SHORTCUT TO THE U.S. MARKETS THROUGH REVERSE MERGERS

Congsheng Wu, University of Bridgeport

CASE DESCRIPTON

A reverse merger takes place when a public company, commonly known as a "shell", acquires a private operating company through a share exchange transaction. The public shell typically has no business operations, but is valuable because of its public trading status. Post-merger, the operating company's owners take control of the newly formed public company. Reverse mergers have long been used in the U.S. as an alternative to achieve public trading status. Conventionally, foreign companies wishing to cross list their shares in the United States have followed the old-fashioned initial public offering (IPO) process. Their shares, typically in the form of American Depositary Receipts (ADRs), are registered with the SEC and are listed on a major stock exchange. In recent years, however, an increasing number of Chinese companies have gained U.S. market listing through reverse mergers. This article provides a detailed case study of an actual reverse merger. The case is appropriate for upper-level undergraduate or graduate finance courses such as corporate finance. Students should have the basic knowledge about the financial markets and corporate finance. Students can work individually or in teams on this project, which requires around 5-8 hours outside of class to complete. Classroom presentations and discussions should be arranged in a regular, 2-hour class.

JEL: G34

KEYWORDS: Reverse Mergers, Chinese Companies, Public Shell; Case Study

CASE INFORMATION

A reverse merger is a merger between a public company that has virtually no business operations and a private company that has a viable business. The public company, commonly known as the "shell", issues shares to the owners of the private operating company in exchange for their 100% ownership. Post-merger, however, the former private company's owners take a majority control over the newly created company, which retains its public trading status. Reverse mergers are also known as reverse takeovers. They have long been used by private companies to achieve public trading status in the United States. Armand Hammer, a world-renowned oil magnate and industrialist, is generally credited with inventing the reverse merger. In the 1960s, Hammer invested in a public shell company into which he merged his Occidental Petroleum. Another notable example is the reverse merger completed by Ted Turner in 1970 with Rice Broadcasting, which went on to become Turner Broadcasting.

Typically the shell companies are publicly traded companies that have fallen on hard times. Frequently, they are companies that went public some years past. Some may have been traded on formalized exchanges such as the New York Stock Exchange (NYSE) or the Nasdaq Stock Market, but now are traded on the OTC Bulletin Board (OTCBB). Most of these companies have ceased business operations for years or on the verge of bankruptcy. They are basically worthless except for the fact that they are publicly traded. In response to the demand for "clean" shells, investment houses specializing in reverse mergers regularly create pure clean shells and other special purpose acquisition companies. To create a shell, they incorporate a company, register its shares and file the required quarterly and annual reports with the Securities and Exchange Commission (SEC), and list the shares on the OTC Bulletin Board. There are no minimum quantitative standards which must be met by an issuer for its securities to be

quoted on the OTCBB, as long as the issuer files required reports with the SEC or other regulatory authority.

Conventionally, foreign companies wishing to cross list their shares in the United States have followed the old-fashioned initial public offering (IPO) process. Their shares, typically in the form of American Depositary Receipts or ADRs, are registered with the SEC and are listed on a major stock exchange. ADRs are negotiable certificates (denominated in U.S. dollars) that are issued by a U.S. depositary bank to represent the underlying shares of a foreign stock. ADRs are sold, registered, and transferred in the U.S. in the same manner as any share of stock.

In recent years, however, an increasing number of foreign companies have opted for reverse mergers as an alternative to achieve public trading status in the United States. Based on a report by Martin (2007) published in the Barron's magazine, as many as 170 Chinese companies were believed to have gained instant stock-market listing in the U.S. via reverse mergers by February 2008. What makes reverse mergers attractive to emerging Chinese companies seeking public trading status in the U.S.? One reason is simple: They have few other options. For privately held small companies in China, going public for a listing on the Shanghai or Shenzhen stock exchange seems to be out of the question. On top of the two-year wait time, Chinese regulators favor large, state-owned enterprises over small privately held companies when approving companies to be listed on the two official Chinese exchanges in Shanghai and Shenzhen.

