SILVIA MORARA/LAPRESSE

Palazzo Mezzanotte, home of the Italian Stock Exchange in Milan.

SPACs, a no brainer

BY RICHARD GRECO AND ACHILLE TEOFILATTO

Everyone agrees. What Europe needs right now is growth. But how to encourage economic growth in areas that are still coming to terms with a deep recession? In countries like Italy, where production tends to come from small to medium-sized companies, the use of Special Purpose Acquisition Companies is smart solution to the problem of raising capital.

Investing in the backbone of Italy's economy – the small and medium-sized enterprises (SMEs) that spring forth from Italy's ingenuity and entreneurship – has traditionally been challenging for the average investor. Private equity funds are closed to the general public and require substantial minimum investments; and only 328 of Italy's six million companys are actually publicly traded. Special Purpose Acquisition Companies, or SPACS, allow the average retail investor the opportunity to invest alongside management teams in their pursuit of acquiring growing SMEs. SPACS allow investors around the world to participate in Italy's economic recovery.

On February 10, 2012 Prime Minister Mario Monti visited the New York Stock Exchange in an effort to convince investors that Italy had turned a corner, both politically and economically. He received a standing ovation from individual and institutional investors, the Italian-American community, the business community of Italy in the United States, and other observers. In response to Monti's visit to New York, which has been followed by concrete labor and fiscal reforms at home, there is anecdotal evidence that investors, including Americans, are returning to Italy. Whether or not the reforms are long-lasting and the anecdotal evidence proves to be true, investing in Italy, which may be at the end of its severe economic crisis, deserves serious study.

According to the World Bank's World Development Indicators database of 2010, the last year for which data is available, Italy is the eighth largest economy in the world, with a GDP of $2.05 trillion. Prior to the economic crisis, in 2006, the GDP was $2.1 trillion and foreign direct investment was $30 billion, an increase of 50% relative to 2005. In 2010, however, foreign direct investment in Italy had fallen to only $9 billion, and $23 billion actually flowed out of Italy.

Nevertheless, Italy is a highly enterprising country with nearly six million registered companies, or one company for every ten people, the highest ratio in Europe. Italy also has the highest patent productivity per capita in all of Europe. In sectors such as fashion and leisure goods, household goods and furnishings, food and drink, and engineering, Italian creativity is often a trendsetter in style, design and the use of new features and materials, representing a significant level of innovation.

According to Bank for International Settlement Basel II criteria, 3,600 companies in Italy are classified as large, with an average annual sales volume of $250 million, and 33,000 are classified as medium. Of these, large and small companies, only 328 are publicly traded; the remaining are private and most are family owned. The weight of SMEs in the Italian economy is very high, with 57% of Italians employed in manufacturing in firms with less than 50 employees. This percentage grows to 77.5% in firms with less than 250 employees.

Recently, two distinct phenomena are forcing Italian SMEs to alter ownership structures and to consolidate, making this an ideal time to pursue investment opportunities in Italy:

EVALUATION OF SPAC PARTNERSHIP ADVANTAGES

PARTNERING WITH:	SPAC	PRIVATE EQUITY	STRATEGIC PARTNER	TRADITIONAL IPO
Management autonomy post-combination	🙂	😐	☹️	🙂
Instruments to incentivize management	🙂	😐	☹️	🙂
Cost of the operation	😐	😐	😐	☹️
Uncertainty about the offering and valuation	🙂	😐	☹️	☹️
Access to capital for growth	🙂	🙂	☹️	🙂
Flexibility of owners to retain ownership percentage of choice or to exit	🙂	😐	☹️	🙂
Visibility on global financial markets	🙂	☹️	☹️	🙂

Source:Filangieri Capital Partners

The first is the changing dynamic of family-run businesses which will need to change their insular management structures to thrive in an increasingly competitive environment. Entrepreneurs who participated in Italy's post-World War II economic miracle have grown elderly and now face an epic decision: either to leave their businesses for their heirs to own and manage or to partner with outside owners and professional management. In many cases, the heirs are either unwilling or incapable of managing the enterprise in the way the entrepreneur would hope, making generational transition problematic.

