EUROMONEY

Fund Management

M&A: Whacked by Spacs?

Helen Avery Helen Avery
1 June 2006
Euromoney

© Copyright 2006 Euromoney Institutional Investor plc.
www.euromoney.com
Spacs take aim for UK presence

Spac spat probe hits wall of silence

Special purpose acquisition companies are being listed in increasing numbers in the US and in the UK, and are attracting the attention of investment banks, mutual funds and now regulators. They are essentially cash shells. Maybe, then, this isn't a serious market but rather one best left to hedge funds. Helen Avery tries to find out more but encounters a marked reluctance among those involved to go on the record.

"WHO WOULD HAND over millions of dollars to a management group of a publicly listed company that does nothing, has no firm business strategy, has no assets and might never have any assets?" ponders a London-based hedge fund manager. The answer? Some of the world's most respected hedge fund managers and largest mutual funds.

Since August 2003, 50 such special purpose acquisition companies, or Spacs, have listed on the OTC Bulletin Board (OTCBB) and the American Stock Exchange (Amex), raising more than $3 billion from investors in their IPOs and generating several hundred million dollars in fees for investment banks. This year alone, six Spacs have listed and, off the record, participants claim to know of tens more that have filed or that intend to file for registration.

And although Spacs were initially the realm of the smaller investment banks, Deutsche Bank, Citigroup and, most recently, Merrill Lynch, have underwritten them – the latter is launching a deal for $120 million for Catalytic Capital Investment Corp. Yet ask the underwriting investment banks to comment and they are reluctant to do so.

Spacs offer impressive returns. The average return of all Spac deals from September 2003 to the end of March 2006 is almost 40%. Yet ask those who are said to be investors, such as Fidelity or the major hedge funds, to confirm that they have purchased Spac stock and you will be met with a wall of silence.

Speak to the lawyers who put together the deals and the messages are mixed – if indeed they will talk at all.

It's a market worth keeping an eye on, but for what reasons?

Unfortunate ancestry

Given the similarity between Spacs and the "blank cheque companies" of the 1990s that were the subject of pump-and-dump scams, suspicion is understandable. In 1997, securities regulator the NASD fined underwriter GKN Securities and 29 of its brokers more than $2 million, alleging that the firm was controlling after-market trading in the blank cheque warrants and artificially inflating prices. Since that time, regulators have been nervous about similar offerings.

The NASD is currently investigating one underwriter of Spacs, EarlyBirdCapital, which is considered the pioneer of the market – several former executives of GKN are now with EarlyBirdCapital, and the firm has underwritten the majority of the Spac deals presently in the market. EarlyBird says that it understands that other investment banks active in Spac underwriting have received enquiries as well and that it is cooperating fully.

The regulator will not comment on the details of the investigation, saying simply that Spacs are one of several NASD enforcement priorities for 2006 arising from the substantial increase in activity for these deals in the past couple of years, and from the fact that mainstream firms are now entering this space. In particular, it is looking at after-market trading activity. This might help to explain why market participants are reluctant to speak publicly.

Compared with its blank-cheque predecessors, though, the Spac is designed to offer the end investor some protection. The founders of EarlyBird are considered to be behind today's safer structure. Typically, a Spac would issue units comprising one share of stock and one or two stock purchase warrants at $6 or $8 per unit. A minimum of 85% of the cash generated in the IPO is placed in a trust that cannot be touched by the management company until an acquisition is made. Until then it is invested in US short-term government securities and so gathers interest. "In essence, investors are buying T-bills at a discount," says one investment banker.

The remaining proceeds are used for fees, expenses and working capital. No members of the management board receive compensation, and they do not receive their shares, typically 20% of the deal, for three years.

The SEC has also introduced a time limit for Spacs to complete a business combination (a merger, capital stock exchange, asset acquisition, or stock purchase). The management team has to complete a deal within 12, 15 or 18 months. The deal also has to have a value of at least 80% of the money in the trust or it has to liquidate the fund and return money, less fees, to shareholders.

Given the time constraints, there are obvious concerns that the pressure to complete a deal might force a Spac's management into making unsuitable purchases. Sellers would have the upper hand, and, with a minimum of 80% of the trust that has to be spent, bargaining could also be difficult. But protection is, to some degree, in place. The choice of acquisition is voted on by shareholders, and no more than 20% of shareholders can disagree with the transaction. If this requirement is met, those shareholders that voted against the acquisition can return their shares in exchange for a proportional slice of the trust's money and continue to hold the warrants. Once the acquisition closes (and Spacs are given six months extra to close a deal), the company trades like any other normal, publicly listed company.

