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THE REVERSE MERGERS – ALTERNATIVES TO INITIAL PUBLIC OFFERINGS

Gheorghe HURDUZEU
The Bucharest Academy of Economic Studies, Bucharest, Romania
gheorghe.hurduzeu@rei.ase.ro

Liviu Bogdan VLAD
The Bucharest Academy of Economic Studies, Bucharest, Romania
liviubogdanvlad@biblioteca.ase.ro

Raluca HURDUZEU
The Bucharest Academy of Economic Studies, Bucharest, Romania
raluca.hurduzeu@rei.ase.ro

Abstract
In recent years the mergers of companies have seen a setback due to the economic crisis and the implications that it has generated in the market. As such, the reasons behind the implementation of mergers have changed, if, in prior periods the common reason for merger was the desire to integrate into current business activity and the profits resulting from the resources which were to be invested in that business creation and development, under the present conditions, the mergers are becoming more and more a way to keep the business or selling on the best terms. One of the options available, especially for small and medium sized private companies, seeking new sources of funding, is to achieve a reversed merger. The objective of this paper is to present the concept of reversed merger in relation to Initial Public Offering. A company must always set to the smallest detail, the reasons for wishing to change its status from private to public. One way to obtain public status is given by the reversed merger, an alternative to the Initial Public Offering. The private company that wants to go public, purchases over 80% of a public company but inactive, company called shell company. Once this shell company merges with the operational company of the buyers, they form an active company, a listed company, in which the majority of the shareholders are represented by the major founders of the operating company.
Keywords: Initial public offerings, Reversed mergers, Shares, Capital.

1. INTRODUCTION

For what reason the private-owned company would be interested to become one of public character? From the literature (Loughran, Ritter and Rydqvist, 1994), (Ritter, 1987), (Ritter, 1991), (Hurduzeu, 2008), (Spatt and Sanjay, 1990), (Tinic, 1988) we can mention some advantages of a public company: (i) easy access to capital, (ii) enhanced liquidity, (iii) expansion through acquisitions or strategic partnerships, (iv) superior managerial performance (trust in management).

(i) It is easier for public companies to increase revenue as compared to private ones. The public companies have five characteristics that make them more attractive for the investors as opposed to the private ones. First, the public companies are required to have a high transparency of the financial results, whether good or bad. The mandatory transparency gives investors confidence because it is more difficult for the public company to conceal their problems. Another benefit to the investor, which increases the access of the public company to capital, it is easyness to create liquidity for investment opportunities. Those who invest in private companies are always concerned with the "exit strategy" and look for companies which gradually will become public. If a company is already public, the ability to "exit" increases considerably. The investors in public companies are able to sell all the shares in three to five months from the investment. This process is much faster than the period of three to five years; the private investor should expect to get their reward. The fact that the shares of a public company can be traded creates liquidity by selling the shares to an investor from the public market. A third strength regards the restrictions and the agreements that apply to private equity investors. They see themselves as partners in management and require a veto in many aspects of the company's decision making process. Usually, once a company becomes public, investors no longer require these powers.

(ii) The liquidity allows all the investors to implement their exit strategy, through the ability to transform their investment into cash. Also, one of the reasons why a private company changes its status into public company is that the company's founders, old investors and executives who own shares can withdraw money from business without totally selling it or without losing control.

(iii) Another very important reason in the strategy of becoming a public company is seeking the expansion through acquisitions, mergers or strategic partnerships. The investors prefer to finance public companies, even if the goal is to make an acquisition.

(iv) Given the requirement of financial transparency, the shareholders of public companies have more confidence that management will expose all the undertaken operations. This information is disclosed under the rules imposed by the capital market authorities. However, there is a limit to the amount of information to be disclosed to the shareholders. Rarely, a shareholder may obtain legally financial documents and the list of investors for more than one year.

2. THE SHELL COMPANIES

A shell public company (in US, there is a class of securities registered under the Securities Exchange Act 1934) is a company that exists by the fact that there was once operational, it became public and for various reasons ceased its operations and liquidated its assets or, although not operational, was created specifically to have the status of a shell company.

In the first case, the financers of the shell companies get control of defunct operating company by purchasing large part of the shares (Flora and Travis, 2011). In the second case, the financer form shell companies by incorporation.

In exchange for the agreement of a operating company to merge with a shell company, the financer is paid with the required amount and maintains ownership interests in the post-merger shell company.

The shell companies can have shares which can be traded or not publicly. Usually, the shares of a former operational company are traded publicly. This company has listed its shares or facilitated the sale in a public market when the Initial Public Offering was completed. The shares of a former operating company end up being traded on OTC markets even if they were originally listed on stock markets.

3. THE LEGAL STRUCTURE

As explained above, the private company takes over the shell public company and receives the status of public company. The reversal occurs because the shell company survives the transaction, although the control will be owned by the private owners. The shell company must survive in order to maintain the status of trading for the new company. The shareholders of the private company usually receive between 65 and 95% of the shell company. This allocation depends on the value of private company (Flowers and Travis, 2011).