Consequently, many Chinese companies seek stock listings elsewhere, especially in the United States (see, Wu, 2005). But traditional IPOs in the U.S. require, among other things, a relatively long and stable earnings history, which limits opportunities for emerging companies. In addition to the regulatory burden and stringent listing requirements associated with an IPO, many of these companies would not be able to attract top-tier investment banks to underwrite a public offer due to their small size and uncertain underlying fundamentals. Touted as a cheaper, easier and backdoor route to the U.S. public market, reverse mergers become the choice of many small companies.

To understand reverse mergers, consider a hypothetical private manufacturing company from China. The company was wholly owned by its sole founder. The company had decided to become a U.S. public company, but the conventional IPO procedure was out of reach due to the stringent listing requirements. With the help of an American investment house that specialized in reverse mergers, the company hooked up with a U.S. public shell, which had ceased business for many years but was still listed on the OTC Bulletin Board. After signing a Letter of Intent, the U.S. public shell company conducted a 100:1 reverse split to reduce the number of shares outstanding. At the closing, the public shell issued enough new shares to the founder of the Chinese company in exchange for his 100% ownership. As a result, the private company became a wholly owned subsidiary of the U.S. public company. At the closing, the former sole director of the U.S. shell company resigned and the founder of the private company was elected as the chairman of the board and the chief executive officer of the new company, which maintains the listing status on the OTCBB.

The benefits from reverse merges are limited, however. First of all, shares of the merged company are quoted only on the OTCBB. Stocks traded in the OTCBB are usually thinly traded "microcap" or "penny" stocks. Many investors avoid these stocks due to a well-founded fear that share prices are easily manipulated. The SEC has issued stern warnings to investors to beware of common fraud and manipulation schemes. Additionally, corporate governance is not required for companies listed on OTCBB. Secondly, top-tier investment houses venture capitalists have almost always avoided such reverse mergers. Thirdly, a reverse merger itself is a pure share exchange transaction: no new capital will be raised. Nevertheless, becoming a public company makes it more attractive to private equity investors.

In some cases, the reverse merger is accompanied or followed by a private equity investment, bringing new capital to the newly formed company.

Despite reverse mergers' emerging popularity, studies on them are rare due to data constraint. A few existing studies are limited to reverse mergers between two U.S. companies (Gleason, Rosenthal and Wiggins, 2005, for example). This paper adopts a case-study approach by focusing on an actual reverse merger between a U.S. public shell (Point Acquisition Corporation) and a private operating company from China (Powersmart Holdings Limited).

The U.S. Shell Company

Point Acquisition Corporation was originally incorporated under the laws of the state of Washington on November 13, 1947 under the name Silver Mountain Mining Company. On August 20, 1979, the articles of incorporation were amended to change the corporate name to Leadpoint Consolidated Mines Company. From its inception until 2001, the company operated various unpatented mining claims and deeded mineral rights in the state of Washington. The unpatented mining claims were terminated and abandoned during 1993 due to increased maintenance costs. The deeded mineral rights were abandoned during 2001 due to their limited economic value. On August 15, 2006, in order to change its domicile from Washington to Nevada, the company was merged with and into Point Acquisition Corporation, a Nevada corporation. From about 2001 until the reverse acquisition on April 25, 2007, the company was basically a blank check company and did not engage in active business operations other than its search for, and evaluation of, potential business opportunities for acquisition or participation.

According to the 8-K Current Report filed by the company to the SEC on April 25, 2007, Point Acquisition did a 1 for 50 share reverse stock split on December 11, 2006. As a result of the reverse split, the total number of issued and outstanding shares of the company's common stock decreased from 5,792,100 to 154,529 shares, after giving effect to rounding for fractional shares. On November 1, 2006, Point Acquisition entered into Subscription Agreements with Halter Financial Investments (HFI), a Texas limited partnership, and Glenn A. Little, Point Acquisition's former sole officer and director. HFI specializes in reverse mergers. Pursuant to the Agreements, Point Acquisition, on January 3, 2007, sold to HFI and Mr. Little, respectively, 1,270,400 and 200,000 shares of post-reverse split common stock at a purchase price of $0.25 per share for gross proceeds of $367,500.