As the Spac market has grown, however, further protection has been added. Although most of the Spacs launched in 2003 and 2004 put 85% into the trust, more recent deals have put away about 95%. In some cases, the underwriting investment bank has agreed to put a portion of its fees into the same trust until an acquisition has been made, in order to increase investor confidence. For example, Deutsche Bank was the underwriter on the Cold Spring Capital Spac that launched last November on Amex, raising $120 million. The bank put half of the fees generated into the trust, to be returned only on completion of a business combination.

Some Spac management boards have also agreed to buy a certain proportion of the warrants issued by the company so as to make it clear that they have a vested interest. "There is a lot of protection for shareholders, and one could argue that Spacs are structurally much better than most IPOs," argues one senior executive with a top-tier investment bank.

Promising returns

Essentially there is the opportunity for high returns if the management company makes a good acquisition choice and the percentage of potential loss is limited to up to 15% (depending on the amount put into the trust) pre-acquisition.

And returns from Spacs have been positive pre-acquisition. The average return as of March was 18.9%, with one Spac, Chardan South China Acquisition Corporation, having produced a return of 173.2% since its launch in August 2005.

Post-acquisition, the returns have been more mixed. Eleven Spacs have announced business combinations but only another five have so far closed a deal. The highest return at the end of March was 595.3%, from Origin Agritech (formerly Chardan China Acquisition Corp), which launched in March 2004. It acquired a majority stakehold in Denong Zhengcheng Seed Company, a developer, producer and marketer of rice, cotton and rapeseed hybrids in China for approximately $5 million in cash. Its stock is trading at around $17.

But two of the Spacs have posted losses of between 8% and 9%. "In both of these cases, it was a result of market conditions in the two sectors they specialized in – shipping and health," says one analyst. "These companies will be subject to supply and demand in their markets. That's just a fact of life."

Although only a few Spacs have completed business combinations and so cannot be used as a measure of how other Spacs will perform post-acquisition, their performance does perhaps highlight the main criticism of the vehicles. "Any fool can go out armed with money and acquire something. But can that management board subsequently run a good company?" ponders a partner at a US law firm.

Investing in people

The lawyer argues that it is difficult to trust a group of people who will take millions from investors, pay a nominal amount for 20% of the company and yet have no firm business plan in mind. Indeed, Spacs are required by the SEC not to have sought acquisition partners before they launch their initial public offering. So investor prospectuses are extremely vague. For example, North American Insurance Leaders, which is listed on Amex, proposes merely a business combination with one or more insurance or insurance services businesses in North America. Another that is currently being touted among hedge funds proposes a business combination with a company with operations primarily in India, focusing on "privately owned businesses within the financial services, healthcare, infrastructure and consumer, retail and hospitality sectors". Spac roadshows are nothing more than management boards touting their own CVs. Investors must make their choices on the basis of the past ability of the management group and make bets on what the performance of sectors or regions will be like in as much as two years' time.

In some cases, the CVs and track records of Spac management boards are impressive. Three former Apple executives, Steve Wozniak, Gilbert Amelio and Ellen Hancock, were behind the launch of Acquicor Technology, whose IPO raised $150 million in March this year. Other Spac executives include Richard Clarke, a former adviser to presidents Clinton and Bush; Tom McMillen, a former congressman; Jonathan Cohen, a former hedge fund manager and Merrill analyst; and Kerry Kennedy, the daughter of Robert and Ethel Kennedy.

So an increasing number of impressive names are starting Spacs, but one person involved in the market argues that less-professional individuals are riding on the tails of the good publicity being created. He says of one potential Spac launch: "It's extremely unsavoury. The people involved in this Spac are just scumbags. But underwriters are salesmen, aren't they? The terms

are massively skewed in favour of the sponsor, and if you look at the small print, you can see that the board might not be getting a set compensation but, believe me, they aren't doing this for free."

With the part of the money that is not going into the trust, the board of the Spac he refers to has set up a luxury office in a prime location with a handful of staff and an expense account. "Keep an eye on the expense budget," he advises. "It's very much about ego. Some of these guys regard owning a public company as highly prestigious. Private equity firms won't back them as they have no cash, and no firm proposition. It's like getting a free loan to have a fancy office and job title for a couple of years. And then when an acquisition is made, you can cash in the shares you purchased for $0.003 or so and sit back."

His suspicion that some Spacs are merely entrepreneurs that have failed to get private equity backing is one shared by many in the industry. But there is an honest business argument for opting for a Spac over private equity funding.

