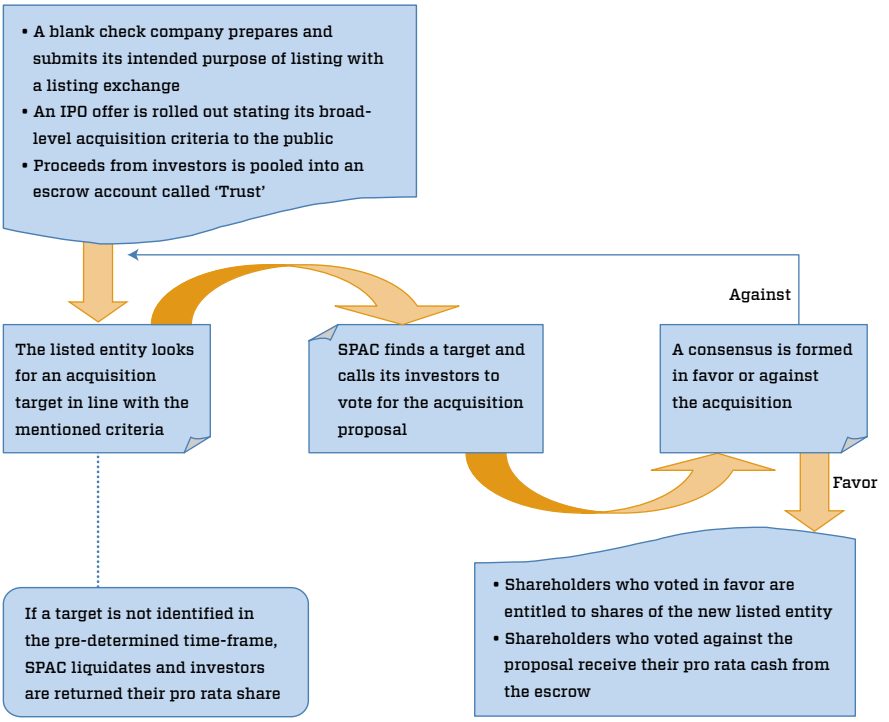
Investor Insight: Special Purpose Acquisition Companies

Hedge funds and institutional investors have been investing in numerous vehicles that are not available to retail investors. Private equity (PE) is among those investment options that a particular set of retail investors are potentially ready to invest in; Special Purpose Acquisition Companies (SPAC) allows all secondary market investors to participate in a PE-type investment scheme, largely reverse merger or Leveraged Buy-out (LBO) transactions.

SPACs follow a structured and time-bound procedure, prepared to best safeguard the capital of small investors. A cash shell/ blank check company (SPAC) with a strong management team is formed to initiate an IPO aimed primarily for acquisition purposes. Subsequently, investor capital is transferred to an escrow account until shareholders vote in favor of a desired acquisition. A pro-rata refund (net of underwriting charges) is made in case the acquisition is not completed within a decided time-frame from the date of IPO listing. This time-frame is in the range of 18–36 months, depending on the listing exchange. The following flowchart shows the complete SPAC process. **(Fig. 1)**

FIG. 1: SPAC PROCESS



Source: TSC Research and Analysis

The benefits for an investor in this instrument as compared with a typical PE investment are numerous:

- Enables retail investors to utilize the management skills of well-known professionals, initially limited to larger hedge funds and High Net Worth Individuals (HNIs)
- Trading of units on the secondary market increasing the liquidity for existing funds
- Provides a convenient exit route for investors
- Investment is safer as regulatory bodies (FSA, SEC) monitor escrow accounts and IPO proceedings
- Better investor participation as their consent is essential for making an acquisition decision
- Provides an alternative and simpler route for private companies to go public

HISTORY

Historically, blank check/penny stock companies traded actively on exchanges during the 1980s. Subsequently, this instrument started being used for business manipulation, and scams followed suit. The year 1987 witnessed one such scandal involving Onnix Financials. Although the company did not have any operations, it defrauded investors by selling non-existent securities. There were approximately 2,700 blank check offerings on the SEC between 1987 and 1990. This ended with the enforcement of the Penny Stock Reform Act (PSRA) in 1990.

