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WHERE UNDERWRITERS LEAVE OFF, PE PROS PICK UP WITH SPACS

By Mark Cecil

It's no secret that special purpose acquisition companies (better known as SPACs) have been growing in popularity over the last year. And as SPACs grow to unprecedented levels, they are taking a larger percentage of market share away from the private equity market and bringing exit opportunities for smaller companies looking to go public.

The SPAC structure was originally designed to help middle-market and small-market companies gain access to the public markets by a reverse merger with the SPAC, which is a publicly traded shell. With the IPO market coming down off a boom in the late 90s, SPACs began to come back into vogue in 2003.

But SPACs have quickly outgrown novelty status and become powerful buying machines backed by top deal talent. The SPAC industry has raised roughly \$3 billion over the last few years, making it a small, but potentially substantial, competitor to the private equity industry, which has \$300 billion-plus under management.

A SPAC is a version of what is known as a "blank check" or "blind pool" company. It has a public offering of shares to raise capital, but with no operating history or assets. All a SPAC has, essentially, is a man with a plan—a deal pro or team of deal

pros, typically with expertise in a certain industry, ready to go out and find a company to buy over 12 to 18 months with the capital it raised in the public offering.

SPACs are different from publicly-traded business development companies (BDCs) like **American Capital Strategies**. The life mission of a SPAC is very short and very specific—find a company to buy. Once it does that, the SPAC ceases to exist, since it becomes a publicly traded version of the company it bought. The BDC, by contrast, is a revolving pool of public money whose value is determined by its many investments. The BDC makes investments in private companies, while a SPAC takes just one company public.

Blank check structures have run into a fair amount of opposition in the media and among lawmakers thanks to prior abuses and penny stock scandals, but they have been gaining credibility. SPACs now, for example, have underwriters like **Deutsche Bank** and **Citigroup**. Nor are SPACs any longer relegated to the bulletin board, but are traded on the AMEX.

Formerly small structures, SPACs have also recently shown they can compete for sizeable deals. For example, a SPAC called **International Shipping Enterprises**, used the \$196 million it raised in an IPO to buy privately held Navios Maritime Holdings

Inc. in a \$608 million transaction in August.

SPACs are structures that funnel money into managers' hands quickly and easily. In a private equity fundraising process, one SPAC pro noted, a private equity firm is faced with filling out six-inch thick questionnaires from every pension fund it meets. A SPAC road show, by contrast, is typically a relatively rapid six-week string of meetings with hedge funds.

Stan Johnson, a private equity partner with SPAC-active law firm **Loeb & Loeb**, recalled how in April of last year he was speaking with a private equity firm with \$1.7 billion under management. The firm hadn't heard of SPACs, and merely responded, "Oh great, more competition." Few PE firms, if any, would say they are unaware of SPACs now, he said.

In contrast to the scandal-ridden past of blank-check companies, one of the main reasons SPACs have gained popularity is the protection they offer to their investors. Between 85% and 95% of the SPAC's invested capital is locked up in escrow and invested in treasury bills until the SPAC finds its acquisition target. SPAC management teams are now putting up their own capital to pay for due diligence fees, which protects investors from almost any downside. For example, late

last year, management of **Star Maritime** put up \$11.3 million to pay for initial costs. The SPAC went on to raise about \$200 million in a December IPO.

SPACTacular Opportunity for PE?

The lure of SPACs has proved irresistible to some PE firms including **Carl Marks & Co.** and **McCown De Leeuw**.

Raising a SPAC “fulfilled a need we saw to buy a larger platform company that would not have the arbitrary exit date you would have with a private equity investment,” said **Peter Schulte**, who is a co-founder of Carl Marks’s CM Equity Partners and heads the SPAC **Federal Services Acquisition Corp.**

CM has completed 32 private equity deals since 1993. At the time it created its SPAC, the majority of its current fund was invested, said Schulte. With its SPAC, which raised \$126 million in October, “We could build a bigger company over time and from the outset provide liquidity to investors,” said Schulte.