The second is the increasing importance of globalization and the heightened need for Italian companies to maintain their competitive positions through economies of scale and innovation. Entrepreneurs in Italy are now awakening to the opportunities and the challenges of post-Cold War globalization. Italy is well-positioned geographically to reach 600 million consumers in Europe, North Africa and the Middle East, with which Italy has had historical economic and political ties for centuries. While world consumers seek the superior quality engineering, craftsmanship, and style of Italian products and are willing to pay a premium for it, many Italian entrepreneurs lack the know-how, capital, and network to expand internationally. And even though Italy enjoys relatively low overall business costs, intense global cost competition is forcing Italian companies to consolidate or move portions of production to low-cost environments.

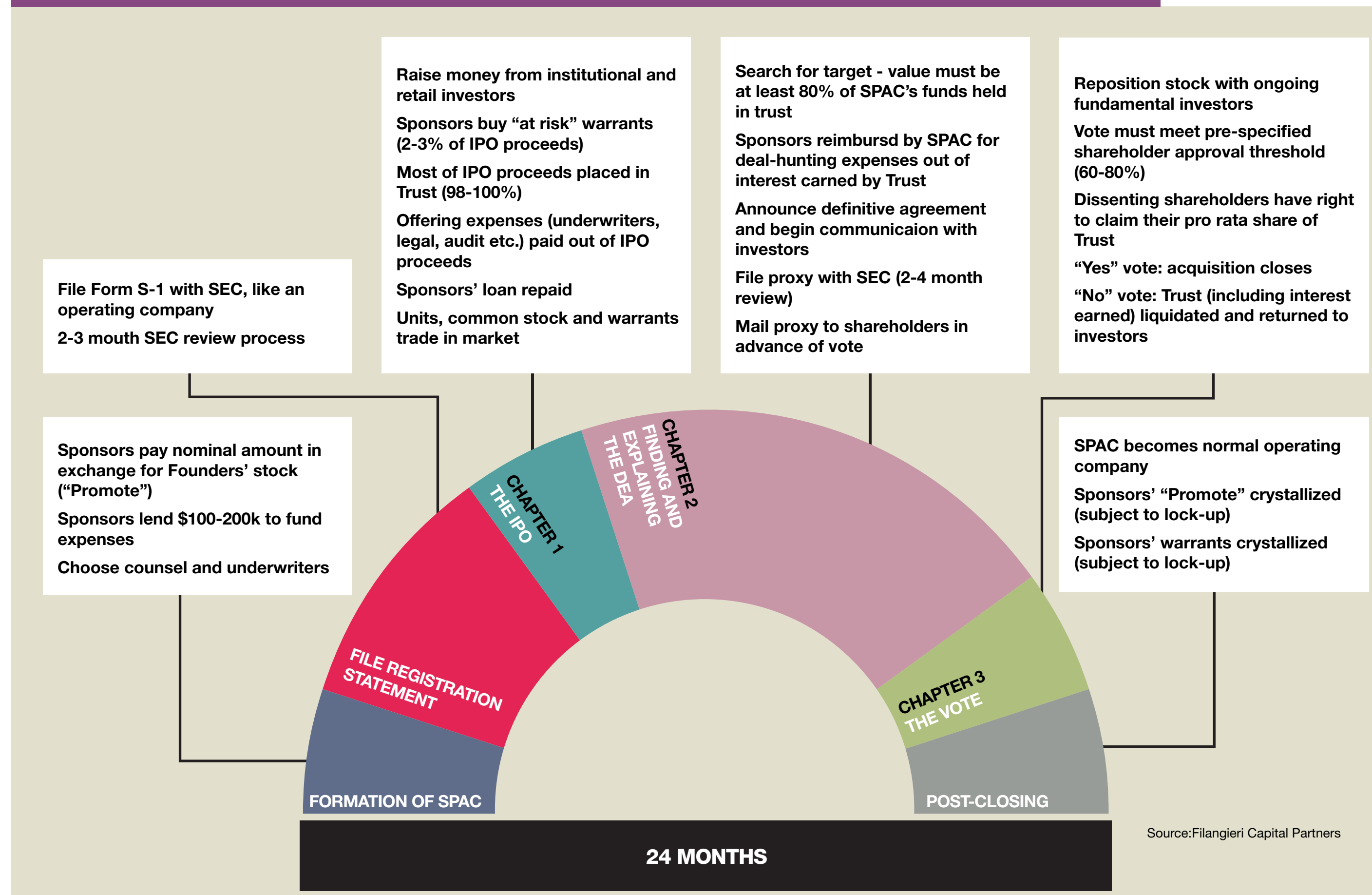
As a result of these pressures to find additional capital and know-how, exacerbated by the banking crisis which has cut off traditional sources of financing, and in an effort to increase brand awareness and to lower costs, Italian family-run companies are increasingly turning to alternative sources of capital like private debt and private equity, or the public markets, and on an international scale. In addition, the entrepreneurs of companies in fragmented industries, such as shoes, furniture, biomedical, ceramics, and textiles, often operating in close geographic proximity within Italy, are increasingly consolidating, or rolling-up, their activities. These trends were evident in the pre-crisis period, which by 2008 saw an increasing number of private equity transactions and initial public offerings.

