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A Case Review on the Success/Failure Factors of Backdoor Listing - Comparing the Case of Korean Food Industry Company to the Similar Previous Study

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Abstract Entering the stock market to adopt indirect methods rather than official stock market procedures and evaluations, such as business transferring, stock swapping, and others, is called a backdoor listing strategy. It is required for public and private financial organizations to review the real backdoor listing cases to find out the possible issues and proper responses and to protect public wealth and the rights of the victims including small investors and public investors. This study compares three companies' backdoor listing cases. Although a backdoor listing has the advantage of providing unlisted companies with an opportunity to enter the capital market and secure stable capital procurement in a short period of time, there is a risk of fraud after a backdoor listing due to the relaxed standards and screening compared to a regular listing.

Keywords Backdoor Listing, Merger Strategy, Financial Strategy

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I. Introduction

As the external environment that affects corporate management rapidly changes, many companies are restructuring their business, eliminating corporate inefficiencies, and minimizing costs to be flexible against a rapidly changing business environment. Their attention could be paid to M&A among diverse companies to develop newer growth chances against their business challenges. Simultaneously, there are a lot of discussions and reviews also on adopting a backdoor listing strategy that can be an alternative M&A strategy or not. The backdoor listing strategy means considering a merger between an unlisted company and a listed company to hold the possibility of a comprehensive stock listing.

Entering the stock market to adopt indirect methods rather than official stock market procedures and evaluations, such as business transferring, stock swapping, and others, is called a backdoor listing strategy. As a result of this indirect listing, the listed company passes on its listing status to the unlisted company to develop a new listed company in the stock market without any regulation when it drops out of the business and the unlisted company inherits the advantages as a listed company and turns its business as a main business of the new listed company (Humphrey & Kuo, 2002; Vermeulen, 2015) while the new company can shorten the period and reduce costs because the company skips the requirement evaluations and procedures and can raise capital market funds in a short period. Furthermore, although the newly listed company is in deficit, it can receive tax reductions and financial and non-financial benefits as a listed company (Ma, 2023; Wang, 2024).

Nonetheless, along with these advantages, there are also controversies of structural distortion and infringement of minority shareholder rights (Li et al., 2021). The controversies and problems in Korea's reverse listing system can be commonly described in terms of fairness violation in financial valuation and transparency. For details, most of all, the merger ratio, which means the exchange rates of stocks between the merged one and the merger, can be issued to decide which company will receive more value during the merger processes. During the process of the company valuation, the merger ratio and the merging price can be over-estimated or not. If the calculation process were not clearly determined, the current shareholders and investors may be negatively influenced because the merger ratio can be determined by the statutory merging price calculation method during the reverse listing processes. According to previous references such as Vermeulen (2015), the listed companies are evaluated and carefully regulated in real time through their stock prices in the market in diverse countries including Korea.

Since the valuation methods for unlisted corporations adopt relative ones, it is difficult to calculate precisely. Also, the asset value and income value are calculated arbitrarily, so it is not easy to accept that the calculated values are objective and fair. As a result, it is not easy to ensure these values are permanent; the shareholders have been forced to accept the unfavorable merger ratio and the valuation result such as the over-/under-valuation of unlisted companies stemming from the unacceptable percentage of shares held by minority shareholders in listed companies.

In addition, if a reverse listing is carried out without sufficient verification of the financial status, accounting information, and sufficient audit of the companies by proper experts, the market's trust in the companies should be significantly damaged. Furthermore, it can result in a negative response to the early exit of the reverse listing companies. In fact, there are many companies that have been escalated to fraudulent accounting issues after the reverse listing because serious problems and vulnerabilities were raised such as the financial statements or inaccurate financial information and decision, unfair acts by the stock price manipulation, and others (Tam, 2002). It is required for the public and private financial organizations to review the real backdoor listing cases to find out the possible issues and proper responses and to protect public wealth and the rights of the victims including small investors and public investors (Lam & Chan, 2016). This study compares three companies' backdoor listing cases. This study carefully examines whether there is any damage on valuation and finds out the success and failure factors of backdoor listing. Based on the results of this analysis, this study will propose supplementary measures to improve the transparency of backdoor listings and protect the rights and interests of minor shareholders.

