



Reverse Mergers Seen as Alternative to IPOs

By Emma Trincal, Senior Financial Correspondent Wednesday, March 26, 2008

NEW YORK (HedgeWorld.com)—The challenging initial public offering market has given rise to a new trend among small private companies that are having trouble going public and finding it hard to raise money in the capital markets: reverse mergers combined with PIPE financing. Hedge funds are capitalizing on this new opportunity, known as alternative public offerings, by getting involved in underwriting and financing these transactions, which some are already calling "the new IPOs."

Lately the bar to accessing the IPO market has been raised, especially with the credit crunch. Small private companies seeking a listing on an exchange need to find alternatives to IPOs. One popular alternative consists of combining a reverse merger and a private placement equity capital raising, also known as PIPE financing. PIPE stands for private investment in public equity.

In a reverse merger, a publicly listed company acquires all the stock of a private company in exchange for approximately 90% to 95% of the shares of the public company. This transaction requires that the acquiring public company reorganize, a process that gives complete control to the private company by installing the private company's directors and officers onto the board of the newly merged corporate entity. The process the private company goes through is similar to an IPO, in that upon completion of the transaction it is a publicly listed company with newly raised equity capital.

"Those reverse mergers combined with PIPE financing are getting more popular, although so far these offerings have not generally been respected," said Steven Davidoff, assistant professor of law at Wayne State University Law School in Detroit. "It's been looked down on as a back-door way for lesser quality companies to go public. But it's becoming more of an accepted practice."

Regardless of their lack of mainstream acceptance, reverse mergers coupled with PIPE financing represent a specialized and labor-intensive, yet potentially lucrative niche for hedge funds. Demand is growing from small private companies that need an exit strategy and that cannot find one via the regular IPO market.

Kevin Pollack, managing director at Paragon Capital LP, a New York-based hedge fund dedicated to alternative public offerings, said there are many reasons why smaller private companies are underserved in the IPO market. For instance, he said, since the 1990s a number of midsize IPO underwriters—such as Hambrecht & Quist, Alex Brown, Robertson Stephens and Montgomery Securities—have disappeared because they have been merged or consolidated into larger banks that focus on bigger deals.

"The disappearance of these underwriters has created a gaping hole in the IPO market, leaving private companies underserved and undercapitalized," he wrote in a client note.

One clear benefit for the private companies using this alternative is that they can access the public markets quicker and less expensively, he said. That's because in an alternative public offering the registration statement is filed with the Securities and Exchange Commission after the reverse merger and PIPE financing, which makes the transaction process faster than a traditional IPO.

Paragon Capital is a hedge fund that specializes in this alternative public offering niche market. "We own several public shell entities," said Alan Donenfeld, president of Paragon, in an interview. "We are merging strong private companies into these public shells bringing them public. Then we do a PIPE financing to give the new company the capital it needs for its growth."

The firm, which has offices in New York and Greenwich, Conn., said earlier this month that it intends to launch a new offshore fund while opening its domestic fund to institutional investors. Both funds specialize in reverse mergers and alternative public offerings, secured debt investments in PIPEs and bridge loans. Since its inception in October 2005, Paragon's domestic fund has returned a cumulative 235%.

Combining reverse mergers and PIPE financing makes sense for small private companies with a critical need for capital. According to DealFlow Media Inc., in 2007 there were 222 reverse mergers completed and 45% of them included a concurrent PIPE, raising approximately \$1 billion.