The blank check companies returned to markets in the form of SPACs in 2003, this time with stricter regulations to ensure better investor protection. Since then, the concept has developed at a steady pace, and it gradually crossed borders to become a known investment medium. **(Fig. 2)**

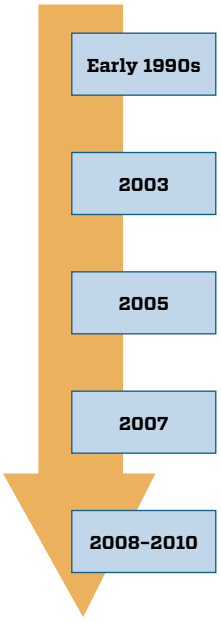
INVESTMENT RATIONALE AT DIFFERENT PHASES

Before investing in a SPAC IPO, despite the benefits, investors should be able to assess the investment vehicle at the macro and the micro level. Following are certain key parameters that should be considered while making a decision at various investment phases:

At the Time of an IPO

- There are SPACs that do not communicate any definite idea or strategy of acquisition and limit investors' judgment-making ability. Thus, IPOs that issue a focused

FIG. 2: EMERGENCE OF SPACS



The concept of SPACs was introduced by David Nussbaum, founder of EarlyBirdCapital, to bring in PE-type investment options for retail investors

First SPAC IPO was launched by Millstream in Pennsylvania, US, raising gross proceeds of $24 million (£14.5 million)

The UK's first SPAC was listed at London AIM as International Metal Enterprises, raising $201 million (£121 million)

SPAC was introduced in the Eurozone with the listing of Pan-European Hotel Acquisition Company on Euronext Amsterdam (raising €115/£98 million)

SPACs were listed in other parts of the world, and listings started on Toronto, Frankfurt, and other major exchanges

statement of purpose should be preferred. An investor should be able to assess the stated industry and other fundamentals of the geography to better evaluate the investment decision

» Background of management/sponsors is essential in gaining investor confidence. An investor should dig into the experience of the key personnel to identify their skill areas and business network. Management with a successful career in PEs is probably a better choice to execute such transactions

During Target Search

» A successful acquisition meets the purpose of the SPAC, which is why the number of SPACs that make an acquisition compared to the total number of IPOs listed indicates the success ratio. This gives investors' an overall success rate of the security, which can be further strengthened by studying what went wrong with previously failed acquisitions

» One should keep a track of the activity of the sponsors through news and market speculation while identifying a target. There is even a chance that sponsors are buying units in the open market at this stage to acquire more voting rights. This is possibly an indication that the management is currently in talks with a target with a probable disagreement among shareholders

After Target Spotting—Up For Voting

This is the most critical stage of the whole process and one should carefully examine the situation keeping the following points in mind:

» As already discussed, one facility that SPACs offer is that it is a relatively effortless listing route for a private company, as compared with launching an IPO. Private companies need not have a clean track of maintaining good books, which saves a lot of underwriting charges. Before voting, investors should verify the target's fundamentals and its market position using information disclosures of the target submitted by the SPAC and other public sources to form an independent opinion

FIG. 3: A FEW EXAMPLES

Best Performers			
Company Name	Date Priced	Gross Proceeds ($ mn)	Returns since Listing Date
Stone Arcade	Aug-05	120.0	166.80%
Rhapsody	Oct-06	41.4	88.90%
Rand	Oct-04	27.6	62.80%
Prospect	Nov-07	250.0	62.70%
Chardan North China	Aug-05	34.5	57.10%

Worst Performers			
Company Name	Date Priced	Gross Proceeds ($ mn)	Returns since Listing Date
Juniper Partners	Jul-05	15.3	-100.00%
Freedom	Dec-06	528.0	-100.00%
Symmetry Holdings	Aug-07	150.0	-100.00%
TM Entertainment	Oct-07	82.0	-99.70%
Israel Technology	Jul-05	37.9	-99.40%

ARBITRAGE OPPORTUNITY

Investors, especially hedge funds, have been exploiting the opportunity to earn risk free income from SPAC securities. This can be achieved by selling off the attached warrants from the SPAC unit at a very initial stage of the IPO launch, and subsequently voting "NO" for all proposed acquisitions. In addition to warrant price, the investors would receive their investment (usually invested in treasury securities) back from the escrow account along with interest earned on it. The only concern with the strategy is the 'uncertain lock in period' of the investor's money in the escrow account that can be as short as three months in case of an early successful acquisition and as long as two years in case of SPAC liquidation.