II. Review of the Cases

In this section, the current main research trends and key studies are reviewed. The study of Park & Lee (2018) illustrates the case of a Korean information security company that has grown in size and capacity since its establishment. Liu (2022) also introduces a case of backdoor-listing to illustrate the motivation and effect of the backdoor-listing strategy. These studies considerable supplementary methods and improvement points for disclosure matters when evaluating the value of the company. Vermeulen introduces that the reliability of accounting information would be related to the impact of regulations on backdoor listings to result in a positive effect on the market's reliability.

1. Brief Review of Previous Study on the Backdoor Listing Cases by Choi & Kwak (2012)

Choi & Kwak (2012) comparatively briefs “A” company, a famous Korean pharmaceutical and bio-industry company that successfully grew after a reverse listing, and “B” company, a former semi-conduct company that is a well-known failure case of backdoor listing because of fraudulent accounting and ethical failure. Their study explains that, after the merger, the company experienced considerable external growth, with its total assets increasing thirteenfold and its financial capital growing ninefold nearly a decade later. Also, in terms of net income, despite the new company had not experienced positive results for several years after the merger (1.9 billion won lost in the first year), it has overcome the break-even-point since 2007, and it reached a level exceeding 108.3 billion won in 2010. They explained that this case may demonstrate that the direct comparison and decision on the financial rewards and profit would not be the only and the simple standard to decide the success of the backdoor listing strategy. As a result of the merger, the company's size and net income doubled in two years in 2010, so, it is possible that the “A” company’s merger case was strategically successful (Choi & Kwak, 2012).

Meanwhile, the “B” company had been negatively affected by significant net losses since the merger, including a substantial reduction in its total assets and financial capital, eventually leading to its delisting from the stock market. In the case of “B,” there are no external shareholders with more than 5% of the shares, leaving the owner family as the absolute largest shareholder. This may indicate that there were no strong and clear controlling towers to look over and audit the financial abuse and issues while “B” tried to list on the stock exchange market to reduce financial crisis rather than enhance their stakeholders’ financial profit and overcome the BEP (Baik et al., 2011). Also, “B” had failed to enhance the technological advantages and strengths because the company rarely invested the financial capital properly. Shortly, “B” might be one of the worst cases that conducted a backdoor listing strategy without concerning long-term profit and business growth. Considering the CAGRs, it is more clear that “B” had experienced very serious financial risk because the CAGR of its operating profit and net income was dramatically dropped despite its revenue and total assets being positive. This means that the total asset of “B” had been increased because the company increased its debts rather than profits.

Table 1. financial results of "A" and "B" from 2003 to 2010

Year	Total Asset		Financial capital	Revenue	Operating Profit	Net Income
2003	"A"	1,357	898	-	(36)	(72)
	"B"	210	64	113	21	9
2005	"A"	2,142	1,196	-	(131)	(142)
	"B"	395	178	250	16	12
2007	"A"	4,400	1,633	635	140	411
	"B"	1,078	557	315	28	25
2009	"A"	5,592	2,857	1,456	718	585
	"B"	2,204	2,196	187	(150)	(838)
2010	"A"	11,555	7,799	1,810	1,066	1,084
	"B"	1,055	-666	612	(355)	(927)
CAGR	"A"	35.8%	36.2%	41.8%	96.7%	38.2%
	"B"	25.9%	(239.7%)	27.3%	(249.8%)	(293.9%)

Reproduced from the study of Choi & Kwak (2012)
Units : 100 Million Korean Won
Note: The revenue CAGR of 'A' is calculated over the period from 2007 to 2010.

2. Case Review of "C", a Korean Food Industry Corporate

By comparing those companies and finding out the success and failure factors of backdoor listings, this study aims to derive the success and failure factors of backdoor listings and to adopt those factors onto "C" company - a semi-large scale marine food industry corporation.