With the introduction of the new "AIM Italia" (Alternative Investment Market) and, more recently, of the "MIV" (the electronic Market for Investment Vehicles) by Borsa Italiana SpA, it is now possible to list a shell company in the form of Special Purpose Acquisition Company, or SPAC, also in Italy.

SPACs are newly-formed companies offering initial public offerings on stock exchanges to raise cash for the purpose of acquiring operating companies. In other words, SPACs are shell companies that raise cash from investors who trust the SPAC's management to acquire a privately held company at favorable terms. SPACs allow average investors, including international investors, the opportunity to participate in unique "private equity" deals with greater transparency and certainty than the typical private equity fund offers by virtue of being publicly traded vehicles with strict reporting requirements. In the US in 2011 there were 15 IPOs by SPACs, raising a total of $1.07 billion; 19 SPACs were filed, and 12 of those have gone public.

In Italy, in 2010 and 2011, two SPACs were listed, reflecting the growing interest for an instrument which is already well known and respected internationally – Italy1 Investment Company and Made in Italy 1. Italy1, a SPAC promoted by Vito Gamberale, Roland Berger, Carlo Mammola and Florian Lahnstein, is a SPAC incorporated under Luxembourg law, listed in January 2011 on the MIV segment of Borsa Italiana. It raised €150 million, a prerequisite for a medium-size deal, and sought to acquire within two years an Italian company with an equity value between €300 million and €1 billion. The acquired company would be merged into Italy1, immediately becoming a public company. Italy1 Investment has recently announced that it has signed an agreement with IVS Italia, one of the leading foodservice operators in Italy and the largest group in the Italian vending machine sector with revenues of approximately €280 million. This merger will allow IVS to go public without passing through the usual placement process because the placement process already occurred when Italy 1 was raised. Made in Italy 1 is the second SPAC listed in Italy (since June 2011 on the AIM segment of Borsa Italiana), the first incorporated under the Italian law, promoted by Luca Giacometti, Matteo Carlotti and Simone Strocchi. It raised €50 million among Italian and foreign investors and its target is Italian SMEs with values between €100 million and €300 million, with high growth potential, active both nationally and internationally. Made in Italy 1 is currently at an early stage of negotiation with Peuterey, the Italian brand that produces down jackets.

SPAC LIFE CYCLE



Source:Filangieri Capital Partners

The incorporation of a SPAC and its listing are often promoted by a small group of sophisticated investors or experts in specific industries (so-called "founding stockholders"), or managers specialized in M&A, usually from the private equity or hedge fund world, and who have a track record of success and a proprietary edge.

