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SPACs: an emerging exit strategy

In an uncertain market, special purpose acquisition companies offer specific advantages.

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The struggling initial public offering (IPO) market and the credit crunch have limited the exit strategies for portfolio companies. In this environment, a relatively new entrant has emerged—the special purpose acquisition company (SPAC)—an entity whose assets consist entirely of cash and cash equivalents. A SPAC is a publicly traded "blank check" company, formed for the purpose of effecting a business combination with an unidentified operating business. The merger of a private operating company with a SPAC is a method for the private company to go public. Recent high-profile offerings, including Nelson Pelz's Trian Acquisition Corp., which raised $920 million, and offerings underwritten by top-tier investment banks, including Citigroup Inc., UBS A.G., and Deutsche Bank A.G., have brought legitimacy to and focus on the SPAC market.

As an exit strategy, SPACs offer advantages over private equity funds and strategic buyers. For example, SPACs have substantial cash as well as publicly traded stock to finance an acquisition. While the owners of a target company typically must accept a portion of their consideration in capital stock, the SPAC's cash position enables these sellers to partially cash out while also increasing the value of their retained interest in the company post-combination. In addition, because of its strong cash position, a SPAC does not need to take on as much debt as that typically taken on by private equity firms to complete an acquisition.

A SPAC management team is highly motivated to complete a business combination. The team members have only a limited amount of time after their IPO in which to do so, and, if they fail, their equity in the SPAC will be lost. In addition, the target company's owners often control the combined company, and members of their management team are more likely to keep their management roles following a merger with a SPAC than they would be if the company was acquired by a competitor, as a competitor likely would seek to consolidate the target's management with its own personnel.

Because it has never had an operating business, a SPAC is a clean shell. Unlike a typical shell, however, a SPAC has plenty of cash to pay a portion of the acquisition consideration and fund the post-combination company's working capital or war chest for future acquisitions. Additionally, many SPACs are already exchange listed, making listing of the combined company simultaneous with the transaction's closing—simpler than in a traditional reverse merger.

There also are distinct disadvantages to sellers in attempting to complete a business combination with a SPAC, deriving primarily from the SPAC's unique stockholder protections. Unlike traditional blank checks, the SPAC's stockholders have the right to vote on each business combination proposed for the SPAC, until one has been approved and consummated. As discussed further below, the SPAC must solicit its stockholders' approval through a proxy statement, which, unless the SPAC is a foreign private issuer, must be filed with and reviewed by the U.S. Securities and Exchange Commission (SEC). Because the proxy statement will be the first public filing with information about the target company, it likely will be highly scrutinized by the SEC. As a result, the timing of the transaction—from the signing of a letter of intent to the transaction's completion—is unpredictable, often lasting more than six months.

Additionally, because the SPAC's stockholders must approve the transaction, its consummation is far from certain. In fact, according to *The SPAC Report*, while six business combinations were approved by SPAC stockholders during the first quarter of 2008, an additional six SPACs announced failed stockholder votes or formal liquidation plans during that same period. Meghan Leerskov, "First Quarter Review," The SPAC Report, Vol. II, No. 4, April 24, 2008, at 1.

Similar to a private equity fund, a SPAC is managed by an experienced management team and a group of advisers. SPAC management teams generally have experience completing acquisitions, managing companies and/or investing in private equity, or they have expertise within a specific industry from which the SPAC will seek a business combination target.

In a SPAC IPO, the SPAC sells units to the public consisting of one share of common stock and one warrant. Each warrant entitles the holder to purchase an additional share of stock at a discount to the price of the public unit, commencing upon the later of the SPAC's completion of its initial business combination and the first anniversary of its IPO.

When the SPAC is first formed, the SPAC's sponsors, i.e., its officers, directors and advisers and their affiliates, typically purchase for a nominal sum—usually $25,000—such number of shares of stock as will equal 20% of the SPAC's outstanding shares following the IPO. In addition, SPAC sponsors make a more substantial equity investment in the SPAC—typically through the purchase of private warrants concurrently with the IPO—to fund the expenses of the offering. Substantially all of the IPO proceeds and the sponsors' investment are placed in a trust account for the benefit of the SPAC's stockholders, as described in more detail below.

A SPAC has a limited time period in which to complete its initial business combination, generally ranging from 24 months (18 months to enter into a letter of intent or definitive agreement and an additional six months to complete the transaction) to as long as 36 months. If a business combination is not completed within the prescribed time, the trust account is liquidated and distributed to the public stockholders. The SPAC's sponsors do not participate in such liquidation and their securities become worthless if a business combination is not completed.

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In addition to applicable stockholder approval requirements imposed by the laws of the jurisdiction in which the SPAC is incorporated, additional business-combination requirements are imposed upon the SPAC through its charter documents and contractually in the underwriting agreement from its IPO. Generally, the target company must have a fair value equal to at least 80% of the SPAC's net assets.

If it is not completed in time, the trust account is liquidated.

The business combination must be approved by a majority of the shares voted by the public stockholders, and the sponsors are required to vote in accordance with that majority. In addition, public stockholders have the opportunity to decide whether to maintain their investment in the SPAC at the time the vote is taken. Any public stockholder that votes against the transaction may elect at the time of such vote to have its shares converted into its pro rata portion of the funds in the trust account when and if the proposed combination is completed. However, if public stockholders holding more than a specified percentage of the SPAC's public shares, typically 30%, elect to exercise their conversion rights, the SPAC may not proceed with that particular business combination.

