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The Return of the Reverse Takeover

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Read the complete report.

Following Canada's legalization of recreational cannabis in 2018, Canadian capital markets have proven to be fertile ground for the financing of issuers in the cannabis industry, both foreign and domestic. Several cannabis issuers have gone public by way of reverse takeovers (RTOs or also called reverse mergers or back-door listings) to access these markets, including Aurora Cannabis, Curaleaf, Zenabis, MJardin, IGC Resources, Pure Global Cannabis and MedMen. Since 2017, a total of 66 cannabis issuers have announced or completed reverse takeovers.

The Canadian Stock Exchange (CSE) has been a particularly active marketplace for RTOs in the cannabis space because its rules allow for the listing of cannabis companies with U.S. domestic operations, whereas the TSX and the TSXV restrict listed issuers from engaging in or investing in U.S. cannabis cultivation and distribution operations, and certain ancillary activities.

How Does an RTO Work?

An RTO is a transaction whereby a public company (Pubco) whose shares are listed on a stock exchange acquires all the shares of a company (Targetco) that has operating assets or an operating business, but whose shares are privately held. As a result, Targetco shareholders exchange their shares for shares of Pubco, which in turn holds the shares of the operating business (Targetco). An RTO is generally seen as an alternative to the traditional initial public offering (IPO) of shares that mitigates execution risk and results in widened access to Canadian capital markets.

Unlike a traditional IPO, RTO disclosure documents are generally not reviewed by securities commissions, only by the exchange on which they propose to list. Although this reduces the regulatory burden on issuers, it also dispenses with an important element of investor protection.

Structures and sizes vary, but RTOs generally involve Targetco shareholders exchanging all the Targetco shares for Pubco shares, which have a deemed issuance price corresponding to the value of the operating assets or operating business of Targetco. Since the value of the operating assets or operating business of Targetco will generally be substantially higher than the value of Pubco on a pre-transaction basis, Targetco shareholders will ultimately control a substantial majority of the Pubco shares following the reverse takeover.

What Explains the Recent Surge?

The recent RTO trend comes in the wake of a cooling IPO market in Canada and may be explained by the fact that RTOs (i) do not necessarily require a concurrent financing, or (ii) are often preceded by private placement of subscription receipts, allowing private issuers to (a) gauge investor interest before going public and (b) complete their financing before going public. Generally, where there is a pre-RTO financing, the proceeds will be held in escrow until the issuer closes the RTO allowing it to list, failing which, investors' funds are returned to them. In either case, the prospect of going public without the need for a financing or going public knowing that your financing is complete significantly reduces the execution risk of the process.

This stands in contrast with an IPO, whereby an issuer may incur significant professional fees without any certainty regarding market sentiment and an ultimately successful transaction.

Advantages and Disadvantages of RTOs

As with any transaction structure, an RTO involves several advantages and disadvantages.

Advantages

- Reduces execution risk by allowing private issuers to go public with certainty that financing is complete or even without financing.
- May be cheaper and faster than an IPO.
- Generally does not involve regulatory review other than by the applicable exchange.
- Provides a lifeline to a dormant Pubco and more liquidity and value for Pubco shareholders willing to exit after the transaction.
- Does not usually involve prospectus liability for the directors, officers and selling shareholders.

Disadvantages

- Involves less market validation of Targetco's business than an IPO.
- Generally requires a Pubco shareholders' meeting.
- Could be stigmatized by scandal (Sino-Forest), and the volume of transactions leading to a "gimmicky" perception.
- Targetco shares are automatically diluted (through the Pubco shares).
- Where no concurrent financing is available, it may be subject to sponsorship or due diligence requirements by stock exchange member organizations.
- May trigger post-transaction tax reorganization and complicated post-transaction corporate restructuring, involving the collapse of the holding and operating company vehicles.

Exchange Sponsored RTO-like Programs

Both the TSX and the TSXV have implemented exchange programs to put in place transactions and structures that functionally have a similar effect to an RTO.

In 2008, the TSX adopted the special purpose acquisition corporation (SPAC) program in order to offer an alternative vehicle for listing on the TSX. The SPAC program is structured as a two-step listing process whereby the SPAC is first listed as a non-operating cash entity, raising a minimum of $30 million. These proceeds must then be used for the qualifying acquisition of an operating company or assets within 36 months of listing.

In the late 1980s, the TSXV adopted the capital pool company (CPC) program in order to offer an alternative vehicle for listing on the TSXV. Similar to the SPAC program, the CPC program is a two-step listing process whereby a CPC is first listed as a non-operating cash entity, following which it raises between $200,000 and $4,750,000. These proceeds must then be used for the acquisition of an operating company or assets within 24 months of listing.

Key Takeaways

The experience of cannabis issuers in their overwhelming use of RTOs to go public serves to highlight three important points regarding RTOs:

- Since RTOs can be completed with financing already complete or without financing, issuers have been able to avoid or minimize market and execution risk on their going-public transactions.
- Because RTOs may be cheaper in terms of professional and other expenses as well as faster than the IPO process, RTOs have been widely adopted by issuers in "hot" industries in order to get to market as quickly as possible.

- Since their initial offering document is not reviewed by securities regulators, RTO issuers may face additional scrutiny from securities regulators on their first prospectus issuance following the RTO.

It remains to be seen whether other industries will adopt RTOs as wholeheartedly as the cannabis industry (and the junior mining industry before it) has done, but for issuers in more speculative or “hotter” markets, it will remain an attractive going-public alternative to the IPO for the foreseeable future.

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