"C" enterprise (hereinafter referred to as "C" enterprise as a holding company of "C" group) was established as a holding company in 2001. In order to achieve rapid financial investment decisions, strengthen cash mobilization, and improve competitive efficiency in the private sector, a merger agreement was signed on April 7, 2022. After a period of receiving notices of opposition to the merger, exercising stock purchase rights, and submitting creditor objections, the "C" enterprise was merged into the "C" company on November 1, 2022. Table 2 explains the brief information of this merger case.

Table 2. Brief information of the merger case of "C" company

Name	"C" company	"C" enterprise
Financial Capitals	18.3 (Billion Korean Won)	58.4 (Billion Korean Won)
Total Asset	1,635(Billion Korean won)	2,493(Billion Korean won)
Number of Workers	717 persons	162 persons
Number of Issued Shares	3,677.6 (1,000 shares)	11,691.5 (1,000 shares)
Stock Par Value	5,000	5,000
Role	Merger	Being Merged
After Merger	Surviving	Extinguished

Source: Annual Reports of the Companies & dart.fss.or.kr

The merging case of "C" company and "C" enterprise demonstrates the problems that can arise during the reverse listing process. For the detail, violation issues of fairness and transparency were particularly prominent in the process of calculating the merging price and ratio. According to Article 176-5 of the Enforcement Decree of the Capital Market Act, when calculating the merging price of a listed corporation and an unlisted corporation, an evaluation method based on the stock price of the listed corporation is commonly used while an evaluation method averaging the intrinsic value and relative value is used for the unlisted corporation. It should be noted that this calculation method tends to overlook the fact that the value of a company can be changed depending on diverse factors, although the financial market tends only to estimate the stock price to represent the entire value of the company. In addition, when calculating the merging price, it is important for the merging process to be conducted and completed because the board of directors, which plays an important role in decision-making, can be unexpectedly and unhelpfully influenced by the controlling shareholder. There is a problem that the controlling shareholders can push for when it can be advantageous to them. Along with this, at the time of the merger, the merger ratio initially proposed by the "C" enterprise was 1 to 3.8, which caused controversy as "C" company's shareholding ratio at the time was reduced by 4.5%, which could result in a loss of over 125 billion won. The most important problem was that the stock value of the "C" company - the mother and holding company of the group was undervalued at around 900 billion won without caring about the value of the "C" enterprise, an unlisted company to be overvalued at over 2 trillion won. "C" enterprise's stake was 99.6% held by the owner family which holds the position of group chair and vice-chair, so the backdoor listing was criticized as 'the owner family's fattening.' In this case, the asset value was used as the merging price. To decide the standard price of "C" company for merger and asset value, a weighted average of closing prices for one month up to the reference date, a weighted average of closing prices for one week up to the reference date, and the closing prices one day before the reference date were adopted.

$$\textit{Standard Price Calculation of "C" company for Merge} \\ = (232{,}848 + 253{,}034 + 261{,}000)/3 = 248.961$$

$$\textit{Asset Value Calculation of "C" company for Merger} \\ = \frac{1{,}405{,}375{,}322{,}549}{3{,}677{,}641} = 382{,}140$$

Meanwhile, the merging price of an unlisted company can be estimated by averaging the intrinsic value and relative value, so only the intrinsic value was adopted which means the weighted average of the company's asset value and earning value at a ratio of 1:1.5.

$$\textit{Essential Value Calculation of "C" Enterprise for Merger} \\ = \frac{191{,}311 + 216{,}684\ \times 1.5}{3} = 206{,}535$$

$$\textit{Earning Value Calculation of "C" Enterprise} \\ = \frac{\left(\frac{(\text{Est. earnings per share} \times 3 + \text{Est. future earnings per share} \times 2)}{5}\right)}{\text{Capitalization Rate}} \\ = 216{,}685$$

In this calculation method, if the price of one "C" company stock is changed from 5,000 won to 1,000 won, the final merger ratio becomes 1 to 2.7. As a result, "C" company partially accepted the opinions of minority shareholders and calculated the merging price as follows, changing it from 1 to 3.8 to 1 to 2.7.