Akis Prokopios Tsirigakis has been working in the shipping industry for 24 years. In November 2003 he became the joint managing director of Oceanbulk Maritime, a private dry-cargo shipping company. In 2004, Tsirigakis and the executives at Oceanbulk concluded that the cyclical shipping market was at the top. "We had proposed going public, but we analysed the market and decided it was time to sell the vessels," says Tsirigakis. "There was a flood of new bulker production on the horizon disturbing supply and we had a fleet, so we sold the assets before hire rates and vessel prices fell. A Spac gave us a means of re-entering the shipping market at lower levels within 18 months. Given that we knew prices of vessels would fall, we thought it was the perfect time to start an acquisition company, when valuations were high enough to raise money ready to acquire ships when the market fell."

Tsirigakis and several of his Oceanbulk colleagues launched Star Maritime on the American Stock Exchange in December last year, raising just over $200 million in its IPO through the sale of warrants and stock shares.

"We looked at private equity to obtain funding but decided that there was greater flexibility with a Spac structure," says Tsirigakis. "There is greater liquidity with a Spac because its shares trade publicly. The Spac also offers additional advantages to both sides. Unlike private equity deals, the investors get to approve the proposed acquisition while the management has more flexibility in making decisions."

One management board of a Spac launched in the past six months decided to take that route because it wanted to raise capital to enter a different line of business without affecting the P&L of its core franchise.

Another argument that is consistently spouted to explain why Spacs are proving a popular means of capital raising is the dearth of investment banks that are prepared to serve the smaller-cap companies – an argument that is also put forward to explain the growth of the Pipes (private investment in public equity) business.

Who should invest?

Whether or not Spacs are viable enterprises, however, is beside the point if investors are educated enough to understand the risks involved, argue those putting the deals together. When the market was first created, hedge funds tended to be the sole investors. "Spacs enable hedge funds to demonstrate to their investors that they are more fully invested in securities and are not maintaining excess cash," says Mitchell Littman, of law firm Littman Krooks.

One hedge fund manager says that every Spac he has seen has been oversubscribed with hedge funds, and he says all the leading hedge funds are involved. In Spac annual reports, Ospraie, Amaranth, Millennium, Elm Ridge, Glenhill Capital and Fir Tree Partners are mentioned.

But mutual funds have become increasingly interested in buying into Spacs, according to some bankers and lawyers. "Think of the largest mutual fund companies in the world, and they are investing," says an investment banker. He names Fidelity as an example of a significant investor in a Spac launched last year. No one contacted at Fidelity was able to confirm or deny this. Listed on one Spac's annual report as investors are other investment management companies: Wellington Management Company and Robeco subsidiary Boston Partners Asset Management.

The Amex listing requirement that a company being traded on the exchange must have at least 400 shareholders is clear confirmation that retail investors are also getting involved, says Floyd Wittlin, a lawyer with Bingham McCutchen. One could hazard a guess that if investment banks with retail networks are joining the Spac party, Wittlin's suggestion looks even more likely. Such investment banks were unable to respond.

It's a contentious issue whether Spacs are a suitable investment for retail investors and mutual funds. One hedge fund manager believes that they are best left to investors such as his company that can implement complex arbitraging strategies using the stocks and warrants. His firm never holds onto the stock after a business combination has been announced. "Although I'm sure some Spacs will work out," he says, "I wouldn't invest in these companies for their supposed long-term ability at running a company. It's too immature an industry to make that judgement, and more money can be made through arbitraging the stock and warrants." He also points out that he expects the issuance of warrants by Spacs to slow down, ending the arbitrage opportunity and possibly bringing an end to what he considers a "fad market".

Exchanges other than Amex are wary of the vehicles. Nasdaq seems uncomfortable with the idea of Spacs ending up in the hands of unsophisticated investors. It will not list Spacs until they have completed an acquisition and have become operating companies. It doesn't wish to list companies whose characteristics are such that potential investors are unable to assess the business enterprises in an informed manner. Nasdaq also wants to avoid instances where it might have to delist a Spac post-acquisition because it doesn't meet the exchange's requirements. The New York Stock Exchange takes a similar view.

Amex's decision to list Spacs came as a surprise to some in the industry, and reportedly ruffled the feathers of the SEC. Amex feels that it can justify its decision. "All the 600 companies that list on the Amex go through a thorough vetting process before they can list," says an Amex official. "Amex companies have to continue to meet our listing and regulatory requirements. These are standards that we take very seriously for all our companies, including Spacs."