On April 17, 2007, the company entered into separate consulting agreements with Heritage Management Consultants, Inc. (Heritage) and Shufang Zhang, respectively. Heritage and Zhang have each been engaged to assist the company in its efforts to consummate the forthcoming reverse merger. In consideration for the services to be provided under the Consulting Agreements, Heritage and Zhang received 50,000 and 127,040 shares of the company's common stock, respectively.

The company's shares were traded on the OTCBB. The OTCBB is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many over-the-counter (OTC) equity securities that are not listed on the Nasdaq Stock Market or a national securities exchange. Although the National Association of Securities Dealers (NASD) oversees the OTCBB, the OTCBB is not part of the Nasdaq Stock Market. Companies quoted on the OTC Bulletin Board must be fully reporting (i.e. current with all required SEC filings) but have no market capitalization, minimum share price, corporate governance or other requirements to be quoted.

The Private Operating Company from China

According to the Form S-1 Registration Statement filed by the company on May 14, 2007, Powersmart Holdings Limited was incorporated in the British Virgin Islands (BVI) on November 3, 2004. It has two

direct wholly-owned subsidiaries: Henan Gengsheng Refractories Co. and Smarthigh Holdings Limited. Henan Gengsheng was incorporated in China in December 1992 and Smarthigh was incorporated in the British Virgin Islands in November 2004. Henan Gengsheng owns 89.33% of its Chinese operating subsidiary, Henan High-Temperature Materials, which was incorporated in September 2002. Smarthigh owns 100% of another operating subsidiary in China, Zhengzhou Duesail Fracture Proppant, Co., which was incorporated in August 2006. Table 1 illustrates the ownership structure of Powersmart Holdings Limited. The company's consolidated income statement and balance sheet are presented in Table 2 and Table 3.

Table 1: Ownership Structure of Powersmart Holdings Limited

Company name	Place/date of incorporation or establishment	Powersmart's effective ownership interest	Common stock/ registered capital	Principal activities
Henan Gengsheng Refractories Co., Ltd.	The People's Republic of China (PRC)/ December 20, 1996	100% directly held by the Powersmart	Registered capital of $6,049,879 fully paid up with share premium of $35	Manufacturing and selling of monolithic refractory products
Henan Gengsheng High-Temperature Materials Co., Ltd.	PRC/September 4, 2002	89.33% indirectly held through Henan Gengsheng Refractories	Registered capital of $363,000 fully paid up	Manufacturing and selling of functional ceramic products
Smarthigh Holdings Limited	BVI/November 5, 2004	100% directly held by the Powersmart	Ordinary shares: Authorized: 50,000 shares of $1 each; Paid up: 100 shares of $1 each	Investment holding
ZhengZhou Duesail Fracture Proppant Co.	PRC/August 14, 2006	100% indirectly held through Smarthigh	Registered capital of $2,000,000 of which $934,822 paid up	Manufacturing and selling of fracture proppant products

This table presents the ownership structure of Powersmart Holdings. Incorporated in the British Virgin Islands on November 3, 2004, the company has two wholly-owned subsidiaries: Henan Gengsheng Refractories Co. and Smarthigh Holdings Limited. Through these two subsidiaries, Powersmart also controls Henan High-Temperature Materials and Zhengzhou Duesail Fracture Proppant, Co.

The main reason why Powersmart and Smarthigh are incorporated in the British Virgin Islands is related to regulations imposed by the Chinese government. China's State Administration of Foreign Exchange (SAFE) rules issued in early 2005 prohibit registered Chinese companies from being acquired by offshore companies. Thousands of Chinese companies restructured offshore prior to the rules taking effect. These companies typically set up a holding company in the British Virgin Islands and then turn the original company located in China a subsidiary. British Virgin Islands have more than 810,000 companies from all around the globe and representing almost every industry one can imagine.

Henan Gengsheng and Henan High-Temperature, the two operating subsidiaries in China, manufacture monolithic refractory products and industrial ceramic products. Another operating subsidiary, Duesail, manufactures fracture proppant products. The first fracture proppant products were manufactured in December 2006 but none had been sold prior to the reverse merger.

The Reverse Merger Deal

The reverse merger was closed on April 25, 2007. The details of the deal are disclosed in the 8-K Current Report filed with the SEC on the same date. At the closing, Point Acquisition Corporation issued to Shunqing Zhang, the sole shareholder of Powersmart Holdings Limited, 16,887,815 shares of the public company's common stock, in exchange for all of the issued and outstanding capital stock of Powersmart. As a result of the exchange transaction, Powersmart becomes a wholly- owned subsidiary of Point Acquisition.