- Prior to an IPO, sponsors are allowed to purchase 20 percent of the firm's equity for a very nominal fee. Thus, they have strong economic incentives to complete the acquisition as they can earn a substantial payout from the transaction. Investors should stay critical to this fact and evaluate its outcome wisely

- Above all, this is the most ambiguous stage throughout the cycle as everyone is uncertain about the completion of the transaction. If desired returns are on the board, maybe this is the time to make an exit

Post Acquisition

- Performance can be benchmarked by comparing annualized return of the SPAC fund to the appropriate market indices

Below is the list of some exceptional performers' from completed acquisition. The returns in the list have been calculated from the listing date until June 20, 2012. **(Fig. 3)**

TRACK RECORD

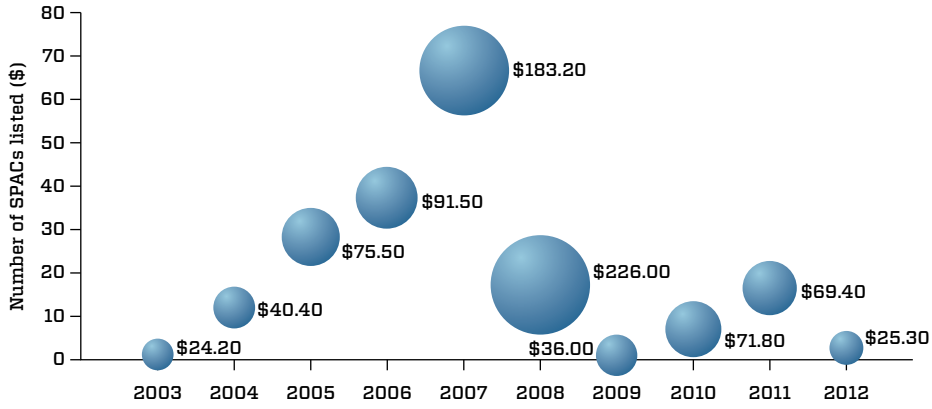
SPACs in the US have had the longest relevant history and, as such, the performance of such securities can be better gauged by looking at the US experience, where the concept is popular with a gross investor capital worth $23.6 billion, compared to a nominal $1 billion (only six SPACs) in Europe. An analysis chart for the US listed securities with reference to the above-discussed parameters is provided below. Over 2003–June 2012, 188 SPACs were listed in the US, generating an average deal proceed of around $126.3 million.

As seen in the chart **(Fig. 4),** until 2007, SPACs witnessed an upright trend for both parameters (number of IPOs and average size of capital raised per transaction). However, the sub-prime crisis of 2008 hit quite hard and SPACs seemed to have to start afresh in 2009, with a single IPO listed in the financial year. Although SPACs seem to be recovering well, reaching the level attained in 2007 might take more time because of the pessimism created in the market by the European debt scenario.

Of the 188 SPACs, 24 are still active, of which 21 are searching for appropriate targets while three have declared their acquisition targets. The liquidated 66 SPACs returned investor money net of underwriting charges thus yielding negative returns. Overall, a success ratio of 60% is not enticing enough to draw further capital from investors.

The performance of 98 successful transactions can be gauged against a relevant benchmark, Russell 2000 annualized return. Assuming the same dollar amount was invested as on the SPAC IPO date, the Russell index yielded relatively better results (0.1%) than the -19.4% (as of 1 June, 2012) annualized return on the US listed completed SPAC transactions.

