Backdoor Listings

Most companies are listed, also called floated, on the stock market through an Initial Public Offering (IPO). In an IPO, a company is formed, and offers shares to the public through a prospectus. Providing the IPO is successful in raising enough capital and meets other requirements including a sufficient spread of shareholders, which can take three to six months, its shares may be listed on the stock market where investors may buy and sell them.

This IPO process is also colloquially known as listing through the front door. However, it is also possible to achieve a stock market listing through a reverse takeover, which is colloquially known as a backdoor listing.

A backdoor listing can be achieved in several ways including by the shell company, one with no existing operating business, but a stock market listing, doing a share consolidation (e.g. 50 old shares for one new share) effectively diluting existing shareholders severely, but allowing them to retain an interest and for the company to keep the all-important existing spread of shareholders. At any time, there are some listed companies that have failed over time to find mineral or energy resources, biotechnology discoveries or otherwise used most of the capital they raised from the public and become unviable. They may be still operating, but are often suspended on the stock market, but not delisted. Their advantage for a backdoor listing is that they may still have some cash and meet the listing requirements for a spread of shareholders. These are usually referred to as shell companies and there is an active market in them, especially in the more speculative times toward the height of bull markets.

A backdoor listing is achieved by the shell company buying a private company from its owners by issuing them new shares in such numbers that the private company shareholders now effectively control the shell company. Hence, they have effectively engineered control of a listed company through a reverse takeover. Not uncommonly, additional capital may be raised at this time through an information memorandum. The shell company now changes its name to reflect the business of the acquiring company and, if suspended, applies for trading to begin on the stock market.

There are many variations on the backdoor listing process, but this example gives the basic idea.

There are a number of reasons advanced for why the backdoor listing method is used:

1. It is cheaper than an IPO. This is probably true in many cases, but there is some argument that it may not always be.
2. It is faster than the IPO process. This is also probably true in many cases, but again not always. It is argued that speed can be important for a technology disruptor business that wants to list quickly before others can analyse its business, as would be more likely given the greater exposure in the IPO process. This may be a spurious argument, however.
3. A private company wants to list on the stock market, but it does not have a sufficiently substantial business or have a sufficient spread of shareholders to meet the requirements for listing through an IPO.
4. These private companies may not have a history of operation and have been unable to raise further risk capital without a proven business model that produces sales revenue or profits. Listing on the stock market opens the opportunity to raise capital.

5. There is often a capital raising that accompanies the backdoor listing. In an IPO, shares must be issued at a minimum of 20c, but this is not a requirement for secondary raisings through an information memorandum accompanying the listing.
6. The shell company may still have some cash which the new business can employ. This often happens when the original company was, say, an unsuccessful resources explorer that had a cash reserve remaining, but insufficient to mount further exploration.

There are also some downsides to backdoor listings:

1. Backdoor listings may bring problems buried within the shell company and sometimes there are disgruntled shareholders of the shell company whose holdings have been seriously diluted in the process.
2. While backdoor listings are subject to the same listing requirements as IPOs, they tend to be much smaller and the reverse takeover process tends to be a more private transaction, whereas an IPO prospectus will have wide circulation and fall under greater scrutiny than an information memorandum for a small reverse takeover. This can pose additional risks for unsophisticated investors.
3. Most backdoor listings are for small companies, generally called microcaps, and although they meet the requirements for a minimum spread of shareholders, trading in their shares can often be very illiquid and result on wider bid-ask spreads, raising risks for shareholders.

Backdoor listings are part of an ongoing process that reflects the speculative cycle. When bull markets move into the wild speculative period toward their end, it is common to see many backdoor listings, often of businesses of dubious merit, but names that suggest the latest successful speculative favourite, because speculators are throwing money at anything that sounds like the investment equivalent of "flavour of the month". The new listings are focussed on the speculative part of the market and often of little intrinsic merit and sometimes controlled by rather dubious operators, who line their pockets in the process. They are usually widely supported by inexperienced and unsophisticated investors who are attracted to the low prices for these stocks and the gamble that they might make the next big discovery or create the next technology powerhouse. It always ends in tears.