Upon the closing of the reverse acquisition, Timothy P. Halter, the sole officer and director of Point Acquisition, resigned immediately from all offices of Point Acquisition that he held. Mr. Shunqing Zhang was elected to the Board of Directors of Point Acquisition and was appointed its President and Chief Executive Officer. In addition, the executive officers were replaced by the executive officers of Powersmart upon the closing of the reverse acquisition.

Table 2: Powersmart's Consolidated Income Statements

	2006	2005	2004
Revenue			
Sales	$27,481,539	$22,184,246	$18,921,617
Cost of sales	(16,534,004)	(12,977,770)	(12,355,100)
Gross profit	10,947,535	9,206,476	6,566,517
Expenses			
General and administrative Expenses	2,411,939	2,077,114	1,707,787
Amortization and depreciation	157,814	129,107	101,283
(Recovery of) provision for doubtful debts	(58,259)	(6,788)	135,906
Selling expenses	3,783,071	3,131,897	2,189,218
Total Expenses	6,294,565	5,331,330	4,134,194
Income before the following items and taxes	4,652,970	3,875,146	2,432,323
Government grant income	33,251	320,783	465,528
Interest income	8,698	7,986	5,628
Other income	36,046	39,368	7,401
Finance costs	(226,236)	(102,824)	(93,084)
Income before income taxes and minority interests	4,504,729	4,140,459	2,817,796
Income taxes	(7,010)	(250,415)	(665,401)
Income before minority interests	4,497,719	3,890,044	2,152,395
Minority interests	(1,617)	(9,162)	(2,465)
Net income	$4,496,102	$3,880,882	$2,149,930
Earnings per share: basic and diluted	$44,961.02	$38,808.82	$21,499.30
Weighted average number of shares outstanding: basic and diluted	100	100	100

This table presents the consolidated income statements of Powersmart Holdings for 2004, 2005 and 2006. Data are obtained from the company's Form S-1 filed with the Securities and Exchange Commission on May 14, 2007.

On April 25, 2007, they also completed a private placement pursuant to which they issued and sold 5,374,594 shares of common stock to certain accredited investors for approximately $10 million in gross proceeds. In connection with this private placement, they paid to the placement agent, Brean Murray Carret & Co., LLC, a placement agency fee of $488,618 and issued to the placement agent a warrant for the purchase of 262,032 shares of common stock in the aggregate. In addition, they paid $195,000 of placement agency fee to a designee of Brean Murray Carret & Co., LLC and granted to said designee a warrant for the purchase of 112,299 shares of common stock in the aggregate. The company is under the contractual obligation to register shares of its common stock as well as shares of common stock issuable upon exercise of the warrants issued to the placement agent and its designee in connection with this private placement within a pre-defined period. Table 4 summarizes the main shareholders and their ownership before and after the share exchange deal.

The "Make Good" Provisions

At the closing on April 25, 2007, Shunqing Zhang entered into an escrow agreement with the private placement investors. Pursuant to the escrow agreement, Mr. Zhang agreed to certain "make good" provisions. The escrow agreement established minimum after tax net income thresholds of $8,200,000 for the fiscal year ending December 31, 2007 and $13,500,000 for the fiscal year ending December 31, 2008. Mr. Zhang deposited a total of 2,673,796 shares, to be equitably adjusted for stock splits, stock dividends and similar adjustments, of the common stock of Point Acquisition Corporation into escrow with Securities Transfer Corporation under the escrow agreement. In the event that the minimum after tax net income thresholds for the fiscal year 2007 or the fiscal year 2008 are not achieved, then the private

equity investors will be entitled to receive additional shares of our common stock from Mr. Zhang based upon a pre-defined formula agreed to between the investors and Mr. Zhang.

