

# Spicing Up the SPAC Structure

## Underwriters Tweak New Offerings to Entice Investors

After years of lying dormant, the SPAC market has emerged in 2005 as one of the hottest areas of activity in the new issue universe. The queue for SPACs hoping to come public is getting so long that investment bankers are seeking new ways to distinguish transactions and entice a wider group of investors.

"The market is saturated with SPACs," explains Richard Prins, head of investment banking at Ferris Baker Watts. "The SPAC market is at a very interesting crossroads. There is no shortage of potential issuers. The problem is that a very narrow band of investors have been the traditional buyers. Investment banks are trying to expand this market."

The SPAC investor universe is characterized as an arbitrage market of hedge funds and high net worth individuals. Bankers are now trying to establish a support base among fundamental investors.

However, there are some structural issues that make it a challenge to attract fundamental investors. SPACs typically trade on the OTC Bulletin Board. Many investors are not comfortable investing in a blind pool. In addition, while deal size is increasing, many of the earlier SPAC offerings raised under \$50 million, making it difficult for institutional investors to receive a meaningful stake.

"There are inherent issues that have made SPACs less attractive. It is a complicated story that requires some education. Many investors will look before they buy. The critical test will be to see how the deals hold up in the long term," says Mike Kaswan, managing director of KBL Healthcare Ventures and COO of KBL Healthcare Acquisition Corp. II (KBLH.OB).

Furthermore, it can not be ignored that SPACs have "bad DNA," as one market participant pointed out. A string of SPAC IPOs in the mid-1990s were cloaked in a cloud of fraud. The structure fell out of favor, not to reemerge until recently.

### Skin in the Game

One of the first innovations that investment bankers added to SPACs is management warrant purchase agreements. The commitment by management to buy warrants demonstrates to potential investors that management has a real financial investment because if a deal is not consummated the warrants purchased will expire and be worthless. Issuers like Echo Healthcare Acquisition specifically state in their prospectus that the warrant purchase agreement is included "to demonstrate to investors that the founders of our company

were confident they could consummate an attractive business combination." Echo company management has committed to purchase up to \$750,000 of warrants, which equals 1% of the gross proceeds of the deal, at a price per warrant not to exceed \$1.20, within 40 trading days after separate trading of the warrants commences.

Issuers who include warrant purchase commitments typically include among their risk factors that the purchase of the warrants in the open market may support the price of the warrants, and accordingly the price may fall after the termination of this obligation. Despite this disclosure, the SEC turned the spotlight on warrant purchase agreements this summer, noting that the commitment may be in violation of Regulation M, which covers the manipulation of a trading market during an offering.

"The warrant purchase commitment has traditionally been a big selling feature for a SPAC. It offers evidence to investors that management has skin in the game. Management has to invest real funds to buy the warrants, which will expire worthless if a business combination is not consummated," explains Steven Uslander, a partner at Littman Krooks.

SPACs are also "building more integrity into the process" by improving SPAC mechanics, Mitchell Littman, a partner at Littman Krooks, said. For example, many companies are tightening up the language in their trust agreements so that if a trust needs to be dissolved, the money will be automatically distributed rather than investors having to rely on a more complicated notice process.

### Structural Changes

A new twist on the traditional simple SPAC unit structure is also evolving. Typically, SPACs offer a unit priced at \$6 with one common share and two warrants (each equal to one common share at a price of \$5 to \$6) or a unit priced at \$8 with one common share and one warrant (equal to one common share).

However, a more sophisticated structure will soon be testing investor interest. In mid-September, three SPAC IPOs for Good Harbor Partners Acquisition Corp., Israel Growth Partners Acquisition Corp. and Global Services Acquisition Corp. were filed, with HCFP/Brenner Securities at the helm.

