Challenges in SPAC land

A debate ensues over how much control should SPACs have over assets they acquire

By STARBIZWEEK TEAM
starbiz@thestar.com.my

KEY POINTS

An issue has cropped up over how much control should SPACs, especially those in the oil and gas industry, should exert over the acquisition targets.

Some investment bankers say that the rules are already clear in the listing guidelines but others beg to differ.

HOW much control should Special Purpose Acquisition Companies (SPACs) exert over the assets they acquire? This is a question that is increasingly becoming a moot point with listed SPACs.

Here's one indication of this: According to sources, Reach Energy Bhd, the oil and gas SPAC seeking a listing on Bursa Malaysia, has tweaked one the clauses in its prospectus relating to control over the assets it hopes to buy. It has now stipulated that it will seek to secure majority control over the assets it buys into.

Apparently this was done to ensure there was no confusion in this area going forward.

SPAC guidelines from the start, had a very strict view on this matter. The rules initially required SPACs to secure both majority ownership and management control over the assets they buy. Subsequently, the rules were loosened after taking into consideration the dynamics of certain industries such as the minerals and resources industry that includes oil and gas.

Here, especially in large production or exploration fields, the norm is for a few parties to have stakes without anyone having more than 50% as a means to diversify the huge capital requirements and spread business risks.

Hence the SPAC guideline rules then allowed for instances where SPACs may acquire non-majority stakes. But the condition of this was that the SPAC still needed to demonstate that it exerted "management control" over the operations of the asset.

For already-listed CLIQ Energy Bhd, the SPAC has had to consider going back to the drawing board of one of its planned acquisitions to ensure it had sufficient control over asset it was looking to buy, sources say.

Then there's the recently-proposed acquisition by Sona Petroleum Bhd – it said it planned to fork out US$280mil (RM903.64mil) for a 40% stake in an operating asset of London-listed Salamander Energy Plc.

Details on this deal aren't available yet as the company is yet to ink its sale and purchase agreement with Salamander, only having announced a heads of agreement.

Indeed Sona's planned acquisition is one of the bigger stories hogging the talk space among retail investors these days.

Instead of seeing investor interest grow after it announced the planned deal, the stock has retreated by 12%.

It isn't yet clear why the stock had been sold down.

But one factor could be this: on the day of Sona's announcement, a major bank issued a note to its private banking clients to "take profit" on the grounds that Sona was poised to be an oil and gas exploration and production player and hence the risk-rewards were different.

The note said that the 72% return for Sona's IPO investors was "phe-

Key facts of the Bualuang field

Licences
- B8/38 Production Licence (100%)
- G4/50 Exploration Concession (100%*)

Activities
- Oil production, development and exploration

*2P - Proven and probable reserves
*2C - Best estimate of contingent reserve

Key facts
- 30.1 MMbo of 2P reserves (as at 31.12.13)
- 27.8 MMbo of 2C resources (as at 31.12.13)
- 2014 production forecast 11,000 - 14,000 bopd
- Over 60 leads and prospects o G4/50 acreage
- Exploration drilling in 2014

A key issue is that Sona will have to indicate that despite having only a 40% stake in the operating asset, it does have management control over it.

All about management control

But why the fixation with management control? If the SPAC is acquiring a stake in a very good asset at a very good price, then aren't the SPAC shareholders going to gain?

The answer lies deep in the philosophy of SPACS.

The rules were created to allow experienced professionals to raise funds from the capital market in order to buy into assets from which they can value add.

investment banker.

The qualifying acquisitions of SPACS have therefore to go through both qualitative and quantitative tests – the former addressing issues such as management control and the later, to ascertain the earnings and potential of the said asset.

This philosophy also has an accounting element to it. In order to equity account and consolidate cash flows and earnings, one has to display it controls the management of the owned asset.

The next question to ask is what exactly entails management control?

The test has to be one of substance over form, notes a corporate lawyer familiar with the SPAC guidelines.

"This "control" issue can take many permutations. In the end, the SPAC has to show that in substance,

listed SPAC to have concluded its qualifying acquisition, where it acquired a 35% stake in a Middle East based exploration firm, Lime Petroleum. Hibiscus became the project manager of the asset and earned a project management fee for that role. It is also understood that it paid a premium for its 35% stake as that acquisition came with management control over the concessions. One typical feature in joint operating agreements in the oil and gas space is that parties may have blocking rights, whereby they are able to block decisions made by the operator. Then there are clauses which require major decisions to be made unanimously, meaning that all consortium shareholders have to agree.

"However, none of this maybe as good as taking over the key manage-

philosophy – the managers have to have that amount of standing in the business segments they operate in, convincing all that their management control over the asset would bring about more value than by them merely being a passive shareholder.

Still, the control issue indicates the serious challenge SPACs face: if they were to pursue buying majority ownership in the asset, then they would probably end up paying a significant premium.

That in turn makes finding acquisitions that deliver attractive returns all the more challenging.

Sona Petroleum's proposed qualifying acquisition

- Paying **US$280mil** (RM896mil) for a **40%** stake in:
  - B8/38 (containing the producing Bualuang field)
  - G4/50 (an exploration field)
- The heads of agreement was signed on **June 5**
- The sale and purchase agreement will be signed by **June 26**
- The deal is subject to regulator and shareholder approvals.

Analysis of recent transactions in Asean

Entitlement