Investing in any company entails risk. Investing in a SPAC entails extra risk, and SPAC managers make no effort to hide this fact from their investors. Primary among these risks is the lack of operating history upon which investors can base a prediction of future performance. Instead of looking to past performance of the fund, SPAC investors must rely on the competence, reputation and past performance of the management team as a forecast of how the SPAC might perform ("bet on the jockey, not the horse"). It is precisely for this reason that SPACs are founded and managed by experienced and skillful individuals who are often well-known and well-connected figures in the business community.

In order to incentivize management's search for an advantageous acquisition, SPACs have an unconventional compensation scheme: managers typically purchase 20% of the SPAC's common equity (known as sponsors' promote) as "founders' shares" for a nominal

Italian Prime Minister Mario Monti, right, visits the floor of the New York Stock Exchange on February 10, 2012.

investment. This management stake with a high amount of potential value puts a SPAC's management's "skin in the game" and aims to ensure that the management team's interests are aligned with those of investors. While the requisite investment by members of the management team is not very sizeable, it often represents their only chance at profiting from the venture. At the end, a SPAC's management only profits if its investors profit.

The yield of the sponsor is determined by two components: on the one hand, the market trend of the shares underwritten at par value upon a SPAC's incorporation, and, on the other hand, the spread between the shares' market price (net of the warrants' purchase price) and the cash outlay for the strike price when exercising the warrant. It should be pointed out that the sponsor's return always stands at very high levels in case an acquisition is completed, even if the shares are subsequently traded at a value lower than the IPO price. This is because the sponsor has underwritten the shares at face value and not at the units' issue price.

For investors, SPACs are an attractive investment with a limited downside from the IPO until the closing of the acquisition. Through SPACs, they can build a personalized portfolio of securities with an exposure private equity style, with the advantage of a liquidity typical of a public market and the right to vote on the proposed acquisition. Of course, SPAC investors also face significant risks, particularly because a SPAC is not an operating company, has no revenues and has not even identified one or more target companies at the time of the IPO. As such, investing in a SPAC is like "a blind leap of faith." If no business combination is completed within the deadline, an investor faces a potential loss of part of its initial investment, with the size of the loss depending on the percentage of IPO proceeds deposited into the escrow account.

SPACs can be underwritten by both institutional investors and retail investors. Since SPACs typically must announce a deal within 18 months of their IPOs or return to investors the money raised (with interest), hedge funds often see them as safe places to park cash while potentially profiting from the price fluctuations between a deal's announcement and its close – a sort of arbitrage play. Unlike investments in private equity funds, SPACs provide immediate liquidity and allow investors to participate in a private equity style investment in listed securities.

SPACs offer significant advantages over private equity, which often is out of reach of the average investor, due to large investment minimum thresholds. For the owners of companies, the advantages are clear. A SPAC can offer more money to owners than a private equity firm because public companies enjoy multiples that are generally higher than privately held companies. The following characteristics of publicly traded companies are reasons offered for this premium: greater market liquidity, motivation for profit maximization versus tax minimization, more flexible and disciplined capital structures, greater product and geography diversification.

Through a SPAC, owners can monetize all or part of their company but still keep control if they wish because a SPAC provides a private company with the option of accepting publicly traded stock as currency versus only cash in a private equity transaction. Even where private equity offers equity ownership, the equity remains illiquid. Through a SPAC, a company acquires a diversified ownership base and the beneficial disciplines of the market including SEC regulations. A company is not beholden to a single private equity investor and can be run in a way that is more transparent than private equity. A SPAC offers the opportunity to be immediately publicly traded on a stock exchange, gaining immediate international exposure, wider access to equity and credit financing, and credibility.

