

REVERSE MERGERS – A NEW OLD WAY TO ACCESS CAPITAL

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Smaller private companies seeking growth capital of \$10 to \$50 million have a number of means of obtaining the resources they seek. While a limited (and shrinking) pool of investment banks will manage IPOs in this size range, more typically capital raises in this range have been done through a private placement of equity or debt, or a merger into a well heeled parent. More recently, we are seeing increasing use of another technique: the reverse merger with PIPE (A PIPE is a Private Investment in Public Equity – essentially a private placement of restricted stock that subsequently gets registered with the SEC for unrestricted trading).

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Considered from a theoretical standpoint, a reverse merger is simply a transaction in which the acquirer (typically a public "shell" company with little or no operations of its own) issues its own stock to purchase a privately held operating company. Because the shell has so little value of its own, the owners of the privately held firm wind up with majority control of the merged entity and typically rename it and elect a new board – effectively taking the private company public in the process. Once public, the company is then free to access the capital markets by issuing securities, typically through a PIPE transaction.

Because stock issued through PIPEs becomes freely trading shortly thereafter, this effectively gives the investors a "built in exit." As a consequence, they are willing to pay a liquidity premium for shares compared to private placements. With its stock freely trading, the company has an attractive currency for acquisitions, and to motivate employees through option grants. These advantages come with the disadvantage of the substantial costs of being public, most notably the expense of Sarbanes-Oxley compliance.

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As our title above indicates, reverse mergers are hardly new, and have been used for decades as a means for smaller companies to "go public". In a number of cases, however, the reverse merger technique has been sold by unscrupulous promoters to unsuspecting owners of private companies that were unsuited for being public. Notable problems included companies that needed additional capital in a timely basis and that could not cover the added expenses of being public from their cash resources. With their earnings depressed from the additional expenses of being public and the thin floats from the shares in the shell, it was sometimes impossible for the companies to raise additional capital under acceptable terms, or at all – defeating the original purpose for the transaction. Because of this checkered past, financing via reverse mergers carries a certain amount of stigma in some circles today.

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However, due in no small part to the increasing activity of hedge funds, many of which limit themselves to tradable securities, this structure of transaction has seen increasing usage of late. Thanks also to the structure of a mutually contingent PIPE with simultaneous close, much of the risk (to all the parties) has been mitigated. Under this structure, funds are escrowed and not released until the PIPE has been funded, at which time the merger is closed and the company becomes public. With these developments, today larger deals are getting done with well known investment houses, and reverse mergers are gaining a newfound aura of respectability. Some have noted that this development parallels the transformation in the reputation of high yield (“junk bond”) instruments over the last few decades.

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Compared to conventional financing, reverse mergers with simultaneous PIPEs can be closed quickly, some times in just a few weeks. This helps reduce the risk that a change in the market psychology takes place while shares are in registration or extended due diligence is underway. All-in expenses and professional fees are typically higher than a conventional IPO or private placement, but are largely success based.

While not appropriate for all issuers, this transaction represents an alternative to private placements and venture capital that can make sense for some. Companies that have these characteristics should examine this financing option:

- Immediate capital needs in the \$5-\$50 million range
- Valuation in the \$60+ million range, or a clear and quick pathway to that range
- Need public stock as an acquisition currency or to motivate employees through option grants
- Significant opportunity cost/risk for delay in closing the financing transaction
- Management and board qualified and ready to accept the additional demands of being public

By John Stone

The Near Earth team is experienced in the execution of reverse merger transactions; please direct any questions regarding this subject to John Stone at john@nearearthllc.com

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