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March 2012

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Becoming a Public Company— Reverse Merger, an Alternative to the IPO

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To provide our clients and contacts with a variety of ideas and insights on accessing and deploying capital, J.H. Cohn has formed the Capital Markets Advisory Consortium. We have teamed with a select group of boutique investment banks that are recognized thought leaders that advise corporations, private equity groups, financial institutions, and investors participating in the small and medium enterprise marketplace. The initial member is CoveView Advisors LLC headquartered in Stamford, CT, an independent corporate finance advisory firm. This article was prepared by Thomas M. Canning, Managing Partner, and Rose M. Wong, Associate, of CoveView.

Traditionally, when a company decided it was time to go public, it turned to the equity capital markets and pursued an Initial Public Offering ("IPO"). However, today's market volatility and economic uncertainty has led to an IPO window that is open just a crack and that has caused many companies, even prominent ones, to delay going public. Despite a busy IPO forward calendar and a large IPO backlog of approximately 150 companies, the market remains highly selective and may not improve in 2012.

In this challenging environment only a few companies—those with distinguished business franchises, critical mass, high sales growth, and the ability to grow earnings faster than sales—will get through the eye of the IPO needle. Especially for a small enterprise, it is hard to count on the IPO market and yet, the fundamental need for capital that was formerly obtained through IPOs remains. There is, however, an alternative to the traditional IPO that owners and management teams can consider: the reverse merger.

Reverse Merger

A reverse merger is a process by which a private company "goes public" by merging into a publicly traded shell company with up-to-date SEC filings. An estimated 166 reverse mergers closed in 2011. The number of transactions is down from 258 in 2010, due in part to increased regulatory scrutiny resulting from accounting scandals relating to foreign, primarily Chinese, companies using this technique. To improve accuracy of reporting results by foreign company reverse mergers, and to help restore investor confidence in this area, the SEC approved amendments in November 2011 tightening listing requirements.

In a reverse merger, the shell company typically has minimal assets and ideally, no contingent liabilities. The consideration paid to the seller of the private company is newly issued stock. The ownership split is to be agreed by the parties but in concept the public company issues substantially all of the new shares to the shareholders of the private company, who then control the newly combined entity.

Often, a company does a reverse merger because capital is required for a strategic purpose such as an acquisition and it cannot access the traditional markets. Frequently, in conjunction with the reverse merger, capital is raised through a private investment in public equity ("PIPE"), which is a privately negotiated transaction with one or more qualified investors. The PIPE can be completed simultaneously with the closing of the reverse merger transaction or immediately following.

The benefits to this approach for going public include:

- Less market risk: unlike an IPO, market conditions have a low impact on determining the timing of a reverse merger
- Lower cost due to lower investment banking fees and lower professional fees

- Availability to smaller companies
- Lower market discount (IPOs typically require 10-20% discount at offering)
- Potential for liquidity to existing shareholders

While these are certainly attractive merits, owners and management teams must carefully consider whether the heretofore private company is prepared for a public investor base. These transactions, while typically less intrusive than an IPO process, do require significant time and focus from management during and after the execution process. As with an IPO, an important consideration to going public is the cultural shift required on the part of the entire company. This manifests itself in many ways, from the reporting required of a public company, which increases expense and requires significantly greater disclosure, to the focus on quarterly performance, and the interaction with a broader, and potentially more demanding, shareholder base. The Board of Directors should also evaluate the company's potential increase in liability associated with public investors and regulatory scrutiny of the business.

Moreover, being public merely sets the stage for the potential capital raising activities. Management will need to develop an investor relations function to educate the investment and analyst community about the company in order to maximize shareholder value and facilitate the ongoing ability to raise capital. Even though the company is technically public following a reverse merger, liquidity for future investments/acquisitions and for existing shareholders to sell their shares is only an illusion. The company must still develop an investor base that is prepared to purchase its stock and/or raise capital from third party investors and meet their needs for liquidity.

	Initial Public Offering ("IPO")	**Reverse Merger**
Summary Description	■ Initial sale of stock by a formerly private company ■ Money paid by investors for the newly issued shares goes directly to the company	■ A private company merges with or gains control of a public shell company ■ Might also include company selling shares in a PIPE transaction
Launch to Close Timing	■ Approximately 6 months	■ Shorter timeline; potentially 2 to 3 months
Costs	■ Requires 10% to 20% discount to market ■ 5% to 7% gross spread to underwriters ■ Professional fees	■ Typically, lower cost option ■ Dilution; discount of PIPE involved ■ Professional fees
Probability of Completion	■ Lower	■ Higher
Benefits	■ Bolstering and diversifying equity base ■ Increasing liquidity and book equity ■ Prospect for equity research coverage following the underwriting ■ Cultivating an investor base	■ Terms are flexible; based on negotiation ■ Less influenced by market conditions ■ Potential to raise additional capital with a PIPE concurrent with or immediately following closing of the reverse merger
Other Considerations	■ Highest cost of going public options ■ Disclosure requirements ■ Management distraction ■ Market risk/investor appetitie ■ Public dissemination of information ■ Extensive marketing process	■ Finding the right shell company and diligencing potential liabilities ■ Still requires an effective registration statement and appropriate disclosure ■ Majority of board from private company ■ Equity research coverage less likely ■ Limited public ownership (5-20% of float) ■ Seasoning requirements for listing must be met; exchange listing not guaranteed

Timing and Key Process Steps

The timing required for a reverse merger is typically two to three months, which is less than the estimated six months for an IPO. Key events in the process include due diligence by both the private operating company and the shell company; board approval by both parties; negotiating a merger agreement; and shareholder approval of the transaction by one or both companies. As with an IPO, an effective registration statement registering the shell company's shares to be issued upon the merger with the SEC is required before the transaction is consummated. The company must also file a proxy statement with the SEC providing the details of the terms of the proposed merger in connection with the requisite shareholder approval. Finally, within four business days of closing, an additional filing with the SEC is required, which must include a description of the transaction, including, among other things, a description of the new company and the new shares issued, information regarding directors/officers, a description of the business, and a full set of the company's audited financials.

Conclusion

Market conditions remain challenging for companies to raise capital in the IPO market. Owners of private companies may benefit from considering the reverse merger alternative as a means of becoming public. Your financial and legal advisors can help you evaluate the pros and cons of a reverse merger, as well as other options to consider, including the private equity marketplace. Regardless of the type of transaction a company pursues, it is critical to have advisors—legal, financial, and accounting—who are experienced and knowledgeable in capital markets transactions. ■

About CoveView Advisors LLC

CoveView Advisors LLC, headquartered in Stamford, Connecticut, is an independent advisory firm providing corporate finance services to corporations, private equity firms, financial institutions, and investors.

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