

# Daily Journal

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PERSPECTIVE

## Private equity sponsors using SPACs

By Sara L. Terheggen

Special purpose acquisition companies, or SPACs, have been around for many years. Historically, SPACs were considered risky investments that only appealed primarily to hedge fund investors. But recent years have seen a shift in sentiment with an ongoing trend of top private equity sponsors and target companies working their way into the mix. This trend is providing validation for the model by increasing the likelihood that an acquisition will be consummated and attracting a new investor base. Further, the structure and mechanics of SPACs that has evolved over time has reduced the overall risk for investors.

### Characteristics of a SPAC

A SPAC is a publicly traded acquisition vehicle whereby a private equity sponsor assembles a management team and raises proceeds through an IPO of the SPAC with the sole intention of acquiring an operating company. Key elements of a SPAC include:

- SPAC IPOs are structured as a sale of units which consists of both common stock and warrants. Post-IPO, the unit is split and the common stock and warrants are traded separately. Units issued in SPAC offerings begin trading on the date of the IPO.
- Most SPACs provide 18-24 months for completion of an acquisition and if no acquisition is consummated, the SPAC is required to liquidate.
- Upon completion of the IPO, most of the proceeds of the offering are placed into a trust and funds may typically only be released from the trust upon completion of a business combination or liquidation of the SPAC. If liquidation occurs, the proceeds are returned to investors.
- The IPO expenses and operations during the acquisition execution window are often funded by the initial sponsor private placement and periodic loans from the sponsor to the SPAC.
- The sponsor team is typically given a 20 percent interest in the SPAC which is purchased through a private

placement prior to the IPO. This 20 percent interest is often called the “promote.” If a deal is consummated, the promote can become quite valuable. If liquidation occurs, the shares and warrants are essentially worthless.

- In connection with the acquisition proposed by the SPAC, investors do have the option to redeem their pro rata share from the trust even if they vote yes on the acquisition.

Management of the SPAC is typically a collection of top private equity operators who have a track record of sourcing and executing successful deals. With the rise of SPAC deal activity in the last few years, investors are increasingly focused on the quality and credibility of the proposed management team, the industry focus and ensuring the structure and size of the SPAC will lend itself to optimal liquidity. When looking at ideal targets, SPACs will generally look for a transaction that is 3-5 times the initial public offering size. These trends in the SPAC market are leading to an increase in the overall size of SPAC IPOs and making it more difficult for smaller private equity sponsors to utilize this financing vehicle.

### Benefits of Raising a SPAC for a Private Equity Sponsor

Established private equity sponsors find SPACs to be a creative way to complement their private fund platforms, offering them an alternative vehicle through which to raise capital outside of their primary buyouts funds and giving them the flexibility to access the public markets and diversify their investor base.

Raising a SPAC can also provide opportunities to access industries that sponsors otherwise would not target or may be prohibited from targeting in their private funds. Another benefit is the timeframe for raising capital. Most private equity funds will require a 12-month fundraising period and that period can be extended in certain circumstances while the timeline for raising a SPAC is significantly shorter. Depending on SEC comments, the timeline to raise a SPAC can be as short as 2-3 months.

**Despite the potential drawbacks, top private equity sponsors are finding ways to incorporate SPACs into their existing fund platforms. As more sponsors enter the space, we continue to see a rise in the legitimacy of the SPAC structure.**

### Potential Drawbacks for a Private Equity Sponsor

When contemplating a SPAC, the primary considerations for a private equity sponsor are quite often their existing fund platform and deal uncertainty. Key issues that arise with respect to existing platforms are conflicts with existing funds and limited partner concerns over time allocation. Partnership agreements will often have limitations around the ability of sponsors to raise successor or competing funds until a certain percentage of capital in that fund has been invested. If the language in the partnership agreement is limiting, it may be difficult for a sponsor to have the flexibility to raise a SPAC. If an amendment to the partnership agreement is required, the sponsor will have to seek the vote of the limited partners and it may be tough to get agreement on such an amendment if limited partners are concerned about losing out on a potential investment that would otherwise go through the fund.

Time allocation is likely to be another concern for limited partners. Partnership agreements will often mandate that key persons in the fund commit substantially all of their time to management of the fund and provide very few exceptions for other activities. If the sponsor is large enough, they may be able to source a team for the SPAC that would exclude key persons associated with their main funds but limited partners may still be concerned about impact on deal sourcing and focus.

Deal uncertainty is another potential obstacle. High redemptions can force the need for additional financing to give targets comfort on funding requiring sponsors to provide additional contributions or seek out



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third party sources. Also, SEC rules and regulations regarding required financial statements coupled with a short window for deal execution can make “getting to a closing” tough.

### Summing It Up

Despite the potential drawbacks, top private equity sponsors are finding ways to incorporate SPACs into their existing fund platforms. As more sponsors enter the space, we continue to see a rise in the legitimacy of the SPAC structure. Private equity funds who are interested in exploring SPACs can also engage with limited partners regarding conflict and time allocation issues early and make necessary adjustments in advance. Based on the increasing activity of SPAC capital raises over the last few years and the number of top-tier sponsors who have already raised one, it seems SPACs have found a place amongst private equity funds offering sponsors the opportunity to diversify strategy and investor base.

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