



FULL SPEED REVERSE!

THE REVERSE MERGER: BACKING INTO WALL STREET'S WORST IDEA

INTRODUCTION

One of the options available to small- to medium-sized privately held companies that are looking to raise additional capital or to make acquisitions is the reverse merger. The reverse merger originated as an alternative to the traditional initial public offering (IPO) process for companies that want the benefits of being a public company without the expense and complexities of the traditional IPO. The reverse merger is often suggested as the best option to provide greater access to the capital markets, increase the company's visibility in the investment community, and offer the opportunity to utilize its stock to make acquisitions. RCW Mirus' analysis indicates that while the reverse merger is a quicker, easier, and cheaper route to becoming a public company, it costs much more down the road in terms of the newly public company's ability to raise additional capital, attract an investment following, and utilize its public shares as a cheap currency for acquisitions.

The traditional IPO process is difficult for a reason. It is part of the vetting process for keeping companies that are not ready for the harsh spotlight of the public markets out of the public markets. Our research of companies choosing the reverse merger route over the past two years indicates that the majority of them end up becoming effectively “publicly traded private companies” with small market capitalizations, single digit (or lower) stock prices, and little to no visibility in the investment community.

Overview of Reverse Mergers

In a reverse merger a private company merges with a publicly listed company that doesn't have any assets or liabilities. The publicly traded corporation is called a “shell” since all that remains of the original company is the corporate shell structure. By merging into such an entity the private company becomes public.

After the private company obtains a majority of the public company's stock and completes the merger, it appoints new management and elects a new Board of Directors. The new public corporation will have a base of shareholders sufficient to meet the 300 shareholder requirement for admission to quotation on the Nasdaq Small Cap Market.

Myth: advantages of being a publicly traded company in a reverse merger:

- Increase liquidity of the ownership shares of the company;
- Higher share price and thus a higher company valuation;
- Greater access to the capital markets through future stock offerings;
- The ability to make acquisitions using the company's public stock;
- The ability to use stock incentive plans to attract and retain key employees;
- Going public can be part of a retirement strategy for owners.

Myth: advantages of doing a reverse merger over doing a traditional IPO:

- The costs are significantly less than the costs required for an IPO;
- The time required is considerably less than for an IPO;
- An IPO may be withdrawn due to an unstable market condition even after most of the up-front costs have been expended;
- IPOs generally require greater attention from top management;
- The lack of an earning history does not normally keep a privately held company from completing a reverse merger;
- The company does not require an underwriter.

The reverse merger is by no means a new invention, having been around almost as long as Wall Street itself in one incarnation or another. It flourished in the 1980s when “you could just about take the kitchen sink public,” according to Eric Stevenson, president of a corporate development firm in Arizona. It recently flourished again in the 1990s with the advent of the Internet gold rush, when every sort of company was looking to cash in on the Internet phenomenon.

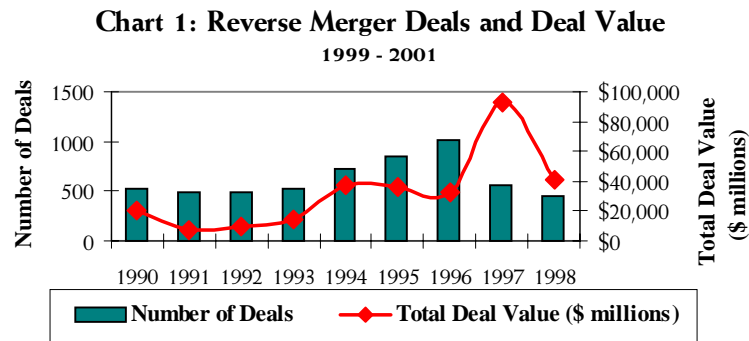
Shell companies used in reverse mergers are generally one of two types. The first is a failed public company that remains to be sold in order to recoup some of the costs of the failed business. These shells have the potential for unknown liabilities, lawsuits, dissatisfied shareholders, and other potential “skeletons in the closet.” The second are created for the specific purpose of being sold as a shell in a reverse merger transaction. These typically carry less risk of having unknown liabilities.

The SEC instituted a number of initiatives in the early 1990s that discouraged the practice of keeping a shell company publicly listed for sale in a reverse merger. These initiatives were designed to decrease penny stock fraud by increasing the minimum capital requirements and the minimum price requirements for listing on the Nasdaq national market, causing a number of the penny stock shells to become ineligible for listing. As a result a number of them moved to the over the counter (OTC) bulletin board, to the pink sheets, or disappeared entirely.

While the SEC doesn't compile statistics on the number of companies that go public utilizing the reverse merger, the number is believed to be in the hundreds per year (see Chart 1: Reverse Merger Deals and Deal Value).

Apart from simply the additional costs incurred by complying with the various filing and regulatory requirements for a public company, our research indicates that the majority of companies that go public through the shortcut of the reverse merger are substantially worse off after the process.