Some newspapers report that the SEC is in talks with Amex about the market, although an SEC spokesman declined to comment.

But one investment banker contends that as long as investors are offered an explanation of the way Spacs work, and can be seen to understand the explanation, it matters little whether they are retail or institutional investors. "What difference is there whether you are betting on the management ability of a Spac or the management ability of a Fortune 500 company?" the banker says. "In both cases the information on the ability of each management team is publicly available."

Going mainstream

The investment banker has a point. However, some bankers and lawyers that are not involved in the Spac market claim that it is just too early to say whether or not unsophisticated investors should get involved and, indeed, whether or not the vehicles deserve the seal of approval that respected institutions such as Amex, Citigroup, Deutsche Bank and Merrill Lynch have given them by taking a role.

It is certainly a gamble for the three top-tier investment banks, whose reputations are at risk. Three other top-tier investment banks Euromoney contacted said they had no intention of entering the market – although it is worth mentioning that they declined to be identified as saying so. Several reasons were given. The first is that Spacs are unsuited to retail clients, thereby immediately cutting out one distribution channel. "Although Spacs are similar to closed-end mutual funds, a retail client is taking a bet on an operations manager, not an investment manager," says one investment bank source. "And a Spac is highly concentrated, unlike a closed end mutual fund." A further argument is that it is hard to convince investors that Spacs are of value. Paying $10 for stock that is immediately worth $9.50 (or whatever the trust percentage equates to) is a hard sell.

A way to feed the children

One lawyer says that it is to be expected that large investment banks will get involved. "The IPO market has not been very hot, so underwriters need to find a way to feed their children," he says. "With the handsome fees they can earn, it is obvious why they would want to get in on the act." A senior executive at one of the top-tier investment banks in the Spac space admits that with $200 million generated in fees last year, it is, of course, an attractive market. But he adds that the bank has taken a long-term view with regards to Spacs.

Although fees are clearly attractive, the banker claims that the returns offered by Spacs, and their appeal to entrepreneurs looking to raise capital, will ensure that this a growth market. "If people are suspicious at the moment, it is because it is still a new market and they don't understand the full potential," he says. He also maintains that the smaller investment banks that have traditionally dominated the underwriting positions of Spacs are concerned about their new competition in the form of top-tier institutions.

The smaller banks disagree. If anything, the entrance of the top-tier investment banks has provided them with free publicity. They contend that the presence of the top-tier banks will be short-lived. One market participant believes that the market is designed for smaller companies that the top-tier banks are not interested in. "The point of Spacs is to fill the void for those companies looking to raise around $50 million. There just are not going to be enough opportunities in the $100 million-plus area to make it worthwhile for the top-tier banks. In that area, Spacs will be competing in auctions for companies, and will be at a disadvantage.

"The company will be weighing up whether to sell to a Spac, to a private equity company, to a strategic investor, or to IPO itself," says the banker. "A sale to a strategic investor could make more money. And a traditional IPO comes with a fanfare. Sale to a private equity company might be viewed as more professional. While a Spac is an option, it's unlikely to be at the top of the list."

This very point is at the root of the likelihood that the Spac market will become mainstream. Only if Spacs succeed in doing what they are set up to do – to find suitable and profitable acquisitions – will they ultimately gain credibility. Until that time, we can expect investors to deny that they are involved, investment banks to be reluctant to comment, lawyers to fail to return calls and regulators to be keeping an eye firmly on all of those involved.

Is the SPAC market maturing?

