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PE Jumps into the SPAC Markets

Raising capital through special purpose acquisition companies, or SPACs, hit its peak around 10 years ago. After a period of diminished fundraising, SPACs are back with a vengeance, and a number of them are backed by private equity sponsors.

What Is a SPAC?

A SPAC is a company formed for the purpose of acquiring one or more operating companies pursuant to a business combination. Prior to having a specific target for the business combination, the SPAC raises the funds through a public offering of the SPAC’s equity securities, with the private equity sponsor retaining 20% of the post-IPO SPAC.

Appeal to Private Equity Sponsors

SPACs have a number of benefits that have led private equity sponsors to use them to raise capital.

- SPACs provide a potential permanent capital solution for sponsors through access to public markets, which allows for more open-ended private equity investments.
- The private equity sponsor retains 20% of the post-IPO SPAC, providing an outright ownership position, which increases the potential upside in the post-business combination entity.
- SPACs can serve as co-investment vehicles, allowing private equity sponsors to do side-by-side transactions with less leverage and more equity.
- SPACs allow the pursuit of larger acquisition targets and targets in industries that fund documents would prohibit.
- SPACs provide greater liquidity certainty for sellers who receive SPAC equity in the transaction, as compared to an illiquid interest in a private portfolio company.

Despite these benefits, sponsors need to consider the potential downsides in seeking to set up a SPAC. For example, sponsors will need to explain the product to existing limited partners, who may be concerned about potential competition for deal opportunities between the SPAC and the existing fund. They might also be concerned that the private equity sponsor employees involved in the SPAC will be distracted from core fund investment activity.

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SPAC Deal Trends

There has been a significant resurgence in the SPAC IPO market since the financial crisis.

warrant in the IPO at a price of \$10.00 per unit. The market custom is that only units are tradeable for the first 52 days after the IPO, after which the

directors and a majority independent board of directors.

Nasdaq rules require that at least 90% of a SPAC’s IPO proceeds be placed in a trust account to fund the business acquisition, but in practice, SPACs typically place the full amount of the IPO proceeds into the trust account. The trust account invests the proceeds in US government bonds. The underwriting discount for a SPAC IPO is typically 5.5%, with 2.0% paid at the time of the IPO and an additional 3.5% paid when the SPAC successfully completes an initial business combination. Typically, the underwriting discount is paid for through a private sale of warrants to the founders.

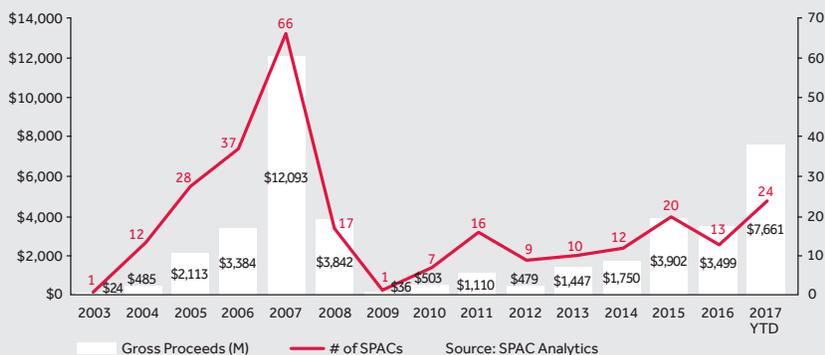
The IPO process typically takes between ten and twelve weeks. Many SPACs make their first registration statement filing confidentially with the SEC, which allows the founders to advance the IPO process with the SEC without having to announce it to the public until closer to the time of the IPO. Since SPACs qualify as “emerging growth companies,” the founders can take advantage of certain accommodations, including reduced disclosure requirements and exemptions from certain Sarbanes-Oxley requirements.

SPAC Business Combination Process Overview

Nasdaq rules require that a SPAC complete a business combination within 36 months of an IPO; this time frame is typically 24 months in a

SPAC Capital Raising 2003-17

- Significant resurgence in SPAC IPO market since financial crisis
- SPACs are becoming a more mainstream structure



Private equity sponsors that have completed IPOs of SPACs in 2017 include Riverstone, The Gores Group, TPG and Thomas H. Lee Partners. In addition, SPACs sponsored by TPG (acquisition of Playa Hotels & Resorts), Centerview (acquisition of Atkins Nutritionals, Inc.) and Chinh Chu, formerly a Blackstone partner (acquisition of Fidelity & Guaranty Life), have either signed or completed business acquisitions in 2017.

SPAC IPO Process Overview

Prior to the IPO, the founders of the SPAC invest a small amount of initial capital to form the SPAC and hold all of the pre-IPO equity. A SPAC will typically sell units consisting of one class A common share and 1/3 of a

class A common shares and warrants trade separately. The founders retain their 20% equity ownership through class B common shares, which are commonly referred to as “founder shares.”

Only the founder shares are entitled to vote on the election of directors prior to the initial business combination, which allows the founders to retain control of the SPAC until it becomes an operating business. Most SPACs list on Nasdaq, which has favorable listing requirements for SPACs. However, Nasdaq rules subject SPACs to similar corporate governance requirements as are imposed on operating companies, so SPACs will have an audit committee made up of independent

SPAC's organizational documents. If a SPAC is unable to meet the deadline, each holder of class A common shares is entitled to its pro rata portion of the assets in the trust account, while holders of founder shares and warrants (including the founder warrants purchased to finance the underwriting discount) are not entitled to any such assets.

Under Nasdaq rules, the fair market value of the target business must exceed 80% of the value of the assets in the trust account. Once management identifies and agrees to a business combination with a

shares for a pro rata portion of the trust account. If a shareholder vote is not held, the SPAC may offer this opportunity to redeem class A shares pursuant to a tender offer. This may lead to a situation in which a shareholder threatens to redeem a large position in order to extract value from the SPAC. Many SPACs attempt to mitigate this risk by limiting redemptions for any individual investor to 20% of the total outstanding class A shares.

The shareholders' ability to redeem their shares can also create significant uncertainty for the sellers, as it can

more than the value of the assets in the trust account and available debt financing. Alternatively, SPACs can seek a PIPE (private investment in public equity) deal, where additional capital is raised through a private offering to a selected investor or group of investors. A potential PIPE transaction, however, lacks the certainty of a forward purchase agreement entered into at the time of the IPO.

Conclusion

Although SPACs are complicated structurally, they can provide private equity sponsors with a number of benefits in terms of transaction targets, structure and returns on investment. The SPAC IPO market has seen significant demand in recent years, which has further encouraged private equity sponsors to take advantage of SPACs. Private equity sponsors should consider whether a SPAC will provide them with benefits that will justify the time and cost of establishing a SPAC and differentiating their investment strategy from that of the sponsors of other funds.

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target, Nasdaq rules require that the business combination be approved by a majority of the SPAC's independent directors. If required by state law, a SPAC may have to submit the business combination to a vote of the class A shareholders. In many cases, however, a shareholder vote can be avoided. Further, the approval of the class A shareholders is usually obtained if needed because of the shareholders' redemption option discussed below.

Whether or not a shareholder vote is required, Nasdaq rules require that each shareholder be given an opportunity to redeem its class A

be unclear whether the SPAC will have enough assets to complete the business combination. Some recent SPACs have addressed the uncertainty caused by the redemption process by entering into a forward purchase agreement with the SPAC's founders, which obligates the founders to purchase additional units from the SPAC in the event additional capital is needed to complete the initial business combination. A forward purchase arrangement can not only fill any gap that is created by redemptions, but can also provide additional capital for the SPAC in the event that the target business costs