Table 3: Powersmart's Consolidated Balance Sheets

	2006	2005	2004
Assets			
Current assets			
Cash and cash equivalents	$426,099	$1,420,344	$269,275
Restricted cash	192,300	-	-
Trade receivables	14,103,129	11,873,660	9,857,058
Bills receivable	238,452	662,161	369,626
Other receivables and prepayments	1,722,429	465,909	2,103,859
Inventories	6,416,703	2,781,771	2,502,324
Deferred taxes	13,561	-	330
Total current assets	23,112,673	17,203,845	15,102,472
Know-how	319,753	-	-
Deposit for acquisition of property, plant and equipment	-	-	107,665
Deposit for acquisition of land use right	-	-	60,500
Property, plant and equipment, net	6,640,189	3,544,450	3,545,331
Land use right	871,738	861,148	181,648
Total Assets	$30,944,353	$21,609,443	$18,997,616
Liabilities			
Current liabilities			
Trade payables	$4,661,178	$2,651,289	$2,882,958
Bills payable	192,300	-	-
Other payables and accrued expenses	3,164,381	2,644,607	2,045,711
Income tax payable	217	-	209,876
Amounts due to related parties	-	-	399,300
Non-interest-bearing loans	1,698,846	837,330	2,231,910
Secured short-term bank loans	1,923,000	1,240,000	1,210,000
Deferred tax liabilities	12,967	14,456	-
Total current liabilities	11,652,889	7,387,682	8,979,755
Minority interests	142,782	125,382	113,278
Stockholder's equity			
Common stock: par value $1 per share	100	100	100
Additional paid-in Capital	6,050,014	6,050,014	6,050,014
Statutory and other Reserves	6,212,239	5,705,454	4,748,365
Accumulated other comprehensive income	867,757	311,556	642
Retained earnings (accumulated losses)	6,018,572	2,029,255	(894,538)
Total Stockholder's equity	19,148,682	14,096,379	9,904,583
Total Liability and Stockholder's equity	$30,944,353	$21,609,443	$18,997,616

This table presents the consolidated balance sheets of Powersmart Holdings for 2004, 2005 and 2006. Data are obtained from the company's Form S-1 filed with the Securities and Exchange Commission on May 14, 2007.

In addition, on April 25, 2007 Mr. Zhang entered into a similar escrow agreement with HFG International, Limited. Under such an agreement, Mr. Zhang placed into escrow a total of 638,338 shares of Point Acquisition Corporation's common stock to cover the same minimum net income thresholds as described above with respect to the investor make-good. Similarly, if the thresholds are not achieved in either year, the escrow agent must release certain amount of the make-good shares that were put into escrow.

After the completion of the two deals, Mr. Zhang made the following statements:

> "We want to thank our financial advisor, HFG International, Limited, for facilitating our efforts in connection with our private financing and the going public transaction. These transactions have given us access to the U.S. capital markets, with the intent of capitalizing on significant growth opportunities."

Table 4: Shareholders and Ownership Before- and Post-Merger

Shareholder Name	*Before Closing of the Share Exchange Agreement*		*After Closing of the Share Exchange Agreement*	
	Amount of Beneficial Ownership	***Percent of Common Stock***	***Amount of Beneficial Ownership***	***Percent of Common Stock***
Original owners, including Glenn A. Little	355,431	19.7%	355,431	1.5%
Halter Financial Investments (HFI)	1,270,400	70.5%	1,270,400	5.3%
Shufang Zhang	127,040	7.0%	127,400	<1%
Heritage Management	50,000	2.8%	50,000	<1%
Shunqing Zhang	0	0	16,887,815	70.3%
Private equity investors	0	0	5,374,594	22.3%
Total	1,802,871	100%	24,038,280	100%

This table shows the main shareholders and their ownership before and after the reverse merger. The second and third columns describe the ownership structure of the U.S. shell, Point Acquisition, before the deal. The last two columns report the main shareholders and their ownership of the newly created company. The figures are collected from the company's various filings with the Securities and Exchange Commission and are based on the author's own calculations.

CASE QUESTIONS

1. Discuss the pros and cons of an initial public offering (IPO), which is the conventional approach for a foreign company to raise equity capital in the U.S. capital market.
2. What are the primary reasons for Powersmart Holdings Limited to conduct a reverse merger instead of an ordinary public offering?
3. Based on the details of the reverse merger deal, please discuss the direct and indirect costs of the deal, from the perspective of Powersmart Holdings.
4. What is the purpose of the "make good" provisions?