Instead of the traditional SPAC IPO, the new structure provides investors the choice between either Series A units or Series B units. The Series A units, priced at \$10.50 per unit, consist of two shares of common stock, five Class W warrants

and five Class Z warrants. The Series B units, priced at \$10.10 per unit, consist of two shares of Class B common stock, one class W warrant and one Class Z warrant. In each of the IPOs filed, the Series A units constitute around 10% of the total offering. HCFP/Brenner has coined the term "START" for the structure.

Both classes of common stock offer voting rights on all matters to be voted on by stockholders other than in connection with the proposed business combination. Only Class B holders can vote on a business combination. (Following the completion of a business combination, there will only be one class of common stock outstanding and each holder will be entitled to vote on all matters.)

If a business combination can not be made within 15 months after consummation of the IPO (or 21 months if a letter of intent or agreement in principle has been executed within 15 months after the IPO), the trust will be liquidated. Only holders of Class B common stock will receive the trust money, including any accrued interest. Purchasers of Series A units will bear all of the expenses of the offering for both Series A and B units.

The Class A units promise investors significantly more warrant coverage while the Class B units have greater voting power and the benefit of the trust.

## Underwriters Step Up

Recognizing the significant market potential of SPACs, an ever-increasing number of investment banks are jumping into the market. The quality and size of the investment banks is also improving, which is a positive indication for the overall growth of the market.

Several in the market speculate that a bulge-bracket firm – rumors suggest Goldman Sachs or Bear Stearns – will be filing a SPAC shortly.

"Higher quality underwriters bring strong relationships with fundamental investors. They have real potential to widen the SPAC universe," explains KBL's Kaswan.

A new innovation by investment banks to attract investors is the deferral of underwriting fees. Ferris Baker Watts introduced this concept to the market when it elected to defer a significant portion of its fee on the India Globalization Capital offering until the SPAC fulfills its mission to complete a business combination.

The strategy underscores that SPAC IPOs are a two-part process: coming public and executing a business combination. Both steps must be completed for the transaction to be deemed successful.

Ferris is deferring \$6.6 million of its \$9 million underwriting fee until India Globalization buys an operating company. The firm will deposit into a trust fund a portion of their discount

and commission equal to 5.5% of the gross proceeds of the deal, of which 1% is attributable to the non-accountable expense allowance and 4.5% is attributable to the underwriter's discount. The money will remain in trust until either the completion of a business combination or the liquidation of the trust fund. Ferris will receive the escrowed fees along with any interest accrued upon consummation of the business combination. If the company doesn't complete a business combination, Ferris agrees to forfeit any right to the escrowed fees and they will be distributed to the holders of the public securities with any interest accrued.

The sweetener was added to the India Globalization SPAC filing in August, which originally filed with the SEC in May.

## Seeking to Avoid Mistakes of Roll-Ups

The sudden emergence of specified purpose acquisition company IPO filings in the past year has caused the term "SPAC" to become largely synonymous with a "blank check" company. Yet as recently as eight years ago, the concept of a blank check firm was markedly different and best exemplified by the \$550 million initial public offering of CEO Jonathan Ledecy's Consolidation Capital Corp.

Consolidation Capital's November 1997 offering represented the top of the trend toward "roll-up IPOs." Aggressive investment banking firms brought close to 55 different consolidation-focused companies to market by the end of 1998. These so-called "poof" IPOs brought in early returns averaging about 18% in their first year of trading.

Ledecy's last blank check offering turned out to be the beginning of the end for the roll-up craze. Beginning in 1998, Wall Street became less enamored with the roll-up model, and investor skittishness caused many previously high-flying consolidator firms' stock prices to plummet over the next two years. The fall included Consolidation Capital, which fell into bankruptcy within three years of its IPO after two name changes and a major corporate restructuring.

The quick rise of the roll-up offerings, and their equally precipitous drop, may offer some sobering reminders for those pushing SPACs as the next big thing in the new issue market.

Roll-up IPOs were offerings for newly created public

Ferris has offered similar deferments for Cold Spring Capital and JK Acquisition Corp., other SPACs in registration.

