

INSIGHT: Private Equity and SPACs — A Mutually Beneficial Relationship

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Special purpose acquisition companies (SPACs) are gaining in popularity with private equity firms as an investment vehicle. Sidley Austin LLP attorneys explain what they are, who is using them, and say they entail a relatively low upfront investment, but offer a very significant upside potential and shorter investment horizon.

In recent years, private equity firms have looked increasingly to special purpose acquisition companies (SPACs) as an alternative investment opportunity. A SPAC is a unique investment vehicle that allows a

company to raise capital through an initial public offering (IPO) prior to establishing any operations and to use the capital to acquire a business.

They are also an attractive alternative to an exit through an IPO because they provide the buyer and sellers greater control over valuation, allow the sellers to receive more cash at closing, and are a viable route to the public markets even during periods of market volatility.

Private equity firms first stepped onto the SPAC scene as sellers, seeking to exit portfolio investments by taking companies public through sales to SPACs.

Private equity firms that have sold portfolio companies to SPACs include Cerberus Capital Management, Apollo Global Management, Platinum Equity, the Blackstone Group, J.F. Lehman & Company, Clearlake Capital Group, Roark Capital Group, L Catterton, Irving Place Capital, Corsair Capital, Peninsula Pacific Strategic Partners and Energy Capital Partners, among others.

Taking on the Role of SPAC Sponsors

Recognizing the potential in SPACs, private equity firms and professionals have been assuming the role of SPAC sponsors in recent years.

Two private equity firms, the Gores Group and TPG, have collectively sponsored nine SPACs since 2015, with IPO proceeds ranging from \$375 million to \$650 million.

Riverstone Holdings, an energy-focused firm, completed a \$500 million SPAC IPO in 2016 and a \$1.035 billion SPAC IPO in 2017. Centerview Capital sponsored its first SPAC IPO in 2016, generating \$402.5 million in proceeds, and its second in 2019, resulting in proceeds of \$450 million. Thomas H. Lee Partners and Apollo Global Management each sponsored SPAC IPOs raising over \$400 million in proceeds in 2017 and 2018, respectively.

Recently, the Yucaipa Companies sponsored a \$300 million SPAC IPO. In addition, experienced private equity professionals—such as Chinh Chu, the former co-head of private equity of the Blackstone Group; Dan Hennessy, a founding partner of CHS Private Equity; and Mark Ein, a PE and VC investor formerly with the Carlyle Group and Brentwood Associates—have all launched multiple SPACs.

The influx of private equity participants has added a further degree of credibility to SPACs, spurring their growth as an investment platform.



In 2019, SPAC IPOs raised more capital than in any prior year, with \$13.6 billion in gross proceeds. Through July 31, 2020, SPAC IPOs have already raised more than \$22.9 billion. The average SPAC IPO size has also increased with private equity participation, rising from \$54.5 million in 2012 to \$230.5 million in 2019. It stands at more than \$400 million year to date in 2020.

Why SPACs Are Appealing

Private equity firms are being drawn to SPACs in large part because of the attractive economics inherent in the SPAC model. In particular, SPACs require a relatively low upfront investment with a very significant upside potential and shorter investment horizon.

Sponsors will typically contribute an amount equal to 2.5% to 3% of the gross IPO proceeds in exchange for 20% of the outstanding shares (i.e., equity value) of the post-IPO company and warrants to purchase additional shares at a 15% premium to the \$10 IPO price.

The sponsor's shares (often referred to as "founder shares") are generally subject to a lock-up agreement for one year following the business combination. The lock-up typically falls away earlier if the share price increases 20% for 20 out of 30 trading days commencing 150 days after the business combination.

Importantly, even if the stock price of the company declines post-business combination and the warrants have no value, the value of the sponsor's 20% ownership will in almost all cases substantially exceed the sponsor's initial contribution.

In contrast, a private equity fund sponsor typically will only realize a gain if the value of its portfolio companies increase in excess of the annual hurdle rate (usually 7% to 8%) owed to its investors. Of course, if the SPAC does not complete a business combination, the sponsor will lose its investment.

SPACs are also capable of earning returns more quickly than a standard private equity fund given that the shares of the SPAC are publicly traded. Because SPACs are without operations at the time of IPO, registration statements can be prepared on a shorter timeline and with fewer SEC comments than a traditional IPO process.

Following the IPO, SPACs are given a shot clock of sorts (usually 18 to 24 months) to either complete a business combination or liquidate. Whereas the typical hold period for a PE portfolio company is five to six years and the life of a fund is often 10 years or more, a SPAC sponsor may generate a sizeable return in as little as two to three years following the SPAC IPO.

Playing to the Strengths of Private Equity

The SPAC IPO is a relatively straight forward proposition. But the complexity of the post-IPO business combination—which is part M&A, part capital markets/IPO and often involves complex financing arrangements, including PIPEs and equity backstops to ensure the closing of a transaction—plays to the strengths and experience of private equity firms, particularly those that regularly look to an IPO to exit a portfolio company investment.

Private equity firms are built to identify, source, conduct due diligence and acquire businesses in complex transactions. They are comprised of dealmakers with the deal experience, industry knowledge and well-developed networks of relationships to source attractive investment opportunities and execute on the business combination transaction.

Private equity firms employ vetted processes for due diligence and identifying avenues for growth. This is critical in the SPAC context as target companies must be public company ready, while also presenting an opportunity for transformation and value creation.

Private equity teams are also able to utilize their extensive networks of financing sources, management teams, industry experts and advisors.

Finally, private equity's hands-on approach to driving portfolio company growth is of critical importance to ensuring the implementation of the growth narrative of the newly public SPAC target post-business combination.

SPAC sponsors frequently place representatives in board and management positions to direct operations and implement strategic initiatives. This is second nature for private equity firms, but may present challenges to other potential SPAC sponsors (e.g., hedge funds) that typically take a more hands-off approach to their investments.

Looking Ahead

As private equity firms continue to deploy SPACs as an investment vehicle, they will seek to innovate and more fully capitalize on their favorable economics.

The future of SPACs likely involves private equity firms applying the portfolio company model to SPACs and leveraging their financial resources, networks, deal making experience, and industry expertise to sponsor multiple SPACs at the same time, continuing the rapid growth of SPACs as a preferred investment vehicle.

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