4. TYPES OF REVERSE MERGERS

A reverse merger is structured, usually as the type of a triangular merger (Arellano-Ostoa, Brusco, 2002). In this type of process, the shell company creates a subsidiary that is wholly owned. This subsidiary then merges with a private company. This merger must be approved by both shareholders of the private company and the shareholder of the subsidiary of the shell company, which is the shell company itself acting through the board. The shares of the private company are given in exchange for the shell. Therefore, the new subsidiary formed of the shell company, as non surviving corporation, disappears, and the private company, the part that survives, becomes a wholly owned subsidiary of shell company. You do not need the approval of the shareholders of the shell company. This type of merger is possible for the shell companies whose shares are traded on OTC markets.

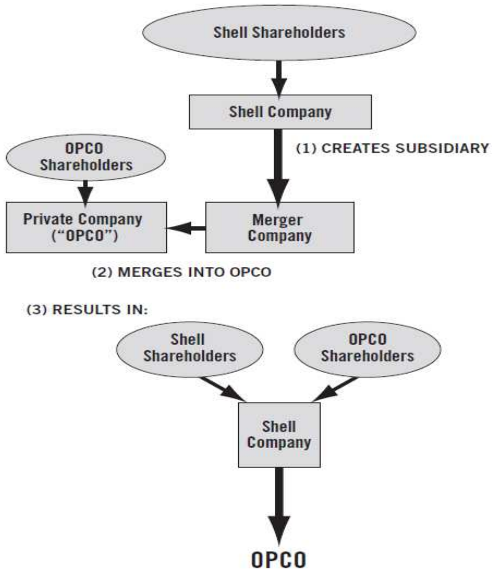

FIGURE 1 – REVERSE TRIANGULAR MERGER

The advantage of this structure is relevant in that the functional business remains intact (Adjei, Cyree and Walker 2008). The bank accounts, the employee identification numbers, the contracts, even the leases remain the same, since the only change made was the ownership of private companies.

This option does not apply to shell companies that traded on major stock markets such as Nasdaq U.S., because their trading rules imply an endorsement of the merger of all shareholders. It is also necessary a new application for listing when the company changes the control (Arellano-Ostoa, Brusco, 2002).

Some reverse mergers are made through an exchange of stock or asset acquisition. This is necessary when the private company is a non-American. The reverse merger can be accomplished with minimal involvement of shareholders, but if you want to change the name of the or the reversed separation of the shares, the shareholders' agreement is necessary. The process of separation of the shares issues the appropriate number of new shares for the former owners of the private company (Adjei, Cyree, and Walker 2008).

5. THE REVERSED MERGER VS IPO

Once a company decides that the benefits outweigh the disadvantages of being publicly listed, it needs to assess the different methods of achieving the objectives.

The Initial Public Offering (IPO) is the most popular way of public listing of companies (Tinic, 1988). The IPO is when, for the first time a company sells shares to the public, it is listed on a stock market. The investment banks subscribe the offer; deal with the transaction for a commission.

Many companies can benefit from public listing, but not all are good candidates for IPO (Spatt and Sanjay, 1990). The companies that are in a premature stage of development for the IPO, those who wish to become public in a time when the IPO market is hostile to or forming part of an industry not known, will be in a position to not find an underwriter for their initial public.

In an IPO, the underwriter helps to develop a liquid secondary market for the shares of the company by facilitating the listing of the company's shares on the stock exchange and by issuing reports with analysis and recommendations that draw interest. Once a public market is established, the pre-IPO investors can cash out part or all securities held by selling shares on the market. The company can use its shares for future acquisitions or compensations (Schipper and Smith, 1986).

Instead, a reverse merger is not a transaction which increases the capital. The shares are not sold for cash, but the private company's shareholders receive shares of the shell company in exchange for the previously held shares. The shell company's shareholders remain with also the shares before the merger. The only money used during the transaction is fee paid to the developer, lawyers and the accountants involved in the merger by the private company.

A reverse merger is often connected to a private placement in public equity (PIPE). The amount of PIPE financing which can be obtained is much smaller than the tens or hundreds of millions that can be collected in an initial public offering.

5.1. The advantages of a reverse merger in relation to IPO

Among the advantages of a reverse merger we can mention: (i) reduction of public listing expenses, (ii) the private company can be publicly listed without the withdrawal of its founders or without attracting new capital, (iii) it accelerates the process of listing - a reverse merger can be listed in 30-45 days, while the running an IPO may take a year, (iv) it decreases the exposure of the founders to stock fluctuations – an initial public offer may be withdrawn if the investors are discouraged by the declining stock market, (v) the shares of the public companies can be used as method of payment for other acquisitions, (vi) the employees and the management can be stimulated through progame of shares' acquisitions, (vi) it requires no subscription agent and detailed information about financial history (Floros and Shastri, 2009).