However, it is likely that investors will be less attracted to the bells and whistles attached to an offering, and more to the traditional draw of a SPAC: quality of management. Higher quality management offers the promise of expertise to find profitable business combinations. In addition, institutional investors who have made money with a management team in a prior venture may be more willing to take a bet on a less familiar SPAC investment.

Recent additions to the SPAC IPO queue boast management teams that have a strong track record with institutional and retail investors. One offering which may widen the SPAC investor universe is Acquicor Technology, which filed in September with the SEC. The principals behind the company are former executives of Apple Computer, including Steve Wozniak, the cofounder, Gilbert Amelio, a former chairman and CEO and Ellen Hancock, a former chief technology officer. Acquicor also counts George Scalise, the current president of the Semiconductor Industry Association (and former Apple executive), as a special adviser.

Jack Klobnak, former chief executive of Laser Vision Centers, is also hoping to bring his latest venture public. He is leading a group of investors to raise nearly \$50 million for Confluence Acquisition Partners I Inc.

Another recent addition to the SPAC market is Jonathan Ledecy, famous in the 1990s for his roll-ups including US Office Products and Consolidation Capital Corp. Ledecy is president of Endeavor Acquisition Corp., which filed its initial S-1 registration on September 20. With an exhaustive history of acquiring companies, Ledecy may lend credibility to Endeavor and its ability to complete an acquisition. (See "Seeking to Avoid Mistakes of Roll-Ups," p. 12.)

It is likely that the ultimate enticement for investors to enter the SPAC market will be a track record of successful acquisitions. To date, only two SPAC IPOs in the last two years have completed acquisitions. Deals that work will lift the overall quality and integrity of the SPAC universe.

**"The SPAC market has to evolve and react to what regulators want, and what investors want in conjunction with realistic management expectations. At the end of the day, a company's success will depend on whether or not it is able to complete successfully accretive transactions," says Littman. -EK**

companies that planned to use their IPO proceeds and stock to acquire, or "roll up" a large number of smaller companies in a fragmented industry. In theory, the consolidated firm's improved efficiencies and scale of size would allow for better profits than would be seen among the individual firms. Wayne Huizenga was widely credited for bringing the roll-up model to the big leagues, as his Waste Management and Blockbuster ventures were created by acquiring small garbage hauling and video rental companies, respectively. However, it was Ledecy who made the roll-up model his forte, using the model to create "poof companies" like U.S. Office Products, U.S.A. Floral Products (ROSI.PK), and U.S. Leasing Inc., between 1994 and 1997.

With the Consolidation Capital deal, underwritten by Friedman, Billings, Ramsey & Co., Ledecy went even further with the concept. He also followed a game plan markedly similar to those of SPACs today. Consolidation Capital's registration statement said that the roll-up company would go to market without identifying a specific industry on which it initially intended to focus. It also made clear that no acquisitions would be made until after the IPO was finalized. Once public, the company eventually decided to enter the building services area, quickly buying up close to 40 small electrical contracting firms.

There are significant differences between the roll-ups of the 1990s and the SPACs of today, though, namely in size. An average of \$51 million in proceeds was raised in the roll-up IPOs, with several deals exceeding the \$100 million mark. These deals often involved underwriting firms with bigger names than have been seen to date in the SPAC world. With the backing of the big investment houses, many of these deals also often saw dot-com like aftermarket jumps in stock price, unlike SPACs, which have traded relatively close to their offering price. Because the roll-ups often involved 10 to 20 firms being acquired at once, the sizes of the target companies were often smaller than is seen in today's blank check acquisitions.

Despite the problems that plagued the stock of many consolidators, there appears to be interest in SPACs from those with a history in the roll-up arena. Both Coconut Palms Acquisition Corp. (CNUTU.OB) and Services Acquisition Corp. (SVI) are managed by executives with ties close to Huizenga at Waste Management, Blockbuster, and AutoNation. -MM