Even within the two companies, the merger ratio differs depending on the valuation, which is disadvantageous to minority shareholders. This means it can be simply expected that there are vulnerabilities in the blind spots of the system.

As previously discussed, "C" enterprise's total assets and capital both increased by 2 or 2.5 times in 2021 compared to 2012. Both indicators had been steadily increasing every year, showing similarities to the cases of "A" company and "B" company before the merger, where both indicators steadily increased.

Table 3. “C” Enterprise Sales Growths from 2012 to 2023

Year	Total Asset	Financial capital	Revenue	Operating Profit	Net Income
2012	31,308	1,373	33,644	2,012	1,242
2014	37,077	12,310	36,382	2,003	1,163
2016	43,892	15,629	46,831	3,867	2,311
2018	54,258	18,743	62,620	3,363	1,486
2020	60,692	23,049	70,109	5,396	3,767
2021	66,852	26,268	76,030	5,087	3,150
2022	70,612	29,085	90,263	4,944	2,966
2023	77,251	31,357	89,486	4,647	2,722
CAGR	8.6%	32.9%	9.3%	7.9%	7.4%

Source: Annual Reports of the “C” enterprise
Units: 100 Million Korean Won

3. Comparative Analysis of the Companies’ Governance Structures

The analysis was conducted using five-years data of the companies. The “A” company had one person performing audit work necessary for auditing before the backdoor listing, and in 2008, when the backdoor listing took place, an audit committee was established and operated with all outside directors and a certified public accountant as the chairman. The “C” enterprise also operated an audit committee before the backdoor listing. After auditing processes, “C” enterprise's financial indicators had increased steadily every year from 2012 until the merger. This study summarizes them of those years, referring to “C” enterprise’s annual December business report published in the Dart System.

Table 4 illustrates that the “C” enterprise has less external transparency than the “A” company, which had a high ratio of outside directors to registered executives, but it has better external transparency than the “B” company, for “B” had no record of outside director activities even after going public. “A” shows that the biggest external shareholder has been acting as a non-controlling shareholder with a stake of more than 5%. In the case of “C,” after the merger, BRDOUT and BRDPRO had steadily increased to suggest that the “C” enterprise had tried to ensure the transparency of its financial governance structure externally. Nonetheless, BLOCK and AUDPRO have shown no concrete and clear views on the financial governance structure, and this may mean that the internal transparency of the company may still be in doubt.

Table 4. Characteristics Summary of "C" enterprise's Governance Structure[1]

	2019	2020	2021	2022	2023
BRDOUT	0	0.25	0.25	0.57	0.56
BRDPRO	0	0	0	1	1
BRDMEET	-	21	33	3	*
AUDPRO	-	-	-	1	1
BLOCK	X	X	X	X	X
CEO=OWNER	X	X	X	X	X

Reproduced from the Annual Reports

III. Conclusions

1. Academic and Practical Implications

This study focuses on finding out the controversy on the methodological unfairness of the merger ratio calculation idea and the level of the governance structure by comparing the success and failure cases. To accomplish academic purposes, this study compares actual backdoor listing cases focusing on the year-by results. This study compared and analyzed the "C" enterprise based on the found factors comparing the "A" company and the "B" company with the review of the study of Choi and Kwak which entered the KOSDAQ market through reverse listing based on various criteria such as growth potential and governance structure after the merger. Also, this study comprehensively analyzed the problems of reverse listing and the success and failure factors through this.