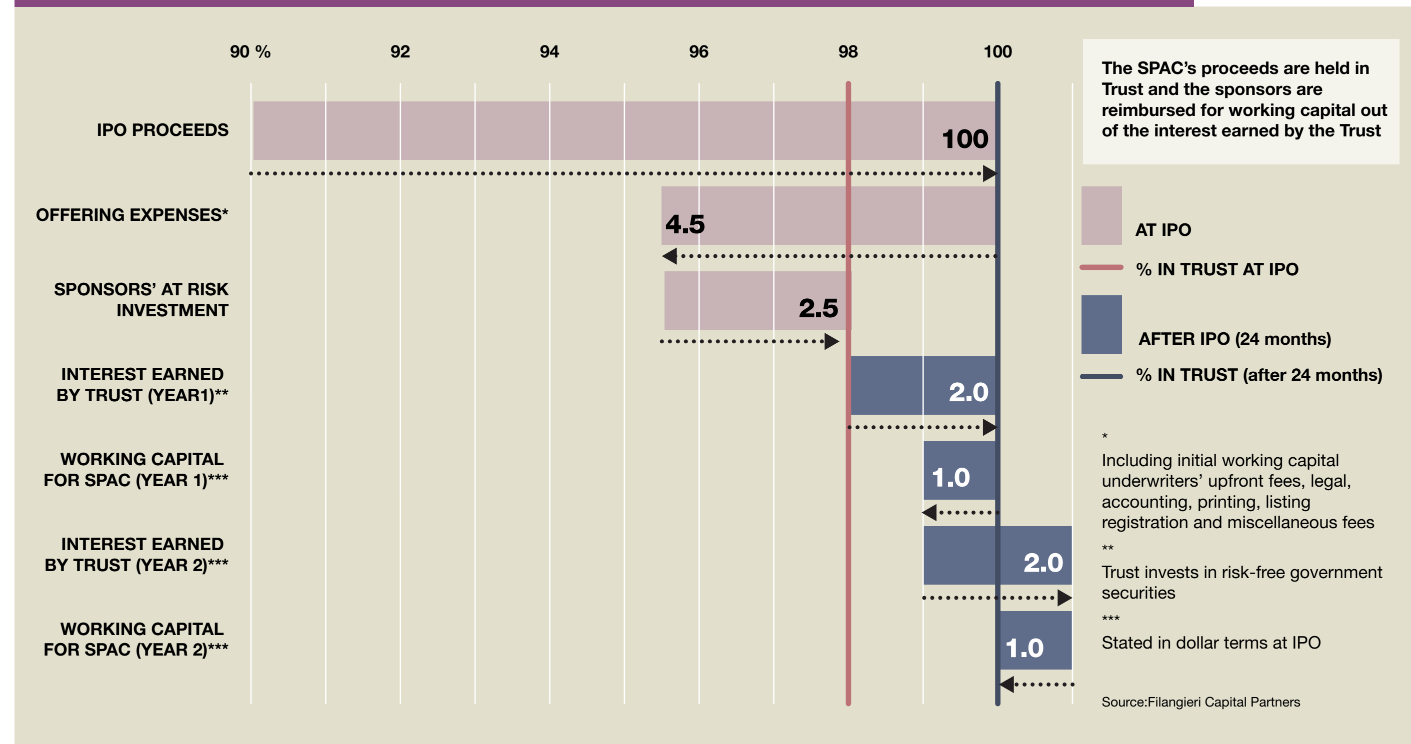
In addition, there are no ongoing private equity fees for consulting, board participation, and other fees that have become common among private equity funds. All interests are fully aligned through equity. It is interesting to note that recently the SPAC has become an attractive means of exit for private equity firms seeking to divest.