FIG. 4: SPAC LISTINGS TRENDS IN US



Note: 1) Average capital raised by each SPAC in a particular year depicts the bubble size and is written next to corresponding bubble.
Source: spacanalytics.com; TSC Research and Analysis

FIG. 5: MJACI INDEX

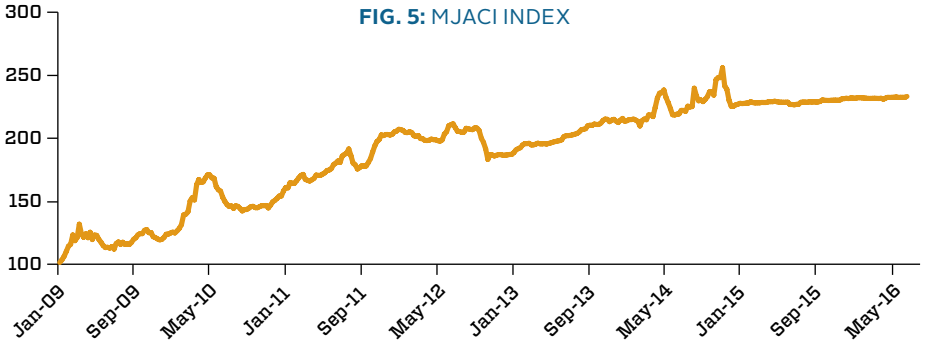
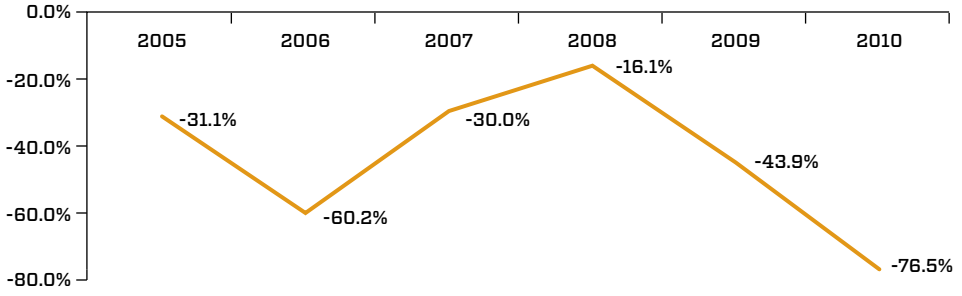


FIG. 6: AVERAGE RETURNS OF SPACS WHICH COMPLETED ACQUISITION SINCE ITS LISTING (%)



Note: Returns are calculated using available data of 70 securities from 98 SPACs which completed the acquisition
Source: Morgan Joseph Triartisan's SPAC update as on 20 Jun, 2012; TSC Research and Analysis

TIMING OF INVESTMENT

As previously mentioned, timing of the investment has played a differentiating role for SPACs. The Morgan Joseph Acquisition Companies Index (MJACI) is a market capitalization weighted index that adds newly formed public acquisition companies at their initial offer price and removes an existing acquisition company upon consummation of a business combination. In either event, index weightings are linearly rebalanced. The index was set equal to a base of 100 as of December 31, 2004. Since this index removes the security once the acquisition is completed, it only tracks active SPACs at a particular point of time. The rising trend of the index gives an idea about the positive performance of its constituent securities at any given point of time. It has been observed that post the listing of the IPO, trading volumes of a SPAC remain significant until an event of acquisition or liquidation.

Average returns from investment in completed SPAC transactions have continuously delivered disappointing results. These results reflect the till date performance (as on June 20, 2012) since the date of listing. Hence, it is evident from the analysis that appreciation in SPACs is mostly recorded when the security is seeking a target while a passive long-term investment has not performed well. **(Figs. 5–6)**

IN BRIEF

Assessment of SPACs should be done while keeping in mind that the very basic nature of this investment (despite being regulated) remains un-altered with huge risks involved, because of various stages of uncertainties and lack of transparency. Also, at present, hedge funds and institutional investors are the primary investor base for SPAC IPOs while it is yet to become popular in the retail segment.

Existence of SPACs has been closely dependent on the economy and market conditions, and going forward, such securities are expected to restate their presence as the market stabilizes. However, an informed active investor stands a better chance (compared to passive investors) to earn from this instrument because of the historical negative returns experienced on longer term investments. Also, dearth of information at various stages makes it important for an investor to keep a close track of market activity. The timing of investment and arbitrage are other vital opportunities that can be exploited through proactive investments. ■

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