SHORTCUT TO THE U.S. MARKETS THROUGH REVERSE MERGERS

TEACHING NOTES

Congsheng Wu, University of Bridgeport

CASE DESCRIPTON

A reverse merger takes place when a public company, commonly known as a "shell", acquires a private operating company through a share exchange transaction. The public shell typically has no business operations, but is valuable because of its public trading status. Post-merger, the operating company's owners take control of the newly formed public company. Reverse mergers have long been used in the U.S. as an alternative to achieve public trading status. Conventionally, foreign companies wishing to cross list their shares in the United States have followed the old-fashioned initial public offering (IPO) process. Their shares, typically in the form of American Depositary Receipts (ADRs), are registered with the SEC and are listed on a major stock exchange. In recent years, however, an increasing number of Chinese companies have gained U.S. market listing through reverse mergers. This article provides a detailed case study of an actual reverse merger. The case is appropriate for upper-level undergraduate or graduate finance courses such as corporate finance. Students should have the basic knowledge about the financial markets and corporate finance. Students can work individually or in teams on this project, which requires around 5-8 hours outside of class to complete. Classroom presentations and discussions should be arranged in a regular, 2-hour class.

CASE QUESTIONS

1. **Discuss the pros and cons of an initial public offering (IPO), which is the conventional approach for a foreign company to raise equity capital the U.S. capital market.**

A foreign company wishing to raise equity capital in the United States may choose the conventional initial public offering (IPO) process. The shares, typically in the form of American Depositary Receipts or ADRs, are registered with the Securities and Exchange Commission (SEC) and are listed on a major stock exchange. ADRs are negotiable certificates (denominated in U.S. dollars) that are issued by a U.S. depositary bank to represent the underlying shares of a foreign stock. ADRs are sold, registered, and transferred in the U.S. in the same manner as any share of stock.

Students are encouraged to do their own research to learn more about the details of ADRs. They will find that there are several types of ADR programs: Level 1, Level 2 and Level 3. Level 1 programs are not listed on a stock exchange such as the New York Stock Exchange (NYSE) or Nasdaq. Rather, they are available for retail investors to purchase and trade in the over-the-counter (OTC) market. The foreign issuer can maintain home market accounting and disclosure standards and is not required to reconcile its financial statements to US GAAP. However, Level 1 programs cannot be used to raise new equity capital in the US. Level 2 ADR programs are more complicated for a foreign company than Level 1 programs. To set up a Level 2 program, the foreign firm must file a registration statement with the SEC and is under the SEC regulation. However, Level 2 programs cannot be used to issue new share or raise new equity capital. Level 3 ADR programs are the highest level a foreign company can have. Setting up a Level 3 program means that the foreign company is not only taking some of its shares from its home market and depositing them to be traded in the U.S. It is actually issuing shares to raise capital. These are the U.S. initial public offerings (IPOs) by foreign companies. To complete a Level 3 program, the foreign company has to follow the SEC registration process by disclosing its financial information. Additionally,

it has to comply with the US GAAP accounting standards in its filings. After the IPO, periodic filings with the SEC are also required.

The advantage of an IPO is that it allows the foreign firm to gain direct access to the U.S. capital market. The firm can issue new shares using a Level 3 program, and the shares (or ADRs) will be listed on a formal exchange such as the NYSE or Nasdaq. A formal listing comes with prestige, liquidity and the opportunity to sell additional shares.

The main disadvantage of an IPO is the direct and indirect cost. The issuing firm will have to hire investment banks as underwriters. The underwriting fees are paid as a percentage of the gross proceeds, typically set at 7%. The indirect cost associated with an IPO is that the offer price is typically set at a substantial discount relative to the first-day close price. That is, IPOs are significantly underpriced. The average underpricing or first-day return is around 15% for IPOs completed in the United States.

