

Pros and Cons of Reverse Mergers: When Is It the Right Choice?

BY JOSEPH A. GITTO



Joseph A. Gitto

A reverse merger is a transaction in which a privately held company merges with a publicly held company whose sole business purpose is to find a private company to acquire. The public company typically has no, or a nominal, existing business operation and no assets, other than possibly cash. This is often referred to as a "shell." Often financing is arranged for completion right before or after the reverse merger takes place.

Upon completion of the transaction, the management of the private company takes control of the day-to-day operations. If the board of directors of the public entity is expected to change after the merger is complete, and it typically does, additional filings with the SEC are required.

Reverse merging a private business into a public shell to become a public entity is one of several alternatives to an IPO. Other methods are through a merger with a SPAC (Special Purpose Acquisition Company) and self filings. This article focuses, at a high level, on the advantages and disadvantages of being a public company, and explores the pros and cons of reverse mergers.

Companies generally file to go public for many reasons. One of the primary reasons is to create liquidity for early shareholders and investors. The second is to strengthen the balance sheet through an equity infusion and perhaps further "leverage" the balance sheet to include a mix of debt and equity. The third is to use the company's new currency (publicly traded stock) and cash to make strategic acquisitions, fill in the holes in its product portfolio or personnel, or pursue a more organic expansion plan. However, like all opportunities, there are advantages and disadvantages to becoming a public entity. Each company should weigh the pros and cons relative to their specific circumstances and other financing alternatives they might pursue.

Four advantages of being public

1. Easier access to capital.
2. Greater liquidity.
3. Ability to grow through acquisitions (using your stock as currency).
4. Ability to use liquid (in theory) stock options to attract and retain talent.

Four disadvantages of being public

1. Pressure to produce short term results, often at the peril of the long term interests of the business.
2. Public disclosure of company information, which can become a competitive disadvantage in bad times.
3. Costs, in terms of time, additional personnel and professional fees related to meet required SEC filings and Sarbanes Oxley compliance.
4. Vulnerability to lawsuits on bad news or movement of the stock in the "wrong direction."

Pros and Cons of a reverse merger

Reverse mergers have grown in popularity in the last few years with the tightening (some would say closing) of the IPO market in 2000.

Additionally, a reverse merger provides an opportunity for companies that are not considered "IPO ready" to raise smaller amounts of capital (\$3 to \$20 million). Reverse mergers were further bolstered by the provisions of Rule 419 which was passed by the SEC under the Securities Act of 1933. The rule spells out requirements for shells that are designed to protect shareholders and investors from fraud. This new landscape has attracted PIPE (Private Investments in Public Equity) investors as well as entrepreneurs.

Reverse mergers provide seven major benefits when compared to traditional IPOs.

1. Lower cost.
2. Speedier process.
3. Not dependent on the IPO market "window" to successfully complete a transaction.
4. Initial stock price not subject to changes to accommodate market conditions.
5. Less up front distraction and executive time required.
6. Less dilution.
7. Underwriters are not necessary.

Reverse mergers also have three major disadvantages when compared to an IPO.

1. IPO generally raises more money.
2. Most companies that become public through a reverse merger often start out trading on the OTC bulletin board as opposed to a major market.
3. The IPO process makes it easier to create market support for a stock.

It is really important to understand the amount of time and effort that will be required to mitigate the disadvantages of numbers two and three above. Failure to be able to solve these disadvantages will neutralize all of the advantages of becoming a public entity.

As important as all of these considerations listed are, selecting the right shell is the first and foremost important decision you will make. As the reverse merger has grown exponentially this decade, the cost of a "clean" shell currently averages around \$1 million. Understanding the history of the shell (this is not as straight forward as this statement appears to be), the current promoters/players involved in the shell, and the existing shareholder base are critical factors in the decision path to becoming a public entity through a reverse merger.

Future articles will explore, in more detail, the pros and cons of a reverse merger transaction as well as techniques for selecting a shell to merge into.

Before deciding whether an IPO, reverse merger or SPAC is the right transaction for your business, you need to be clear about what benefit having a publicly traded stock provides to your business' long term growth that you could not achieve as a private business.

For more information contact Stash Lisowski, Acting Managing Director, Emerging Business Group, Geller & Company at slisowski@gellerco.com. Geller & Company provides finance, accounting and tax services to public companies and emerging businesses.