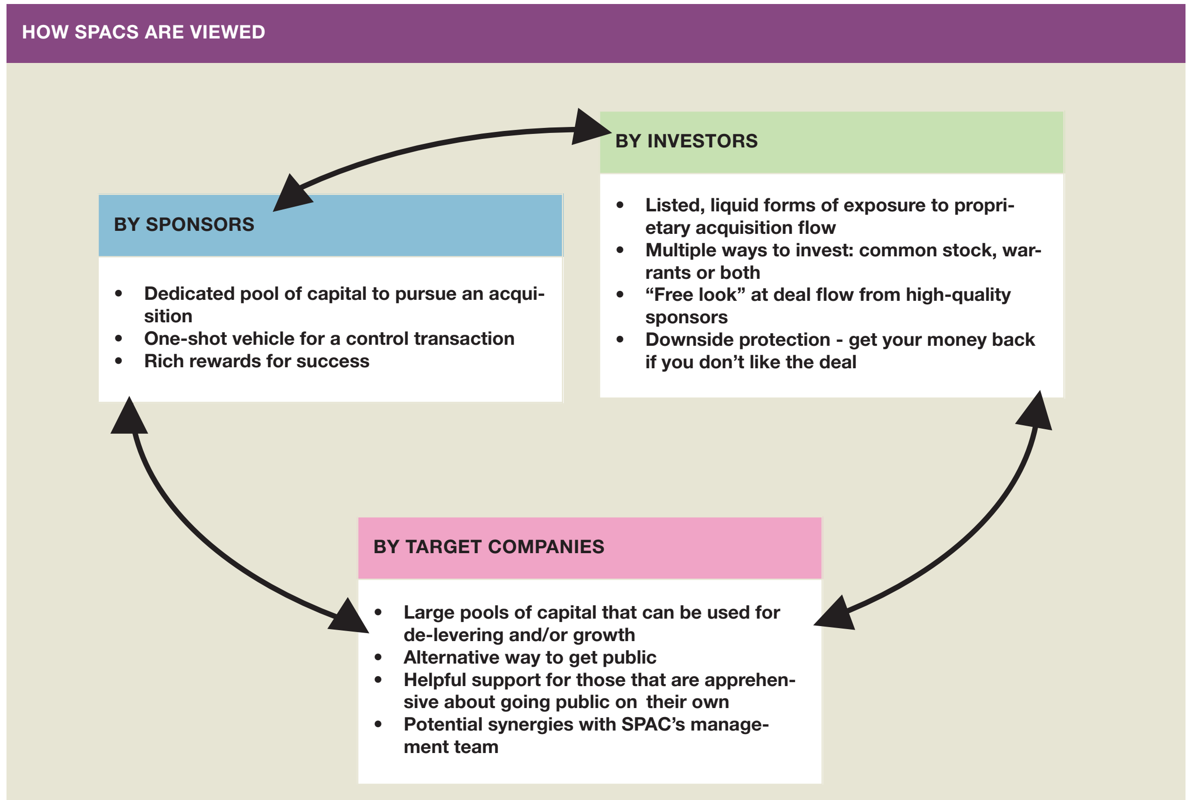
The SPAC also offers advantages over a traditional local country IPO. An entrepreneur can liquidate his entire holding and still retain control through a part-cash part-equity deal. In a traditional IPO, an owner that seeks to retain control generally will float only 30%-40% of the equity, but the controlling interest remains illiquid. Smaller companies often have difficulty reaching underwriters because underwriters prefer bigger, more profitable deals. Owners avoid the 5%-7% IPO underwriting fee that it would incur if the company went public on its own. This is because the underwriting fee has already been borne by the SPAC investors in its IPO, and not the target. The target's management team also avoids the loss of one year's time to prepare the company for IPO. This is crucial for smaller companies with limited resources.

There are risks with a traditional IPO, especially in an immature market, that a SPAC can mitigate such as unexpected delays that may result in diminished market confidence in management, damage to brand names, and overall doubt about the direction of the company. Some argue that money is left on the table in a traditional IPO as underwriters typically underprice in order to sell the deal. A SPAC can give some of this money back to owners and still underpay. A SPAC and subsequent American listing offers a target company instant international exposure and access to US markets and capital, especially low-cost debt capital in the US, where the cost of debt is still relatively low. This allows a company to pay down high cost debt with equity, optimize capital structure, and re-lever with lower cost debt. A US listing can increase brand awareness, offer significant marketing and sales opportunities, and thus increase revenue. This is particularly useful for an international company that principally exports its products and has been hurt by a weak dollar.

