



Reverse Mergers

“A Unique and Potentially Effective Method of Capital Formation in Today’s Financing Environment”

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Background

Reverse mergers have been utilized as an alternative to the traditional Initial Public Offering (IPO) for taking private companies public since the dawning of organized public markets. However, for good reason this “back door” method of bringing companies public generally has been stigmatized as an illegitimate method of going public. In fact, most companies that reverse merge into a public shells eventually fail.

That being said many companies have been successful in utilizing the reverse merger as a method of financing and entering the public markets. For example, Blockbuster Entertainment, Inc., Occidental Petroleum, Waste Management, Inc., Turner Broadcasting, and RadioShack all can credit their public beginnings to a reverse merger transaction.

Reasons for Failure of Reverse Mergers

The following reasons can be attributed in order of importance to the long term failure of most reverse mergers:

1. The private company being merged in doesn't have a sustainable business model or has inexperienced management.

This can be said of most young enterprises and has nothing to do with the reverse merger process. In fact, many of these companies are less developed than many venture capital financed companies. The venture capital model assumes approximately 10 to 15 percent of the portfolio companies will eventually prove to be successful.

2. The private company is better off private.

There are roughly 9000 active public companies and approximately third of them rarely trade above private market valuations. Many of these companies came public when markets were frothy and rather inexpensive capital was abundant. However, once reality set in, these companies found themselves struggling to achieve valuations that allowed them to raise further capital or a realize liquidity for the major shareholders. Hence, in the current market environment, we will begin to witness many going private transactions.

3. No significant capital was in the public shell company or no significant capital was raised in the process of the reverse merger.

In theory, even if the company ultimately failed as a result first two reasons, the company could have had a successful financing in the reverse merger process if significant capital was raised.

Most private companies merge into shells that have no significant resources or cash with the promise that being public will "magically" give them the ability to raise cash.

This rarely happens and in MDB's opinion, **no** company should merge with a public entity with the hope of raising capital. The company usually finds itself public having expended valuable cash on attorneys and accountants fees and then being relegated to infrequent trading on the OTC Bulletin Board or Pink Sheets.

4. By far the first three reasons are the principal reasons that most reverse mergers don't live up to expectations. The following list of reasons are contributory to failure or are as a result of the first three factors:

- Poor structure that leaves a limited float, thereby limiting interest
- Complicated capital structure that includes too much preferred stock, warrants, etc. that cloud the picture for the company
- Promoters that control the shell dump their shares immediately
- Lack of a Wall St. sponsorship
- Company doesn't trade on a national exchange
- Too high a value placed on the shell and the promises of the promoters

Keys to a Successful Reverse Merger

These keys are somewhat the inverse of what not to do in a reverse merger, explained in more detail. For the purposes of this part of the discussion we will assume that the company's business is sustainable and management is capable of guiding the company.

1. Will the company attract investor demand?

Would the average investor buy stock in the company if presented with the opportunity? In order to attract investor demand in this market, the company must have a business that the general public will find attractive. Issues to think about in this regard:

- Has the company begun to demonstrate the validity of the business model? Is it too early to gain the confidence of an already weary public?
- Is the business easy to understand? Can the management explain why it will be successful in five minutes or less and be credible?
- Is the business scalable? Is there a clear path to significant growth.
- Can one easily distinguish the business from that of the competitors?

2. Make sure that enough capital is in the shell or is raised upon completion of the merger to sustain the business until a market can be developed for the company's stock.

This will be different for each company. We wouldn't expect that an exciting biotech venture would need to raise all the capital necessary to reach FDA approval for their technology. The biotech company would need to make sure that enough capital is raised to get significant data generated that would induce new investors to invest in the future of the technology. A more basic company would probably want to raise enough capital to get it to being profitable and self sustaining from operating cash flows.

In addition to the operating needs, the market value of the "float" is important because these are the shares that allow new investors to get involved in the company. If no significant cash is raised in the process of the reverse merger then the only possibility for developing a "float" is done through insider sales which will not be viewed upon as positive especially right after the merger.

There are significant challenges to locating a shell with cash and successfully negotiating a transaction, just as there are challenges of raising capital in conjunction with the merger.

3. Having a credible plan to develop Wall St. interest post merger.

This can be achieved a number of ways, some of the points to consider are:

- Target a investment audience by who it is likely to care about the opportunity represented. Individual investors are attracted to easily understood businesses that they can relate to. Institutions are willing to look at more complicated businesses but still want the message to be simplified.
- Is a sponsor necessary? Having an investment bank that is committed to helping communicate a story may be crucial if the company is short on Wall Street contacts. Make sure that sponsor has a vested interest through stock ownership and is committed to making success their success as well.
- Work with experienced Wall Street professionals (investment bank, IR firm) to simplify and condense a message into a twenty minute PowerPoint presentation that is compelling.
- Make sure to make contact with stock buyers(stockbrokers, institutions) on a regular basis and follow up with them on a regular basis. Plan key executive business trips to include visits with stock buyers. Always be looking to make additional contacts. Not only will the company be widening its audience, but just as important it will get valuable feedback.
- Plan supply of stock availability well to minimize volatility of the share price. Many companies make too many shares available for sale before awareness is built for the company. This can lead to unwarranted volatility and consternation among the shareholders early on.

- Attend and present at as many conferences that are targeted at your investment audience as time will permit. These are typically put on by investment banks and are great forums to meet potential buyers of your stock and are generally a good use of time.
- Keep a record of everyone you make a presentation to and send follow up information to reinforce your message. Most substantial buyers of stock need time to get comfortable. Information that reinforces what you first told them is key to gaining their confidence and trust.

Good Reasons to Consider a Reverse Merger

The following reasons to consider a reverse merger are not the typical reasons that a “shell promoter” would give. The following examples are for real companies looking to establish a real market for their equity.

- Company with a complicated capital structure that can utilize the catalyst of the reverse merger as a way to convert stakeholders to common stock. Many times young companies have had to resort to complicated financing means to get financed. It is generally much easier to get convertible debt, preferred equity, straight debt, trade debt, etc. to convert to common if the common will be tradable.
- Many venture financed companies have completed several series of capital raises in different tranches. To further complicate matters many of the financings have different terms that allow for future rights, etc. These provisions often make it very difficult to accomplish future financings due to the fact that the company has to go back to old investors for consent which is generally difficult. The reverse merger process gets investors enthusiastic about the beginning of a trading market for the shares and usually makes these negotiations much easier.
- Company that would be able to raise money at a better valuation being public as opposed to private. These are generally exciting businesses with terrific growth potential that are easy for the common man to understand. Almost in all cases these are better off public, even if the business is early in its development.

- Company where it is important to retain and motivate talented employees through ownership of stock or incentive stock options.
- Company that may have significant shareholders that are no longer interested in the business and are looking for an exit strategy and company management doesn't wish to sell the business.
- Company with great growth prospects but hasn't yet fully developed its' management team or its' business model. Many of these companies can begin building a following on Wall Street before they would usually be able to with a traditional IPO.
- Company looking to execute a "roll-up" strategy to consolidate a fragmented industry. It may be easier to acquire a company if it is possible to include stock as another currency to complete the acquisition. In addition, in fragmented industries it is many times possible to acquire private companies at significantly lower multiples than what the subsequent trading multiple will be.
- Companies that already have a significant number of shareholders where a traditional IPO may be unwieldy.
- Company that doesn't want to raise more than \$20 million but sees the benefit to being public. It is difficult in today's environment to get an IPO done let alone interesting an underwriter in doing one under \$20 million. The reverse merger allows the company to begin building a market immediately without the substantial dilution that a larger IPO financing may bring.