Understanding Reverse Mergers

The reverse merger is one of the most misunderstood instruments in the financial sector. At Tudog Capital, the merchant banking arm of The Tudog Group, we view reverse mergers as one possible path to bringing a company public on the microcap markets, and using the event to recruit additional capital for the company.

In our view the microcap markets are the venture capital market for the average investor. With entry investments in traditional investment funds and venture capital funds at sometimes more than $100,000, the average investor is locked out of emerging and growth business opportunities. The remedy for this is a willingness to consider the opportunities presented by some promising microcap companies.

The microcap exchanges have many lemons, and because of them the entire listings on the Pink Sheet and OTC exchanges are subject to suspicion and initial resistance. But like any high risk – high reward investment strategy, these exchanges can work well if you pick the companies carefully and are comfortable with a win some – lose some philosophy (the idea, of course, being that the ones you win more than make up for the ones you lose). This win some – lose some, actually, is the strategy taken by every venture capital group because they know that many of their investments will fail or not make money, but that the ones that do succeed will drive sufficient return for all the others.

The reverse merger is a method of bringing a company public through an alternative route, placing upon it all the benefits and responsibilities of a publicly traded company. This article explains the process and benefits in detail.

Defining Reverse Merger

A reverse merger is a financial transaction that results in a privately held company becoming a publicly held company without having to go the traditional route of filing a prospectus and undertaking an initial public offering (IPO). The Reverse Merger is accomplished by the shareholders of the private company selling all of their shares to the public company in exchange for shares of the public company.

Technically this transaction is a merger of the private company into the public company. It is called a reverse merger because the public company involved is typically a "shell" or a non-active company with no operations and no assets (just the legal and organizational structure), which issues a sufficient number of shares to the shareholders of the private company so that they end up controlling the public company. So while the public company “bought” the private company, the shareholders of the private company end up in control of the company, which they then place their operations and assets into, resulting in the private company now being a public one.

Process

In a reverse merger, as long as the shell is an SEC-registered company, the private company does not need to go through a review with state and federal regulators (which can be expensive and time consuming) because this process was completed beforehand with the public company.

The process requires that the private and shell company exchange information on each other, negotiate the terms of their merger, and sign a share exchange agreement. At the closing, the shell company issues a substantial majority of its shares and board control to the shareholders of the private company. The private company's shareholders pay for the shell company either by placing their shares in the private company into the shell company (which they now control), or, in some case also by paying an agreed upon sum of money to the public companies shareholders. This exchange and change of control completes the reverse merger, and the formerly privately held company would now be a publicly held one trading on the exchange on which the previous company was trading.

Benefits

There are a number of advantages to being a publicly traded company. These include:

- The possibility of being able to command a higher price for the company's securities in a subsequent offering.
- A reverse merger separates out the capital recruitment component of an IPO. This means the company can go public without necessarily raising funds simultaneously. For small companies the ability to separate the two is sometimes highly advantageous.
- The Company can go public regardless of current market conditions. The deal is completely dependant on the two companies merging and not the timing of the merger with regard to the state and mood of the public markets.
- A reverse merger can be fully executed within a matter of months, whereas a a conventional IPO can take a year or more.
- A conventional IPO can be very costly, with legal, accounting and investment banking fees adding up. A reverse merger can be completed at a significantly less cost.
- Being publicly traded may allow the company to acquire other companies through stock transactions, meaning that an acquisition is completed without the need for capital but rather through an exchange of shares.
- The company’s stock may serve as an attractive incentive to recruit high quality executives and retain valuable employees.
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Future Financing

Perhaps the most apparent benefit of the reverse merger is the number of financing options that become available to the company once it is publicly held. Depending on how these capital raises are structured, the company can ensure for itself a consistent flow of capital as it is required to fund operations and growth. These options include:

- The issuance of additional stock in a secondary offering.
- The exercise of warrants, which granted stockholders the right to purchase additional shares in a company at predetermined prices. When the warrants come due and many shareholders opt to exercise their rights, the company receives additional capital.
- The liquidity of the stock may make an investment in the company attractive to private investors.

A reverse merger is not right for every situation and there are many credible reasons to be cautious and careful. It is important to select the right shell and understand why the shell company’s initial business did not succeed. It is critical to research the shell for any

liabilities that may carry over to the new company. The need for an excellent attorney and studious accounting group cannot be overstated.

Nonetheless, in circumstances where the company is right and the shell is clean, a reverse merger can serve to significantly accelerate a company's growth, provide it with the tools to raise necessary capital, and provide all shareholders with an eventual exit. For these reasons Tudog always looks at the viability of the reverse merger as one of the strategies to be considered when developing a growth plan.