For companies that must "import" management talent, due to a lack of local country talent and due to

ILLUSTRATIVE SPAC FLOW OF FUNDS (%IN TRUST)





generational changes, a company's listing in the US might make it more likely for an A-rated American or other international management team to join the company. While multiples may be higher in local markets like China, India, and Poland, the American markets are more mature and stable. Italian multiples are generally lower than American multiples.

A company can also be acquired by a strategic partner, but in that case an actual merger and intensive integration process needs to take place, along with associated risks. In addition, in a sale to a strategic partner owners who are also managers are likely to leave. Through a SPAC, the management team of the operating company generally remains in place.

The SPAC also has some disadvantages over traditional private equity and local country IPOs, however. The biggest disadvantage of a SPAC over private equity is that deal closure in a SPAC is often lengthier, due to a shareholder approval process that requires 70%-80% of shareholders to agree to the acquisition. SPAC deals include warrants which if exercised may result in share dilution for investors and owners. Among other things, although the risk of expropriation is present in any IPO, it is even more pronounced in the SPACs because of the high information asymmetries between the insiders and the outsiders. The investors are, in fact, unable to have available and appropriate information about the securities, since they can rely only on intangible assets that, even in business contexts identified as "normal," are usually not easy to quantify.

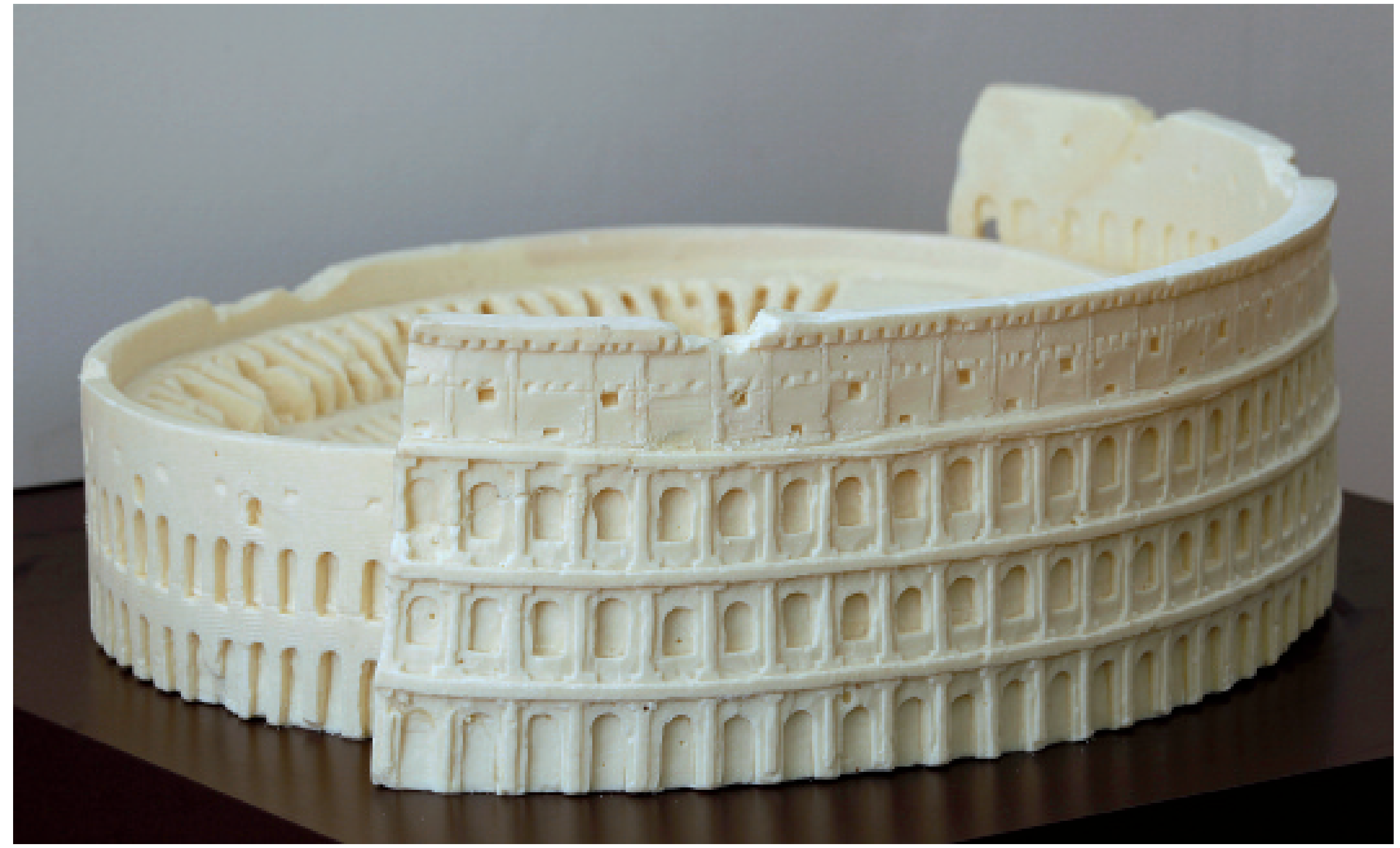
Italy is an ideal country in which to pursue a SPAC given the predominance of SMEs. The ideal SPAC target would have some of the following characteristics: SMEs in a consolidating industry facing acquisition by a competitor and in need of cash in order to acquire other companies itself, taking advantage of economies of scale and a consolidation trend; owners who do not necessarily want to cash-out but whose companies need cash to take advantage of growth opportunities including acquisitions, particularly on an international scale (e.g., industry consolidation, international market expansion, product diversification from a successful platform); owners who want to sell relatively quickly at the highest price but do not want to wait for an IPO or the hassle of an IPO; owners who might want to liquidate their holding but maintain control; companies that face generational changes and need outside management, access to low-cost capital, and international networks; companies facing low-cost production pressures and want to invest in low-cost production facilities abroad but need the capital and international network to do so; owners who want greater celebrity status by listing (famous designers, for example); companies whose owners and managers recognize the need for market discipline in order to focus on commercial decisions rather than personal decisions, otherwise they face going out of business; companies whose owners seek to implement generational change while maintaining liquid control; SMEs with little access to underwriters or exposure to private equity funds; and companies belonging to funds that sooner than later would be happy to exit through a listing.

