Reverse Takeovers: An Investment Opportunity or Trap for the Unwary?

By Michael Kemp

Our recent Federal Treasurer, Joe Hockey, isn't the only one who is lamenting the long lost mining boom.

With the iron ore price down by more than 75 percent over the past four years a long list of ASX-listed junior miners have given up any hope of turning a profit. Many have effectively become "shell" companies; that is companies in name but lacking a viable business model.

Interestingly many of these shell companies (particularly those with some cash left in the bank) are presently receiving new attention from a different group of investors. These investors are the owners of viable privately owned businesses looking to list their companies on the ASX by combining their business with an already listed shell company.

The corporate marriage can result in a win-win situation. The shell company receives a new lease of life and the non-listed company gains its listed status. The two companies don't even have to operate in the same business sector. Right now the toads are mainly junior miners with fledgling tech companies delivering the corporate kisses.

The process is referred to as a reverse takeover or back door listing and it provides an alternate method of listing to the more conventional Initial Public Offering (IPO).

This article explores the process of reverse takeovers as well as their benefits and risks.

How the Deal is Sealed

Before the two companies can officially tie the knot of their corporate marriage there are certain steps that need to be taken.

The ASX Listing Rules require that the companies seek shareholder approval before the deal is executed and that ASX admission requirements are met. These requirements are broadly the same as for an IPO.

The already listed shell company can then acquire the shares or assets of the unlisted company. In exchange the owners of the unlisted company receive shares and/or cash. If cash forms part of the deal, it can be delivered either through an associated capital raising or from the shell company's bank account (if any cash remains). The deal typically changes the company's ownership, operations and leads to new management and directors.

The broad benefits reverse takeovers deliver are often overstated and in most cases there are few if any advantages over an IPO. Two commonly stated benefits are the speed and ease of back door listings compared to IPOs. However research undertaken by Peter Lam of UTS Business School has found that the average backdoor listing takes longer to complete than a comparable IPO. In addition brokers commonly state that a backdoor listing can cost the same or more to execute.

It seems that the decision between undertaking a back door listing or an IPO is strongly influenced both by the prevailing stock market conditions and the availability of suitable shells. When the stock market is flat or underperforming investor appetite for new floats tends to be low. Under these conditions small IPOs are difficult to get away and back door listings come back into vogue.

Last year (2014) saw 30 back door listings undertaken on the ASX, just short of the record number back in 2000 (when there were 32). This compares with 58 companies choosing last year to list on the ASX via the traditional IPO route.

Below is a list of the oft-touted advantages and disadvantages of back door listings:

Advantages

Regulatory

The ASX listing rules require that a listed company's share register has a minimum number of investors holding at least $2,000 worth of shares. The required minimum varies between 300 and 400 shareholders with the actual number dependent upon the percentage of the total issued capital held by related parties. This requirement can be difficult to meet for small companies that are seeking listing.

A back door listing facilitates this requirement since the required shareholder spread is already established.

Access to cash

The shell might already have cash in its bank account that the new management can put to work. This can also reduce or sometimes even dispense with the need to raise new equity capital.

Scrip-for-Scrip rollover relief

The ATO allows Capital Gains Tax rollover relief on the disposal of shares if at least 80 percent of the consideration paid for the shares in the unlisted business is paid using shares in the ASX listed company. CGT liability is then deferred until the ASX listed shares are ultimately disposed of.

Simpler than an IPO?

As already mentioned backdoor listings aren't necessarily easier to undertake than IPOs but sometimes they can be. For example when both companies operate in a similar line of business and are of a similar size a prospectus isn't required, which simplifies the process.

Conversely a back door listing can add complexity in some areas. For example due diligence needs to be done on two companies (shell and target company) rather than just one as per an IPO.

Cheaper than an IPO?

Typically the costs are similar for a backdoor listing and an IPO. A major cost associated with both is the production of a prospectus/information memorandum, so unless the need for the prospectus can be dispensed with (when undertaking a back door listing) there is often little to choose between them.

Disadvantages

Dilution

Capital raisings and capital reconstructions associated with backdoor listings can dilute existing shareholders. A potential offset for these shareholders is if the share price lifts on the announcement of the plan.

Underperformance

Whilst there have been a number of corporate success stories following back door listings, there is evidence that, when considered as a group, they underperform the returns delivered by both the broader share market and comparable IPOs. Dr. Peter Lam of UTS Business School looked at 200 backdoor listings undertaken on the ASX between 1999 and 2007. He found that over three years from their reinstatement to the ASX, backdoor listings underperformed the S&P/ASX 200 Index by 62 percent on average and IPOs in similar industries by 37 percent.

Lam also found that the share price of the shell company spiked as the market speculated on a takeover, or as news was announced. Which means that buying into the shell company before its takeover was a better strategy than buying it after the listing. Of course this strategy is difficult for the average investor to undertake since there is usually little fanfare associated with back door listings. They aren't promoted in the same way as IPOs because there isn't the need to establish a broad base of new shareholders.

Lam's findings indicate that existing shareholders typically gained more from backdoor listings than those who bought in after the company was reinstated to the ASX.

And whilst this might sound like good news for existing shareholders remember that for many investors the price spike provides only partial compensation for a long suffering share price.

Lam's research identified some common characteristics in successful backdoor listings with larger ones tending to perform better than smaller ones and those accompanied by capital raisings also doing better.

Conclusion

Every investment needs to be considered on its own merits. But, as a general rule, when considering an investment which involves a back door listing, you are better to:

- become involved at a very early stage of the process
- stick to the larger offerings
- favour those coupled to a capital raising
- seek companies with a history of positive earnings

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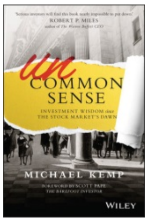

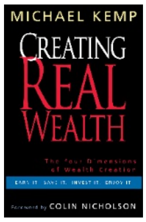

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.