Then when the next cycle comes around, these failed shell companies are used for backdoor listings of the next speculative phase. We saw many technology listings in the 1990's, often backdoor listings of earlier failed resources explorers. When the technology boom gave way to the resources boom of the 2000's these technology shell companies were used to backdoor list resource explorers again. Now the resources boom has ended and we are seeing those shell companies used to backdoor list a growing flood of technology disruptors. In backdoor listings, what comes around goes around on an endless chain.

While there are some examples of backdoor listings that went on to be successful, buying shares in a backdoor listed company has often proven to be very risky in the past. This is especially so when the backdoor listed "business" is simply exploiting the latest speculative fad – remember the internet and tech boom, the biotech boom and resources booms. More recently, backdoor listings have brought up businesses that are completely based and controlled overseas, where laws are different to ours and reliable information is hard to come by. There have been scandals on overseas stock markets, including where straight-out fraud has been involved.

Some reasons why backdoor listings may be more than unusually risky include:

1. The start-up businesses that have been backdoor listed may not have proven viable businesses and are so new they are yet to record any sales revenue. They may therefore not be conservatively financed, or anywhere near being so.
2. The backdoor listed businesses may have directors and managements that are full of enthusiasm for their new enterprise, but lack experience in managing a business, including a lack of awareness of legal, regulatory and stock market obligations on managers and directors. For example, they may lodge financial reports that do not meet the requirements of accounting standards. Further, they may fail to comply with our continuous disclosure regime. Of even more concern, they may fail to disclose related party transactions or even that there are arrangements that result in associated parties having more control than has been disclosed to shareholders.
3. The backdoor listed company may operate in an overseas jurisdiction where there is a much lower standard of regulator supervision than we commonly expect in our market.

With a reverse takeover or backdoor listing it is usual that the companies involved have to obtain approval from the shareholders in the shell company. Where a few large shareholders control the shell company, the smaller shareholders will have very little power. Nevertheless, they should be given notice of a meeting and an explanatory memorandum, independent (a much abused term) expert report and a prospectus if additional capital is being raised. Before voting to approve a reverse takeover and especially if considering applying for more shares under the prospectus, as a bare minimum it is wise to make sure that you understand what is proposed. One of the most important “rules” in investing is that if you do not understand something, don’t approve it and don’t invest in it.

The key takeaway here is that many backdoor listings may be far more risky than we might expect from established listed companies and IPOs. The overwhelming body of backdoor listings are speculations, not investments. Be especially wary if the backdoor listing seems to be tagging onto the latest market favourite or fad. Research shows that backdoor listings underperform the ASX 200 stocks and also underperform similar businesses that came to the market though an IPO. One survey of technology backdoor listings over the last decade showed that two-thirds had delivered negative returns to shareholders. Of the one third that gave a positive return, it was still below the ASX 200 return. Backdoor listings are like buying lottery tickets. You might buy the winning ticket, but most likely you will lose your money.

Remember that backdoor listings are most often businesses that were unable to get funding using conventional channels because they could not satisfy the requirements of professional investors and/or lenders. The backdoor listing is a last resort to a capital raising mechanism by sub-standard businesses. If the reason for a backdoor listing is that capital could not be raised conventionally and or that a listing served the purpose of giving credibility to their dubious or unproven business model, it should be of great concern to investors attracted to them.

Most backdoor listings therefore suit experienced investors who understand the risks and are comfortable with assuming those risks. Unfortunately, backdoor listings are often targeting inexperienced punters, who a led like lambs to the slaughter, attracted by maybe one in a hundred or more of these stocks that becomes very successful.

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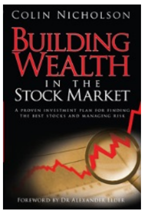

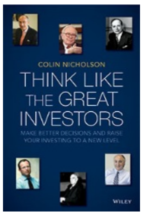

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