

PE Hot Topics

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PE firms returning to special-purpose vehicles

A new generation of special-purpose acquisition companies (SPACs) is being raised by PE sponsors and others with well-established track records in private capital. What makes them so attractive?

A structure with a turbulent history

SPACs have seen a marked uptick in activity over the last 2-3 years, driven by a number of factors, including choppy IPO markets, greater acceptance among the small and mid-size companies that typically make up the universe of SPAC targets, and perhaps most significantly, increasing interest in the structure by financial sponsors and management teams with experience in private equity.

SPACs are investment vehicles that raise capital from investors via an IPO to use at a later date in an acquisition of a target that is still undetermined as of the listing. Investors in SPACs are essentially backing sponsors with the belief that they'll be able to effectively deploy the capital in an attractive asset that will provide a good return.

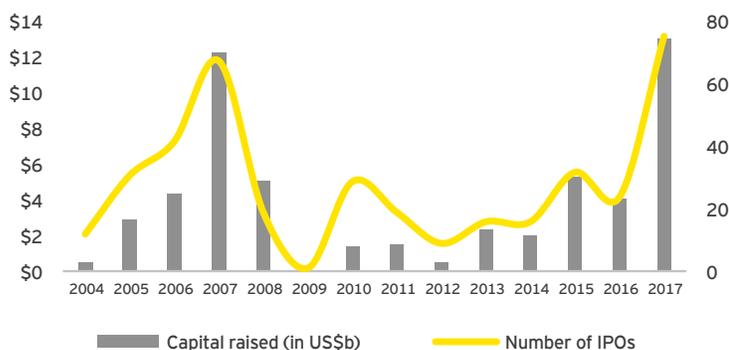
Proceeds from a SPAC listing are typically set aside in an escrow account until a target is identified, at which time investors have the ability to either approve the transaction or receive their money back; promoters typically have between 18-24 months to identify a suitable investment.

Earlier generations of SPACs had a mixed reputation, the result of deals that didn't play out as originally planned. This is beginning to change, however, with a new generation of SPACs backed by experienced management teams and sponsors with successful track records and long histories of strong performance for investors.

Legitimacy, and an increasing force in the market

SPACs have seen multiple boom and bust cycles since their advent in the 1980s; in 2007, 69 deals raised US\$12.3b. Activity once again peaked in 2017, with 76 deals raising US\$14.8b. Moreover, not only are SPACs raising more capital than ever, but the proportion of the overall IPO market they represent is at a record high, as low interest rates and high valuations pushed investors further afield in search of attractive returns. In the US, SPAC listings accounted for 19% of the total IPO market by value last year, up from just 12% in 2007.

SPACs and other BCCs see a record year in 2017



Source: Dealogic

The amounts that individual SPACs are raising are also getting larger – since the beginning of 2016, 10 SPACs have raised more than US\$500m each, enabling them to effect larger transactions, including several multi-billion dollar deals. In August 2017, for example, Silver Run Acquisition Corporation II, a SPAC-backed by Riverstone Holdings, announced a US\$3.8b deal for Kingfisher Midstream and Alta Mesa Holdings, both Oklahoma-based energy companies. The SPAC had raised US\$1.0b in an IPO earlier in the year. Another recent deal involved Quinpario Acquisition Corp. 2, which merged with Apollo-backed Novitex Holdings Inc. and SourceHOV in a US\$2.8b deal to create Nasdaq-listed Exela, which provides transaction processing solutions and enterprise information management services across the globe.

Why raise a SPAC?

As a structure that bridges the gap between public and private equity, SPACs fill a small but important niche in the market. Indeed, the resurgence in issuance is reflective of a number of benefits the structure has for sponsors, the companies they acquire and investors.

For sponsors:

- ▶ **They allow sponsors to go beyond their traditional LP base** – the exchange-listed nature of SPACs and their increased liquidity makes them attractive to a range of investors above and beyond PE firms' typical investor base of pensions, foundations and endowments.
- ▶ **They allow for greater flexibility and creativity in structuring than a traditional IPO** – SPACs can give sponsors more tools to close deals than other structures. Some recent SPAC acquisitions have seen sponsors assign portions of their shares to other stakeholders in order to facilitate a transaction, for example.
- ▶ **SPACs can increase a firm's investible universe** – SPACs can attract management teams outside of a firm's particular purview or allow them to invest in deals that might fall outside of traditional LP agreements.



For companies:

- ▶ **They can enable cost savings relative to traditional IPOs** – SPACs allow companies to achieve cost and time savings vs. a traditional IPO, which can involve multiple underwriters and months of road shows.
- ▶ **A reverse merger with a SPAC allows for greater certainty in terms and conditions** – companies are able to negotiate the terms of a sale with greater confidence in their ultimate valuation vs. a standard IPO, which subjects companies to the vagaries of the market on any given day. Companies are able to avoid much of the underpricing and first-day volatility that is inherent in a typical listing process, and enter the public markets with a shareholder base that is oriented toward the long term.
- ▶ **SPACs can represent a streamlined regulatory approvals process relative to trade buyers** – because they don't have existing operations, SPACs encounter less bureaucratic hurdles. When Fidelity & Guaranty Life received an offer from a strategic investor for US\$1.6b in 2015, the deal struggled to win the necessary regulatory approvals and was ultimately scrapped. Within months, however, Fidelity & Guaranty Life had found a new buyer – CF Corp., a SPAC raised by former Blackstone executive Chinh E. Chu and former Fidelity National CEO William P. Foley II. The deal was ultimately struck at a 16% premium to the original offer.

For investors:

- ▶ **They allow investors to participate in types of deals that might be otherwise off-limits** – sometimes called the “poor man's PE,” SPACs can offer access to PE-like opportunities for public market investors. PE's nascent push into retail notwithstanding, they're one of the few opportunities available for many to invest in the private markets. Of course, they also come with increased risks – while a traditional commingled fund might have 10 to 20 or more investments in its portfolio, a SPAC typically has just one.
- ▶ **They have increased liquidity relative to commingled PE funds** – although trading volume in SPAC shares is typically thin, they're exchange-tradeable and relatively liquid compared with PE funds, which can lock up capital for the better part of a decade.
- ▶ **The structure and economics of SPACs favor alignment** – because SPACs don't charge an annual management fee, but instead typically allocate 20% of the company's shares to its sponsors, incentives for sponsors to perform are high. They also provide investors with a built-in put option – allowing them to participate in the upside for attractive deals, and to receive their cash back for unattractive deals.

However, their compressed time frames often necessitate an accelerated public market readiness process

Since SPACs only have typically 18 to 24 months in order to identify a target and execute an acquisition (though this can sometimes be extended a few months to allow deals in process to close), one of the common criticisms against their use is that they can push managers into rushed deals. Complicating matters is the fact that SPAC targets are often not currently reporting entities.

More on the way?

Particularly in light of recent market volatility, it's reasonable to wonder whether SPAC formation will continue its upward trajectory, or whether future market disruptions, regulatory developments or investor disfavor might once again curtail their attractiveness.

There are a number of tailwinds that suggest that SPACs might become more prevalent in the coming years – both the increasing sophistication of public market investors and the strong demand for PE-style investments to represent powerful secular trends. Indeed, some SPACs have seen such strong demand that they're moving away from the traditional 1:1 ratio for warrant offerings, instead offering investors warrants exercisable for a half-share or third-share. US tax reform, which limits the deductibility of interest payments, could spur increased demand for equity capital, and other regulatory changes, such as the NYSE's recent changes to its listing requirements to make itself more amenable to SPAC offerings, could represent additional enablers of growth.

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