David Nussbaum, chairman of Early Bird Capital and credited with inventing the SPAC structure in the mid-90s, had his hand in about half of the 42 SPACs that have gone public since August 2003, said the entire SPAC fundraising process takes about 12 weeks. In other words, in just three months, a dealmaker can go from no capital to deal hunting.

The SPAC form also offers more liquidity than private equity—the SPAC manager is paid in shares, which are locked up for three years, but after that, he can begin reaping the proceeds as long as the shares have gone up in value. Investors, of course, are liquid even sooner—they can sell as soon as the SPAC finds its merger partner.

But the key to a SPAC, from the target’s point of view, is what the SPAC is offering: a public shell. If a target is comparing a bid from a SPAC with a bid from a private equity firm, the only major advantage the SPAC offers is that of being public. Early Bird Capital’s Nussbaum said the underwriters

for smallcaps have disappeared over the last 10 years and the minimum IPO range has become the \$80 million to \$100 million. That and other factors created a “perfect storm” in 2003 for SPACs to make a comeback, he said.

The Dark Side of the SPACtrium

But if the target doesn’t want to be public, a private equity bidder makes much more sense. Disadvantages of SPACs include: an overhang of warrants which will be dilutive to shares; the headaches and expenses of Sarbanes-Oxley and regular financial reporting and the longer time to closing due to the need for SPAC shareholder approval. On the last point, the difference is big. While SPACs certainly raise money faster, private equity deals typically close in about 45 days, while SPAC deals take between three and four months. The SPAC vote also adds uncertainty to the deal, which could be a turn-off for the target.

To investors and to the deal pros themselves, there are other issues that arise. For investors, SPACs present an enigma on returns. Although there are 42 SPACs that have raised cash in the last 30 months, only 12 have announced deals and only four have closed them. While those 12 that have announced deals have seen their shares move up, there is little long-term evidence of the SPAC as a good place to put one’s money.

From the point of view of the deal pros themselves, there is the unsavory prospect of having to put up more cash for their SPACs, the Star Maritime deal being just one example. Although private equity general partners also put up their own capital, it is on a staggered basis, not all at once.

Mitch Nussbaum, a partner with Loeb & Loeb, who helped structure the Star Maritime IPO, said, going forward, “the market for SPACs will be between where it

was with Star Maritime and where it was before.” He added, “Clearly the market is much more receptive to management having more skin in the game.”

One more difficulty with SPACs is that they are somewhat inflexible. Although SPACs can invest in companies much larger than itself, a SPAC is required to invest at least 80% of its capital in the deal it chooses, so the IPO sets an automatic floor on the size of transaction it could do. SPACs are flexible on the upper end of the size range. Paul Brook, CEO and chairman of SPAC Itheca Acquisition Corp., said he is looking with his \$50 million SPAC at companies worth up to \$800 million.

Growing ReSPACt

In spite of those disadvantages, the growth of SPACs can’t be denied. Professionals in the industry disagree, though, over what kind of growth is sustainable. Brook, for example, thinks that the IPO market is so poor, there is no obvious limit on the growth of SPACs.

Others disagree. Nussbaum of EarlyBirdCapital strongly believes that SPACs have a kind of natural ceiling, which is the level where traditional underwriters step in. The sweet spot for SPACs is between \$20 million and \$60 million. He said it remains to be seen if the larger SPACs, which compete more heavily both with traditional underwriters and private equity firms, can generate the same kinds of returns as the smaller SPACs.

Arthur Specter, chairman of medications supplier NationsHealth, which is one of the few completed SPAC deals to date, also believes SPACs lose their attraction when they move beyond their function of bringing the public markets to smallcap private firms. Once SPACs have more than \$100 million or so, they are just large pools of capital looking for an acquisition, but less flexible than private equity firms and at the same time forcing its targets to be public. ❖

Reprinted from *Buyouts*, February 6, 2006 • 195 Broadway, 9th Floor, New York, NY 10007 • (646) 822-3043