SPAC listings and their performance September 25 2003 to March 23 2006

IPO date	Company	$mln raised	Trust %	Total return	Lead underwriter
22 Mar 2006	North American Insurance Leaders	100	95.6%	4.4%	CRT Capital Group
15 Mar 2006	Acquicor Technology	150	95.3%	14.2%	ThinkEquity Partners
3 Aug 2005	Good Harbor Partners Acquisition	53.429	100.0%	5.4%	HCFP/Brenner Securities
27 Feb 2006	Grubb & Ellis Realty Advisors	143.75	95.7%	8.3%	Deutsche Bank Securities
16 Feb 2006	Global Logistics Acquisition	88	97.2%	5.6%	BB&T Capital Markets
25 Jan 2006	Highbury Financial	46.46	93.2%	12.7%	ThinkEquity Partners
24 Jan 2006	Argyle Security Acquisition	29.6	97.0%	9.7%	Rodman & Renshaw
16 Dec 2005	Boulder Specialty Brands	102.087	96.3%	15.0%	Citigroup
16 Dec 2005	Endeavour Acquisition	129.286	93.6%	11.9%	Ladenburg Thalmann & Co.
15 Dec 2005	Star Maritime Acquisition	188.675	100.0%	10.5%	Maxim Group
11 Nov 2005	Cold Spring Capital	120	91.5%	12.8%	Deutsche Bank Securities
24 Oct 2005	Platinum Energy Resources**	115.2	91.5%	0.9%	Casimir Capital
21 Oct 2005	Paramount Acquisition	54.825	95.1%	38.5%	EarlyBirdCapital
20 Oct 2005	Key Hospitality Acquisition	51.6	91.0%	1.9%	Maxim Group
19 Oct 2005	Federal Services Acquisition	126	93.0%	23.7%	CRT Capital Group
9 Sept 2005	Coconut Palm Acquisition	69	90.8%	21.3%	Morgan Joseph & Co.
25 Aug 2005	Ad. Venture Partners	54	93.3%	16.0%	Wedbush Morgan Securities
17 Aug 2005	Ithaka Acquisition	53.094	88.5%	10.8%	EarlyBirdCapital
15 Aug 2005	Stone Arcade Acquisition	120	92.4%	16.0%	Morgan Joseph & Co.
8 May 2005	Chardan North China Acquisition**	34.5	86.5%	326.7%	EarlyBirdCapital
8 May 2005	Chardan South China Acquisition	34.5	86.5%	173.2%	EarlyBirdCapital
29 Jul 2005	Healthcare Acquisition	75.2	90.3%	30.6%	Maxim Group
15 Jul 2005	Fortress America Acquisition	46.8	89.7%	17.2%	Sunrise Securities
15 Jul 2005	Juniper Partners Acquisition	14.519	100.0%	11.9%	HCFP/Brenner Securities
13 Jul 2005	Oakmont Acquisition	51.451	90.1%	16.5%	Morgan Joseph & Co.
7 Dec 2005	Israel Technology Acquisition**	37.908	86.9%	16.8%	EarlyBirdCapital
7 Jan 2005	Courtside Acquisition	82.8	89.1%	10.0%	EarlyBirdCapital
30 Jun 2005	Services Acquisition**	138	91.8%	84.5%	Broadband Capital Management
29 Jun 2005	TAC Acquisition	132	92.0%	14.2%	Wedbush Morgan Securities
22 Apr 2005	KBL Healthcare Acquisition II	55.2	89.1%	13.7%	EarlyBirdCapital
18 Apr 2005	Terra Nova Acquisition	33.12	86.5%	11.2%	EarlyBirdCapital
4 Nov 2005	Mercator Partners Acquisition	53.429	100.0%	15.7%	HCFP/Brenner Securities
24 Feb 2005	Ardent Acquisition	41.4	87.5%	16.3%	EarlyBirdCapital
17 Feb 2005	Aldabra Acquisition	55.2	89.4%	17.7%	Morgan Joseph & Co.
15 Feb 2005	Coastal Bancshares Acquisition	33.12	86.0%	8.3%	I-Bankers Securities
17 Dec 2004	Millstream II Acquisition	27.6	86.0%	23.8%	EarlyBirdCapital
12 Oct 2004	Navios Maritime Holdings*	171	91.5%	-8.0%	Sunrise Securities
18 Nov 2004	China Unistone Acqusition**	20.7	85.0%	141.2%	EarlyBirdCapital
28 Oct 2004	Rand Acquisition**	27.6	86.0%	23.3%	EarlyBirdCapital
24 Aug 2004	China Mineral Acquisition**	24	85.0%	7.0%	Broadband Capital Management
29 Jul 2004	FreeSeas*	6.565	100.0%	3.2%	HCFP/Brenner Securities
27 Jul 2004	Sand Hill IT Security Acquisitions**	24.66	85.0%	17.3%	I-Bankers Securities
24 Jun 2004	Arpeggio Acquisition**	40.8	86.6%	27.2%	EarlyBirdCapital
13 May 2004	Tremisis Energy**	37.95	87.3%	25.5%	EarlyBirdCapital
17 Mar 2004	Origin Agritech*	21	85.0%	595.3%	EarlyBirdCapital
17 Mar 2004	Great Wall Acquisition**	27.096	85.5%	17.2%	Broadband Capital Management
2 Dec 2004	Etrials Worldwide*	21	85.0%	48.0%	EarlyBirdCapital
25 Aug 2003	NationsHealth*	21	85.0%	-8.8%	EarlyBirdCapital

* Completed a business combination ** Announced a business combination

Source: Euromoney