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SPACs Show Impressive Growth In The Investment Community And IPO Markets

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Characterized by investment safeguards and strategic management teams, special purpose acquisition companies (SPACs) are generating much buzz as the new darlings of the investment community.

A SPAC is a business entity formed to complete an initial public offering (IPO) with the specific purpose of using the IPO proceeds to acquire other businesses. Frequently, individual SPACs focus on finding target companies within a pre-determined business sector such as oil and gas, mining, shipping or media. SPAC securities often are sold in units consisting of common stock and warrants. SPACs are structured to enhance disclosure and provide liquidity, thereby boosting overall investor confidence. They represent an attractive alternative to earlier blind investment pools that became known for penny stock manipulations, pump-and-dump schemes and unchecked conflict-of-interest situations. There are currently more than 50 SPACs publicly traded and dozens more are in registration.

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Structured To Protect Investors

SPACs are particularly appealing because they are structured to protect investors. The certificate of incorporation for each SPAC is replete with investor protection provisions that typically cannot be amended prior to the SPAC's completion of a business combination, whether in the form of a merger, stock purchase, asset purchase or other structure. A substantial portion of the SPAC's IPO proceeds, often greater than 90 percent, are deposited into a trust account that is invested in high-grade government securities. These securities may be released only upon consummation of the SPAC's first business combination transaction or in connection with the SPAC's liquidation. Another protection is the requirement that the SPAC complete an acquisition within a specified time period – typically 18 to 24 months – or be liquidated, with its trust funds, plus any remaining working capital, returned to the public stockholders.

Typically, the certificate of incorporation will also have other important investor safeguards. For example, the certificate of incorporation will require that the SPAC's first acquisition target have a fair market value equal to at least 80 percent of the SPAC's net assets. Regardless of state law requirements, the initial business combination transaction

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is subject to a SPAC stockholder vote. A public stockholder who purchased shares in the IPO who votes against the transaction has "conversion rights" and may elect to tender SPAC stock in exchange for a pro rata share of the trust account. If 20 percent or more of the public stockholders exercise their conversion rights, the initial business combination transaction cannot be consummated. Since a significant portion of a SPAC's available funds would likely have been expended on the aborted or failed transaction, as a practical matter, a liquidation of the SPAC and its trust fund will ensue.

Balancing Management Obligations, Incentives And Restrictions

The management team is the critical component of any SPAC because there are no operational components until another entity is acquired. Consequently, the classic SPAC structure provides a balance that seeks to provide incentives for management performance while imposing obligations and restrictions that serve to better align management's interests with those of investors. Some examples of this delicate balance appear to be derived from private equity fund practices including:

- The SPAC management team typically purchases 20 percent of the outstanding common stock for nominal consideration, a percentage comparable to the 20 percent carried interest often granted to general partners of private equity funds. The typical SPAC pays no management fees while the industry norm for private equity funds is a management fee of 1.5-2 percent.
- The SPAC management team oftentimes will purchase shares at the time of the offering, similar to the way in which private equity managers commit to purchase a meaningful percentage of the limited partnership interest in their funds.
- Management's SPAC equity interest will be subject to a two to three-year lock-up, contrasted to the conversion rights and public market liquidity afforded to the SPAC's public stockholders, as described below.
- Management provides price supports to the warrants after the IPO. For example, management may agree to repurchase approximately 10 percent of the outstanding warrants after the IPO if the stock price is below a specified threshold.
- If an acquisition target cannot be found or an acquisition transaction is not otherwise timely consummated, management will not participate in the liquidation of the trust account, thereby rendering their shares worthless.
- Management cannot earn finder's fees, consulting fees or other compensation from the SPAC prior to, or in connection with, its initial business combination transaction. Private equity funds vary as to what extent their managers may collect these kinds of fees.

Advantages And Disadvantages Of SPAC Investments

Clearly the most important advantage with respect to a SPAC investment is the guaranteed downside protection that a private equity fund or a traditional IPO could never offer. In the worst-case scenario, if no initial business combination is found or completed, a SPAC investor will recoup at least 85 percent of its investment from the trust funds within 18-24 months. As publicly traded companies, SPACS also are available to small investors who typically do not have the requisite resources to invest in private equity funds.

SPAC investments are made in the form of securities and are more liquid than private equity investments. For example, once the initial business combination is completed, any individual investor who has a change of heart with respect to the SPAC's acquisition can sell its SPAC shares, while a private equity investor must wait for the fund to exit from an undesirable investment. It should be noted, however, that initial SPAC trading is likely to be thin, making their securities relatively illiquid and undervalued.

SPACs can immediately use public stock as an acquisition currency for future growth or as an incentive to retain qualified management. If a private equity fund wanted to use public stock as an acquisition currency, it must first go through the time-consuming and expensive process of taking one of its portfolio companies public using the traditional IPO route.

Despite the SPAC structure's many advantages, there also are disadvantages. While management typically consists of industry gurus or successful executives who have built and run companies, they often are unproven in their ability to locate valuable targets and successfully complete acquisitions. These talented managers often are involved in other projects that may distract them from focusing on the best interests of the SPAC. Managers of hedge funds and similar investment vehicles evaluate the business acumen of SPAC management prior to making investment decisions.

The SPAC's status as a public company also can be a disadvantage. It means mandatory compliance with all Securities and Exchange Commission regulations, including required filings, corporate governance processes, investor relations obligations and ongoing regulations that include the Sarbanes-Oxley Act, proxy solicitation rules and Section 16 reporting requirements. In the case of management without prior public company experience, these obligations may divert attention from successful business operations and prove to be intrusive, as they now must disclose their salaries, corporate perks and retirement packages. All SPAC acquisitions become public companies and also must comply with these SEC requirements.

Future Considerations

SPACs currently represent one of the most active areas in the IPO market. In the first quarter alone, ten SPACS completed IPOs, representing 22 percent of all IPOs completed during that period. The first quarter also saw five SPACs announce mergers with private companies – a 25 percent increase from the previous quarter. This trend suggests sustained growth and continued investor interest in SPACs as a way of bringing private companies valued between $50 million and $500 million into the public market.

Current SPAC investor protection exists through self-imposed industry standards. While these standards are based upon SEC rules that were intended to combat abuses of the past, it is likely to assume that limits will be pushed and investor protection may erode over time. Consequently, we can expect the SEC and other regulatory agencies to more closely scrutinize SPACs in the future – especially if abuses begin to emerge.