

Interview

Going Public Via a Reverse Merger

Biotech Companies Seek to Survive a Frozen IPO Market

David N. Feldman, Founder and Managing Partner, Feldman Weinstein & Smith LLP

Mr. Feldman is the founder and Managing Partner of Feldman Weinstein & Smith, a New York-based law firm, and an expert in reverse merger transactions. We asked him about the current market for reverse mergers and PIPE (private investments in public equity) transactions.

With the initial public offering market essentially closed, reverse mergers are becoming more popular among biotech firms. What are the benefits of reverse mergers for biotech firms?

Feldman: The first question any private company needs to ask is what is whether it makes sense to go public, regardless of the method by which it is accomplished. There are two questions I ask any company to answer. First, can you benefit from being publicly held? And second, can you bear the cost of doing so? The advantages of being public include easier access to capital; the opportunity to grow through acquisitions, because you can use your public stock as a form of currency in acquisitions; the opportunity to create a path to liquidity for prior investors and the entrepreneurs; the opportunity to reward executives with stock options and other equity; and the public relations benefit of having your information available to all for all to see. There are also disadvantages. Cost is one. Transparency can be an advantage as well as a disadvantage, as firms also need to disclose competitive information about what their executives are earning and how their operations work. For biotech companies, to the extent that private equity and venture capital is available, it is usually available early on or in the late stage, but not necessarily in the middle stage, such as when a company needs to fund phase 2 trials. Venture capitalists that have funded preclinical development or phase 1 clinical trials may want to fund phase 2 trials, but often there are restrictions in their funds on how much they can invest in one company or what percentage of their fund can be invested in one company. But there are investment banking firms that understand the biotech business and have doctors on their staff, and they are willing to help cer-



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tain biotech companies raise, for example, the next \$20 million needed, and additional rounds of financing after that, but only if the company is public. For those companies, clearly there are benefits to going public, because it is what gets them the capital they need to continue growing. And if they are raising \$10-20 million at a time, can they afford the cost of being public, which can amount to as much as \$1 million a year? Yes they can.

In the current market, is it still possible to find investors for biotech PIPE financing?

Feldman: Our firm handles more PIPE transactions for investment banks than any other law firm, and we are still seeing deals, including some with biotech companies. It is true that, among PIPE investors, including hedge funds and other fund managers, there are some that are experiencing redemptions in their funds and are holding off on new in-

vestments. And there are others that, even if they do not have that problem, just think the current market is too volatile and are, therefore, also holding off on new investments. But there are still many funds that see great opportunities now and are still very active. There was a pause in the market after the steep decline in the stock market because many companies were reluctant to raise new funds at such low valuations. At some point, however, they can no longer afford to wait. For most of these small companies, there is really no other source of financing available. They are not able to borrow money from banks, and venture capitalists generally tend stay away from investments in public companies, as do private equity investors, and both venture capital and private equity firms are facing their own difficulties in being able to raise new funds. So, despite the much lower valuations, companies are still turning to PIPE financings to raise money because they have no choice.

We have observed that foreign companies have used reverse mergers to enter the US market. Are foreign firms becoming more prominent in reverse mergers? If so, why do you think this has been happening?

Feldman: The answer is yes. More and more foreign companies are doing reverse mergers, especially companies from China. Probably close to a third of all reverse mergers last year were companies from China, and it does not appear to be letting up. But it is not just companies from China. I just closed a deal in October with a company from the UK, and we have a number of companies from Korea that are interested. In the case of China, the stock exchange is heavily controlled and only allows a few new companies to list each year. But even companies from the UK, where the stock exchange is very well established, are coming over. For those companies, it may be because they have important business relationships in this market.

We understand that the SEC has tightened rules on reverse mergers over the years, contributing to a more positive image of reverse mergers in the eyes of investors.

Feldman: In the 1970s and 1980s, the reverse merger world was mostly populated by shady characters who were doing questionable things. The regulatory tightening began in 1992, when the SEC

made it harder for them to operate. That helped begin the process of more legitimate people coming into the market. Then in 2005, the SEC passed a rule requiring increased disclosure at the time of the reverse merger. It used to be that you could wait almost three months after a transaction before any information had to be released. Now a full, comprehensive disclosure document, including fully-audited financial statements and so on, must be submitted within four days of completing a reverse merger.

How does the cost of doing an IPO compare to the cost of doing a reverse merger?

Feldman: The cost difference is very significant. What I generally tell people is that if you have high confidence that you can complete a traditional IPO with a strong underwriter, who definitely will raise the money they promise to raise at a reasonable cost and within a reasonable timeframe, that it is almost always the best option. The reality, however, is that in many situations, none of those things happen. You can spend millions of dollars and nine months to a year working on an IPO, and then, at the last minute, because of market conditions on the week of the IPO, they either shelve the deal, change the price, or change the number of shares, and that is a very significant risk. A reverse merger can be done for well under a million dollars in total costs, including auditors, lawyers, and the costs of acquiring a shell, in most cases, whereas there is no way to do a traditional IPO without spending millions of dollars, or at least an IPO with a strong underwriter.

Profile

David N. Feldman

Mr. Feldman is one of the country's leading experts on reverse mergers. He is the author of *Reverse Mergers: Taking a Company Public Without an IPO*, which was published by Bloomberg Press in 2006, and has since entered its third printing. He has been quoted in the New York Times, Wall Street Journal, The Financial Times, and Forbes, among other publications. Mr. Feldman received a Bachelor of Science in economics from the Wharton School of Business at the University of Pennsylvania in 1982 and his Juris Doctor in 1985 from the University of Pennsylvania Law School.