OF REVERSE MERGER

Based on the above, it seems apparent that the reverse merger process is not for every company. The best candidate to pursue a reverse merger is a strong private company, with sales of at least US \$10 million, good growth potential, strong management, and a sound business plan. What this company lacks is the easy access to the public markets, greater liquidity, sources of cheaper capital and higher enterprise value that publicly traded status confers.

By accepting the strategy of a reverse merger, such a private company can benefit from the following advantages:

1. Fast and cost effective (does not require registration statement or SEC approval, far less detailed, simply requires the agreement of the two merging entities)
2. Requires little public disclosure (file Form 8-K only)
3. Avoid high investment banking fees which typically reach millions of dollars based on 7% of the IPO value (if using a Bulge Bracket Wall Street firm like Goldman Sachs or JP Morgan)
4. Not dependent upon the external market conditions which afflict every IPO and can significantly affect valuation, timing and ultimate liquidity/results
5. If the shell is carefully selected, the merged companies may benefit from a large existing shareholder base who invested in the previous public company and who are vitally interested in the financial viability and success of the new entity.

DISADVANTAGES OF REVERSE MERGER

Such an approach is not without its pitfalls. The past history of reverse mergers is littered with failed companies, companies who never created a public market for their stock, scams that saw millions of shareholders bilked of their investments and a reputation for “Pump and dump” schemes which left millions of investors defrauded at the whim of stock fraud artists. With this background, it is easy to see why the “reverse merger” is considered a highly suspect strategy to be viewed with great caution.

By accepting the strategy of reverse merger, the private company must be cognizant of the following disadvantages:

1. Transaction does not raise any cash for the private company. In fact, the private company must pay out anywhere from \$500,000 to \$1,000,000 in cash to execute the full strategy. While this is much less than the usual cost of an IPO, it is still cash out of the bank.
2. Limited disclosure means limited information has been disseminated to future investors. An uneducated public is not likely to buy the stock of an unknown company.
3. Most of the time, shares are concentrated in few hands. The shareholders of the shell company and the new management are usually the largest stockholders.
4. Share prices are low (penny stocks) and markets are thin
5. Transaction seldom qualifies for a major stock exchange

6. No investment bank/underwriter exists to help support the stock price going forward (as would be the case in an IPO). This means no research, no analysts, no principal market maker, and no relationship to institutional investors.
7. The private company must be careful who controls the new entity going forward. This suggests the need to avoid “super conversion right” that might allow the former owners from regaining control of the company.
8. Under the strict regulations of the Sarbanes-Oxley Act, every public company, regardless of size, is subject to very rigid reporting guidelines which did not pertain when the company was private, thereby demanding an increased level of compliance, financial reporting and dramatically increased accounting expenses.

PROFESSIONAL EXECUTION OF REVERSE MERGERS

Based on a brief discussion of the above points, it can be seen that the reverse merger strategy can deliver significant benefits but only under the right conditions and for the right companies teaming up with the right shells.

As with all intelligent business strategies, the process starts with a clear analysis and agreement to the goals of the venture. The private company must commit to a vision of the final outcome, and be prepared to endure throughout the process to see the goals attained. This includes an analysis of where the financial structure is today and where it will be after the reverse merger is consummated.

It also includes a post-merger plan for development of a public profile, a professional investor relations program, a company publicity effort and an effort to develop relationships with investors and research analysts. None of this will happen without a professional public relations and investor relations program and resources (internal and external) committed to this task.

In our experience, few if any small to mid-sized companies are motivated, prepared or equipped to handle the reverse merger process themselves. That is where professional boutique investment banking firms fit in. The large Bulge Bracket firms are not interested in deals below \$200 million in size. Nor would middle market companies find their services to be affordable, even if they expressed nominal interest.

Our job is to step in as your consultant at the very outset. To understand and advise you on the outcome to be expected. To search out the right shell companies. To stay with you right through the post-merger promotion phase. To make sure your effort and your dollars would not be wasted on a shell transaction that ultimately has no market, no valuation, no trading activity, no liquidity, and no purpose. We are the gatekeepers who prevent you from making mistakes and move you toward a satisfying financial outcome. That is the role for professionals like us in the execution of reverse mergers.