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DEBUNKING THE REVERSE MERGER BENEFITS

The problems with reverse mergers go beyond the potential for the “skeletons in the closet” described above. RCW Mirus’ research indicates that many of the benefits ascribed to the reverse merger process are ephemeral at best and that the quick entry into the public markets without the discipline of the traditional IPO process is hardly beneficial to shareholders. The rigors of the traditional IPO process exist for a reason, serving to keep companies that are “not ready for prime time” out of the public markets. Our research of approximately 50 companies that have become public through the reverse merger process since 1999 indicates that in a high percentage of cases the new public company in a reverse merger quickly becomes effectively a “publicly traded private company.” These have an illiquid, low priced stock, a low valuation, and little to no institutional following. The newly public company is effectively worse off after completing the reverse merger than it was prior to leaving the private domain (see Chart 2: Public Returns Since the Reverse Merger, 1999–2001).

Other problems awaiting companies that emerge from the private arena include issues surrounding the disclosures required by a public firm and the regulatory requirements that the SEC demands. Public companies are required to file regular quarterly and annual reports, meet stringent accounting standards, and make themselves available to their public investors. Small to medium size private companies often lack the infrastructure and back office capabilities to support the requirements

of a public company. This requires additional capital expenditures in order to meet the regulatory and financial burdens of a publicly traded company.

Given the high percentage of reverse mergers that end up on the illiquid OTC bulletin board or the even more illiquid pink sheets, it begs the question: are the espoused benefits of reverse mergers real? Our research indicates that the companies we sampled over the past two years saw little benefit from being public, and even the few companies that increased in value since going public remain penny stocks (stock price below \$5) with a small market capitalization. Management's plans to obtain access to the public markets is effectively non-existent given the low valuation and the lack of cheap currency with which to do acquisitions.

The benefits ascribed to going public through a reverse merger rather than through a traditional IPO process don't bear up under scrutiny. Many of the difficulties ascribed to the traditional IPO process are there for a good reason. Changing from a private to a public company is a monumental step, and the demands of the public markets can exact a heavy toll on unprepared companies. Through the IPO process, the public markets weed out early those companies that aren't ready to be public in the first place.

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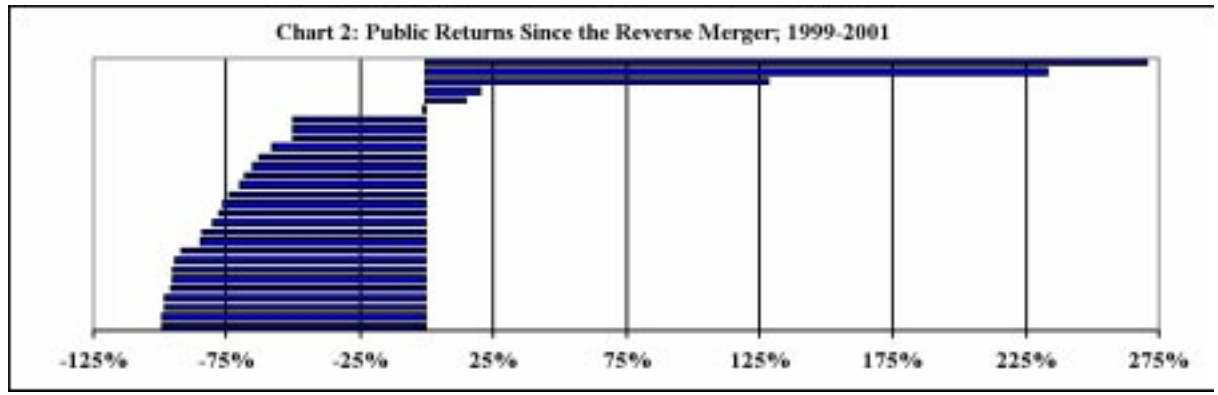
Reality: becoming a "publicly traded private company" after a reverse merger:

- Low stock price, typically a "single digit midget";
- Low liquidity, stock ends up trading OTC or on the pink sheets;
- Capital markets closed, no institutional following to raise stock price;
- Unable to make acquisition, low valuation and illiquid stock precludes this option;
- Stock incentive plans unattractive due to penny stock status;
- Private placements difficult due to low public valuation.

Reality: traditional IPO process serves a meaningful purpose:

- Early vetting process for companies unprepared for the public markets;
- Management forced to focus on increasing shareholder value pre- and post-IPO;
- Reputable underwriter increases institutional following and confidence;
- Underwriter can support stock in the secondary markets post-IPO;
- Relatively few reverse merger success stories compared to IPO.