[1] BRDOUT: Ratio of outside directors, BRDPRO: Number of accountants, tax accountants, tax officials, and business professors among outside directors in the board of directors, BRDMEET: Number of outside directors attending the board of directors, AUDPRO: Accountants among audit committee members , Number of tax accountants, tax officials, and management professors, BLOCK: Existence of external shareholders holding more than 5% of shares, CEO=OWNER: CEO = largest shareholder

Table 5. Comparative Evaluations of the Three Companies' Backdoor Listing Results

	"A" company	"B" company	"C" enterprise
Key Growth Factor	Development of biosimilar drugs	Production Yield Increase and Cost Reduction by Continuous Process Methods	-
Purpose	Joint Venture Investment of Foreign Investor and Domestic Investor	A Private Company Established by the Founder's Expertise	A Holding Company to Rule the Entire Group Affiliates
Core Business	Protein medicine production by consignment contract	Solar silicon wafer supply	Business Service Providing and Trademark Using of Affiliates
After Merger	Assets increased by 13.5% 1% increase in debt Financial capital increased by 34.5%	Assets increased by 23.3% Debt increased by 46.9% Financial capital decreased by 49.7%	Assets increased by 5.6% Debt increased by 2.3% Financial capital increased by 10.7%
Decision	Very Successful	Failure	Somewhat Successful
Decision Basis	Comprehensive improvement in financial status with increased assets and financial capital Technology capability enhanced and stable profitability and growth opportunities Strengthened Accounting transparency of Annual Reports and Audit Committee	Moral Hazard and accounting fraud by the Owner despite stable profitability and technology advantages Debt increasing and financial capital decreasing Company bankruptcy and legal punishment of the owner	Vulnerability of Technology Differentiation Strengthening control over affiliates by the owner family rather than the minor stakeholders Positive financial situation with steady increase in assets and financial capital

Considering the analysis results comparing those companies in Table 5, it can be understood that only simple financial concerns are not enough to decide the validity of the backdoor listing strategy. For the detail, the "C" enterprise maintained a stable financial status and had shown steady growth to maintain the composition of the board of directors and audit committee comprised of outside directors and major products. It is also positive that the business department has continued stably, but it should be stressed that the merger result also illustrates the negative circumstances before and after the merger - extraordinarily supporting the personal and private favors of the major shareholders including the merger ratio of the stocks and merging price rather than supporting the minorities of the shareholders. It is necessary to note that the background of this negative aspect is that the transparency of the “C” enterprise's governance structure is similarly unclean and unfair as that of the “B” company.

Although a backdoor listing has the advantage of providing unlisted companies with an opportunity to enter the capital market and secure stable capital procurement in a short period of time, there is a risk of fraud after a backdoor listing due to the relaxed standards and screening compared to a regular listing. It may lead to irregularities and negative situations such as breach of trust and embezzlement by the company and management, or even to delisting. In addition, serious asymmetries of essential information and weak governance structures can be the reasons to choose a reverse listing pursuing private interests despite unlisted companies’ profitability cannot be guaranteed. In other concerns, there can be a high non-financial risk, such as stakeholders, owners, and business relatives, to enforce ambiguous speculation of newly listed and merged companies, so shareholders should carefully consider this risk.

Therefore, there should be institutional and public mechanisms to enhance and keep shareholder value and clearly distinguish between investment and speculation. For this purpose, it is essential to strengthen the fundamental analysis function of the company. In conclusion, the reverse listing strategy cannot be wholly accepted as negative, but the governors need to recognize the various problems, both financial and non-financial, that may arise and establish appropriate shareholder protection measures. Also, institutional efforts to alleviate information asymmetries including accounting information need to be considered.

2. Limitations and Future Study Suggestions

Although this study suggests important factors to maintain the positive concerns of backdoor listing strategy and to diminish the negative concerns, there are still issues to be studied further.

In future research, this study suggests conducting additional factor analysis on the success/failure factors of backdoor listings. In addition, an in-depth study on the problems of the mobilization merger ratio and the calculation method for public and understandable valuation would be needed.

Through these, the various challenges and tasks that backdoor listing companies face can be understood by providing essential data and fundamentals for future backdoor listings and for the protection of diverse shareholders.

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