It's clear that SPACs can be an important tool in a company's life cycle, particularly in special situations that require skills and financial resources difficult to find through more traditional ways. The SPAC, as a listed investment vehicle, is a good way to promote a start-up even in extreme early stage or as a means of a Management Buy Out (MBO), for example. To neglect this type of tool that is becoming increasingly popular in Anglo-Saxon countries would be contrary to the objective of developing the financial and economic system as a whole. It could be a good way to promote productive and not speculative investments, especially to international investors. And this is precisely what Italy needs and seeks. In order to introduce permanently the SPACs also in the Italian context, it is important not only to promote and advertise them, but also to foster a more intensive process aimed at protecting minority shareholders (aligning the interests of insiders and outsiders) and increasing the financial education of the average Italian investor.

The SPAC phenomenon, as a potential alternative to the traditional model of private equity fund, is a very interesting investment model, but at the same time it is also unique, because its success depends on the promoters' reputation and on their ability to raise capital from experienced investors, which probably have already tested the managers' ability to create value. Their ability to raise large amounts of capital needed for growth, may represent an important factor facilitating access on the stock exchange and to the average investor by SMEs, thus becoming a significative growth factor for the Italian economy.

RICHARD GRECO, JR. *is the president of Filangieri Capital Partners, a merchant bank based in New York. He has taught economics and finance at the Bocconi Scuola di Direzione Aziendale in Milan and at LUISS University in Rome.*

ACHILLE TEOFILATTO *is an Associate at Filangieri Capital Partners and former Intern Analyst at Lazard & Co.*


BOBBY YIP / REUTERS

A chocolate sculpture of the Colosseum, created by Italian chocolatier Mirco Della Vecchia, is displayed as part of his "Chocolate World Heritage" exhibition in Hong Kong.