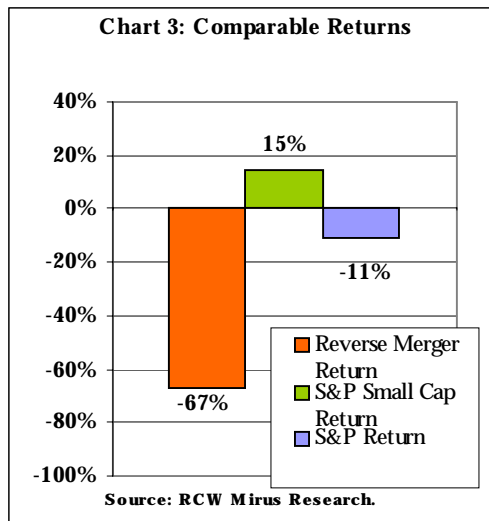
CHART 2



Selecting a credible underwriter is one of the first steps to instilling confidence in both institutions and the investing public. While it is beneficial to keep the costs of going public low (traditional IPO fees can run into the millions when commissions are included), the more credible investment banks apply an initial level of due diligence helping to ensure that companies looking to go public are ready to be public. Underwriters also provide a vital level of experience and support to management as they go through the difficult process of preparing a formerly private company for the glaring scrutiny of the public markets. They not only allow the new public company to get on the radar screen of some of the largest institutional names in the industry, thus helping to get the best IPO price, they can also provide support in the secondary markets for the company's stock after the IPO.

There have been some notable exceptions to our evidence that reverse mergers generally do not work. In 1970 Ted Turner completed a reverse merger with Rice Broadcasting, which grew into Turner Broadcasting Systems. In the 1950s Arman Hammer invested in a

CHART 3



public shell company, which grew into Occidental Petroleum. These are two of the most frequently cited examples of reverse merger success stories. The fact that there are an estimated 500 reverse merger transactions per year and the most frequently cited success stories occurred 30 and 50 years ago stands as mute testament to the difficulty of creating long-term shareholder value through the reverse merger process.

EXAMINING THE DATA

RCW Mirus examined approximately 50 companies that went public through a reverse merger over the past two years from 1999 to 2001. In that time frame the comparable S&P Small Cap index increased in value approximately +11% while the average value of the 46 reverse merger stocks declined approximately -67% (see Chart 3: Comparable Returns).

A consolidated view of the data reveals the same picture (see Table 1: Consolidated Data). Only four of the 46 firms we researched were able to increase their stock price over the past two years after going public in a reverse merger, and all four remain penny stocks. These “single digit midgets” face significant hurdles attracting institutional support, which is vital to increasing the stock price. They face serious dilution to existing shareholders when they go back to the markets to raise additional capital, and any stock option plans will have limited success in attracting and retaining top talent given the low stock price and the likelihood it will remain low.

There is a significant survivorship bias in the data as we have excluded from the averages the 18 companies for which we could not find any current share price data. These companies have presumably moved to the pink sheets, gone bankrupt, or returned to being private companies. The pink sheets are run by the National Quotation Bureau, for all practical purposes have no listing standards, and true price discovery is very difficult if not impossible to obtain.

TABLE 1 TABLE 1: CONSOLIDATED DATA 1999 - 2001

Price	Number	Avg. Change	Ave. Price	Ave. Market Cap.
All	46	-67%	\$0.99	\$8.1 million
Declined	24	-79%	\$0.69	\$5.9 million
Advanced	4	+163%	\$2.61	\$10.2 million
No Data	18			

Source: RCW Mirus Research

BETTER OPTIONS AVAILABLE

There are alternatives available for smaller firms that need to raise additional capital or that are stuck in a small market segment. They are to remain private and raise capital in a private placement or to seek a merger or an acquisition. Companies can do private placements after going public through a reverse merger, but it is difficult to get around the fact that as a public company the valuation can be much more transparent than it is for a private company. Private companies have the option to more selectively choose appropriate comparables thus increasing its valuation, while a public company is valued daily by the marketplace.

The reverse merger process can serve to prove one of the oldest quips of investing on Wall Street: "If you want to make a small fortune in the stock market, start with a large one."

Another option is to examine a merger or an acquisition alternative. Rather than face the execution risks of remaining a stand-alone company, a smaller firm can look to partner with a larger entity that has the resources to support the company's development efforts or to leverage its sales and distribution channels to drive increased market penetration.

CONCLUSIONS

RCW Mirus' research indicates there are few companies that succeed long-term shareholder value through the reverse merger process. While the route to the traditional IPO is time consuming, expensive, and fraught with difficulties, it serves an important purpose: to keep companies that shouldn't be public out of the public markets. The reverse merger all too frequently creates a "publicly traded private company" that has a small market cap, an illiquid stock, and little ability to raise additional funding without significantly diluting existing shareholders. A better option for smaller firms is to remain private and raise funds through a private placement or look to do a merger or an acquisition to get the firm to the next level.

It is important to remember that the primary purpose of a public company is to create long-term value for its shareholders, and only a select few companies are able to consistently perform that task. The majority of the benefits ascribed to the reverse merger process are beneficial to getting to the public markets quickly, but very few translate into benefits for the shareholders of the newly public company. The reverse merger process can serve to prove one of the oldest quips of investing on Wall Street: "If you want to make a small fortune in the stock market, start with a large one."

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