SPACs commit to solicit stockholder votes through a proxy statement containing the information required by the SEC for U.S. public entities, even if it is not required under the federal securities laws. This process is lengthy, often 120 days or more between the proxy statement's initial filing with the SEC and its mailing to the SPAC's stockholders. If, however, the SPAC is a "foreign private issuer" under the federal securities laws, the proxy statement may be mailed to stockholders without filing and review by the SEC.

Upon the completion of the business combination, the funds held in the trust account, less any funds used to satisfy public stockholder conversion rights, are released to the SPAC.

A business combination with a SPAC is very different from a business combination with an operating public company. Because of the SPAC's unique characteristics, a target company must invest a lot more time, effort and money in the transaction process when merging with a SPAC. In addition, almost every SPAC and its target must undertake a road show, similar to an IPO road show, to convince existing stockholders to maintain their investment in the combined company and to attract new investors to buy shares from those investors who would vote against the transaction and exercise their conversion rights.

The economics of the SPAC's common stock/warrant unit provide a quantifiable return to IPO investors if a business combination is not completed but an even greater return to those that exercise their conversion rights in connection with a vote against a business combination that is subsequently completed. Most SPAC IPO investors are hedge funds that base their initial investment decision on their expected return and are not typical IPO fundamental buyers. The per share amount in a SPAC's trust account at the time of the IPO is often 99% to 100% of the IPO's unit price and continues to rise as the account earns interest. Therefore, if the IPO investor sells the warrant, it can reduce its cost basis in the original IPO unit to a price below the per share amount in the trust account. The typical SPAC IPO investor calculates its expected rate of return based upon its estimation of the warrant's sale price and the expected interest rates over the SPAC's 24- to 36-month term. The earlier in a SPAC's life that a business combination is completed, the higher this annualized return will be for the IPO investor that has exercised its conversion rights. These economics and the IPO investors' guaranteed return expectations create a hurdle for the SPAC and its target to overcome, as they predispose the arbitrage investor to vote against the transaction and exercise its conversion rights rather than bank on the combined company's success.

During the proxy process, a key indicator of market acceptance or resistance to the transaction is the market price of the SPAC's warrants. Unlike the common stock, which is converted into a pro rata portion of the trust account upon the SPAC's liquidation, the SPAC's warrants would become worthless in such a situation. Therefore, a low trading price for the warrants (compared to their historical market prices or theoretical value under financial formulas, such as the Black-Scholes option-pricing model), indicates that the market expects the transaction not to be approved.

A key indicator of success is the price of a SPAC's warrants.

Experienced investment bankers on both sides of the transaction can make the difference between a successful transaction and a failed one. They will help identify those SPAC stockholders that are fundamental holders and those that are not and also help find potential fundamental buyers. SPAC holders that have already sold their warrants should be expected to exercise their conversion rights and vote against the transaction. Accordingly, they either must be motivated to maintain their investment or replaced, in which case they represent blocks of stock available to be placed with potential fundamental buyers. Conversely, those SPAC holders that hold warrants can be expected to vote in favor of the transaction and viewed as fundamental holders and potential buyers of additional stock. The investment bankers will help to identify the expected votes, structure transactions to motivate SPAC holders to maintain their investment and fundamental buyers to purchase stock, and arrange for sales by those SPAC holders that would otherwise exercise their conversion rights.

Concessions or restructuring

For most SPAC business combinations, obtaining the stockholder vote and limiting conversions are the most difficult and uncertain aspects of the process. The uncertainty relates not only to whether the transaction will be completed but also the extent to which concessions will have to be made to the SPAC's stockholders, or deal terms will have to be restructured, to prevent the deal from being rejected. The greater the percentage of stock held by arbitragers or the less favorably the transaction is perceived to be priced or structured, the greater these concessions or the restructuring will have to be.

Because the SPAC's sponsors typically hold 20% of its common stock, as well as warrants to purchase additional equity, they are highly motivated to complete the best deal they can. The better the business combination, the better the combined company's stock should perform and the greater the sponsors' profit. With a poorly structured or poor-quality deal, the SPAC sponsors risk the transaction being rejected by the stockholders. Once the proposed transaction has gone through the proxy process, if the SPAC stockholders vote against the transaction, the SPAC may not have enough time left to identify another target or complete another transaction and, as a result, will be forced to liquidate. In this case, the SPAC sponsors' investment in the SPAC would be rendered worthless and their reputations for completing acquisitions would be greatly tarnished.

The target company will also feel the adverse consequences of a rejected deal. First, it will have spent a great deal of time, resources and money to complete the transaction and may have rejected other possible transactions. Information about the proposed deal becomes publicly available and other potential holders will know what the target's owners were willing to accept to sell their company. Additionally, the target will have made extensive disclosures about its business that it would not have made as a private company, which could place it at a competitive disadvantage as a private company.

Successful SPAC deals are business combinations with a quality business, valued at a healthy multiple of the amount held in the SPAC's trust account and fairly valued and structured to overcome the SPAC's structural limitations. Attributes that will help support a favorable vote for a transaction include a high-profile target company; retention of substantial cash from the SPAC's trust account following the acquisition to help the post-combination company achieve growth or complete acquisitions; a strong growth potential—a target's cumulative annual growth and earnings before interest, taxes, depreciation and amortization above industry or sector averages; a successful strategy with significant expansion potential; and a target's willingness to accept a fair price rather than holding out for maximum value—the SPAC must leverage the dilution of its sponsors' equity, and pricing a transaction fairly helps to achieve this goal. NLJ