2. **What are the primary reasons for Powersmart Holdings to conduct a reverse merger instead of an ordinary public offering?**

Most of the information needed to answer this question can be found directly in the article. In recent years, an increasing number of foreign companies have opted for reverse mergers as an alternative to achieve public trading status in the United States. The reason is simple: They have few other options. For privately held small companies in China, going public for a domestic listing seems to be out of the question. Chinese regulators favor large, state-owned enterprises over small privately held companies when approving companies to be listed on the two official Chinese exchanges in China. Consequently, many Chinese companies seek stock listings elsewhere, especially in the United States. But traditional IPOs in the U.S. require, among other things, a relatively long and stable earnings history, which limits opportunities for emerging companies. In addition to the regulatory burden and stringent listing requirements associated with an IPO, many of these companies would not be able to attract top-tier investment banks to underwrite a public offer due to their small size and uncertain underlying fundamentals.

Touted as a cheaper, easier and backdoor route to the U.S. public market, reverse mergers become the choice of many small companies. This is basically the situation facing Powersmart, the Chinese operating company. Prior to the reverse merger, the firm was owned by its founder, Mr. Shunqing Zhang. The firm wanted to gain access the U.S. market, but found it almost impossible to follow the traditional IPO approach.

3. **Based on the details of the reverse merger deal, please discuss the direct and indirect costs of the deal, from the perspective of Powersmart Holdings.**

It helps to review the process of the reverse merger and identify the various parties involved. The U.S. shell company, Point Acquisition Company, is basically worthless and the only purpose for its existence is for this deal. The deal maker is Halter Financial Investments (HFI), a specialist in reverse mergers. After the deal was completed, on April 25, 2007, the original owners of Point Acquisition retained 355,431 shares or 1.5% of the newly created company. HFI retained 1,270,400 shares or 5.3% of the new company. Two other parties involved in the deal also maintained some ownership. Together, these parties control 7.4% of the newly merged company.

Since the reverse merger itself didn’t raise any equity capital, the firm relied on a private placement in which private investors gave the firm approximately $10 million in exchange for 22.3% ownership.

After the deal, Shunqing Zhang owned 70.3% of the company, surrendering 29.7% of his ownership to new investors.

4. What is the purpose of the "make good" provisions?

The primary purpose of the provisions is to align the interests of the original owner and the CEO of the new firm, Mr. Zhang, with the new investors. In the "make good" provision with the private placement investors, Mr. Zhang deposited a total of 2,673,796 shares in an escrow account. If the minimum goals laid out in the escrow agreement are not reached, then the private equity investors will be entitled to receive additional shares of our common stock from Mr. Zhang based upon a pre-defined formula agreed to between the investors and Mr. Zhang. Mr. Zhang also entered into a similar escrow agreement with HFG. Under this agreement, he placed into escrow a total of 638,338 shares to cover the same minimum net income thresholds. If the thresholds are not achieved in either year, the escrow agent must release certain amount of the make-good shares that were put into escrow.

REFERENCES

Gleason K.C., Rosenthal L., Wiggins RA III (2005) "Backing Into Being Public: An Explanatory Analysis of Reverse Takeovers," *Journal of Corporate Finance*, vol.(12), p. 54-79.

Neil A. Martin (2007) "Curdled Expectations," *Barron's* Magazine, vol. 87(51), December 17, 2007, p. 48.

Wu, Congsheng (2005) "Overseas Listing of Chinese Companies: An Overview," *China and World Economy*, vol.13 (5), p. 44-57.

Form 8-K Current Report filed by Point Acquisition to the Securities and Exchange Commission on April 25, 2007. Retrieved from the SEC's EDGAR database at its web site: http://www.sec.gov/edgar.shtml.

Form S-1 Registration Statement filed by Powersmart Holdings Limited the Securities and Exchange Commission on May 14, 2007. Retrieved from the SEC's EDGAR database at its web site: http://www.sec.gov/edgar.shtml.

BIOGRAPHY

Congsheng Wu is Professor of International Finance at the University of Bridgeport. His research interests include international finance, the relationship between economic freedom and economic growth, new securities offerings, emerging markets, and financial services. He is the co-author of two books and numerous research articles. His papers have appeared in *Financial Management, Journal of Banking and Finance, Review of Quantitative Finance and Accounting, Journal of Multinational Financial Management, Journal of Business and Economic Studies*, *China and World Economy*, *The Chinese Economy*, and others. He can be reached at University of Bridgeport, 230 Park Ave., Bridgeport, CT 06604. Email: congwu@bridgeport.edu.