In terms of reduced costs in general, the reverse mergers can be made up to $ 1 million. Also, the majority of costs can be predetermined. One of the biggest variables in the total cost of a reverse merger is the cost of the shell company with which the private company will merge.

A reverse merger can be completed in less time than an IPO. The period can be further reduced by preparing by private companies, the information necessary to conclude, before finding the shell company itself (Adjei, Cyree and Walker, 2008).

The parties involved are lesser than for IPO: the shareholders that control the shell company, the owners and the managers of the private company and financing sources. Lawyers from both parties are involved. An IPO is risky that the underwriters may terminate an agreement or make a significant change in the share price offer at the last minute. The success of an IPO depends on market situation during the week that the company's shares begin to trade. Instead, the reverse mergers are not sensitive to market changes, except for disasters such as the terrorist attacks of 11 September from U.S., or wars. The IPO underwriters help the large companies to obtain public status and to raise significant sums. Their goal is to make a company look good for the IPO, without taking into account of the long-term effects. Often, the managers barely recognize their own company only after the underwriters and the board finish writing the IPO prospectus. In fact, the company may have large debts that the underwriter change or cover them. According to the agent, the company can develop new business areas that have long term potential, but currently, it absorbs and loses money.

5.2. The disadvantages of a reverse merger in relation to IPO

Among the disadvantages of a reverse merger: (i) the shell company can hide information related to certain obligations and processes, (ii) the past of the shell company could hide lower financial results, (iii) there is a risk that some of the shareholders of shell company to sell the shares, the first opportunity arose, (iv) an Executive Director who has no experience in public companies, could become an easy prey on the public market, (v) the shares are liquid only when the company becomes interesting for investors (Floros and Shastri, 2009).

An important issue of the reverse mergers is the lack of market support for newly public companies, a situation which is in contradiction with the IPO. In an IPO, the underwriter places the company's shares to the major exchanges, which increases the share price in the period following the end of the initial public offering. This cannot happen in the case of the reverse mergers.

6. WHY DO COMPANIES CHOOSE THE REVERSE MERGER?

6.1. The PIPE (Private Investment in Public Equity) financing

Companies that are listed through reverse merger do not have the same benefits as those listed by IPO, namely a large infusion of additional capital and the liquidity of shares.

PIPE issuance type of financing is the solution for companies refused by banks. The PIPE shares (equity issue as a private placement), must be held by investors at least a year. Thus, they are sold at the discount price to specialized mutual funds and to investors in hedge fund. After registering with the SEC, in about three or four months, the company may move to an exchange premium, on which the PIPE investors can sell their shares. These types of investments are spread among the hedge funds and can make gains even in the absence of relisting of shares or subsequent assessments (Floros and Shastri, 2009).

6.2. Special purpose acquisition company- SPAC

In reverse mergers involving SPAC companies, the situation differs to some extent. SPAC is a publicly listed shell company through Initial Public Offerings, in order to obtain an unidentified functional business within 18-24 months. To attract investors, some of the IPO terms for SPAC involve the placement of more than 90% of earnings in a collateral deposit. Also, SPAC buying an initial business if the business does not have a fair market value equal to at least 80% of SPAC net asset value. SPAC supports the process which starts with an initial proposed acquisition if the acquisition is approved by a majority of IPO shareholders, though such approval is not required by law.

In terms of operating companies, merging with a SPAC company can be compared with traditional IPO, depending on the structure of the transaction. If it is structured as a reversed merger, the private company will receive a large infusion of capital because the SPAC company to which is merging will have the IPO earnings. It will also benefit from the liquidity of shares after initial establishment of a stock market for the SPAC financial securities and the underwriters involved in the SPAC initial public offering will be interested in supporting the reversed post-merger market.

7. CONCLUSIONS

In the past years, the reverse mergers have become an important alternative for the private companies to be publicly listed and the shell companies have brought the fuel required for this process. The shell companies have no business and no assets, but instead have investors. They offer investors the hope of a successful reverse merger and a significant gain. However, only half of the shell companies are involved in a reversed merger in a given year, a situation leading to a decline in the share price.

From the perspective of private company that seeks the appropriate shell company, the performance of the latter is irrelevant. The normal shell companies do not offer cash or managerial expertise. The private companies that tend to choose a reversed merger generally have small, low profitability and low licquidity, being in a stage of development, which requires high costs for research and development.

The asymmetry of information about these companies is high, which implies a reduced capacity of the investors to evaluate their potential.

In many cases, the private companies opt for a reverse merger in order to make strategic acquisitions by payment in publicly traded shares. Also, the managers who opt for a reverse merger have plans to develop new projects in the newly formed company. The financing and the certification is obtained through PIPE, thus the way to one of the main U.S. stock markets is open. The reverse mergers have a short negotiation period, and are often financed through PIPE. A limited number of them manage to change their listed market by expanding the operations. Often, the decision to become public through a reverse merger is made in order to exploit private information held by insiders, which leads to obtaining future cash flows.

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