The Resurgence of SPACs in a Quiet IPO Market

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More than 20 years old, special purpose acquisition companies (SPACs) — publicly listed companies established with the goal of acquiring unspecified targets — have recently experienced a surge in popularity. Ten SPACs for U.S.-based companies raised $1.44 billion in 2013, 12 SPACs raised $1.64 billion in 2014 and 25 SPACs raised $5.12 billion in 2015, according to Thomson Reuters data. Between January and early March 2016, four SPAC initial public offerings raised a combined $920.85 million. To date, the largest IPO of 2016 is Silver Run Acquisition Corp. at $500 million.

The rise in popularity comes at a slow time for the IPO market and is in part due to the fact that well-known private equity firms increasingly are serving as SPAC sponsors as a means to expand their potential sources of equity capital outside of the traditional private equity model. The presence of respected private equity sponsors, with their significant expertise, makes SPACs more attractive to would-be targets and potential investors.

How SPACs Work

Modern SPACs began in the early 1990s and have experienced periods of popularity. In the 2000s, SPACs acquired household names such as Jamba Juice, American Apparel and Talbots.

SPACs tend to be sponsored and formed by an experienced management team, with the goal of raising capital from public investors to leverage the management's expertise and connections in identifying a target and completing an acquisition. Each SPAC has different investment criteria and a different investment focus, ranging from specific industries such as energy and financial services to more generic mandates such as seeking "value-oriented investment opportunities."

The connection between SPACs and private equity is a natural one, with SPACs providing a means of pooling downside-protected public capital to be deployed by private equity sponsors in evaluating, acquiring and reinventing companies — potentially offering attractive rewards when done successfully.

Benefits of SPAC IPOs

A SPAC provides upside opportunity to public investors in its IPO by offering "units" of common stock and warrants. Separately, the sponsors invest in common stock (typically equal to 20 percent of the outstanding shares, called the "promote") and warrants to purchase common stock, and provide management services leading up to the acquisition at no cost. All proceeds from the SPAC's IPO are placed in a trust account that can only be used in connection with an acquisition. The SPAC's IPO expenses and day-to-day operations (approximately 3 to 5 percent of the offering size), which consist of identifying and negotiating with acquisition targets, tend to be funded by the sponsor's initial purchase of common stock and warrants as well as by periodic loans from the sponsor, which may never be repaid if the acquisition is not completed. While sponsors absorb all of the downside risk for failure to complete an acquisition, the potential upside of the promote and warrants upon successful completion of the acquisition is a very attractive proposition for many potential sponsors.

Enhancing the allure of SPACs for potential investors is a combination of statutory and contractual protections. For example, SPACs typically have a life span of 18 to 24 months in which to complete an acquisition or liquidate, so public investors' money is not tied up indefinitely. Prior to the consummation of the initial acquisition, shareholders in SPACs also have the option to redeem their securities for a pro rata share of the money held in the trust account, whether or not they support the acquisition or the SPAC liquidates. Additionally, SPACs tend to obtain an independent fairness opinion if the SPAC seeks to complete an acquisition with a target that is affiliated with its sponsor. And while a SPAC is unable to offer certain deal protection features of traditional acquirers (such as break-up fees), it does have certain attributes which may be attractive to targets. For instance, the fact that it is a public company with no prior operating history makes it an ideal vehicle for a target's existing ownership and its management's continued involvement post-transaction, from a liquidity and incentive perspective.

Deal Uncertainty

SPACs are accompanied by additional levels of deal uncertainty absent in typical private equity transactions. Given the relatively short life span of the SPAC, as well as the fact that a SPAC acquisition is effectively the IPO of the target (which may not have been able to conduct an IPO otherwise), both the SPAC and target should seriously consider whether they can get to closing before the SPAC expires. The typical roadblock to a quick closing is the need for SEC-ready audited financial statements for the target company. In addition, analyzing the financial statement requirements for a SPAC's merger proxy or prospectus is not straightforward, as the SEC does not provide the same accommodations for SPACs as it does for operating companies that can take advantage of the JOBS Act.

Moreover, since SPACs permit investors to vote for the acquisition and redeem their common stock (while enjoying the potential upside of their unredeemed warrants), the number of redemptions can be very high. As a result, SPACs have realized that in order to compete for targets, they need additional capital available to "backstop" any acquisition. This backstop capital may come in the form of some combination of sponsor contributions, third-party private placements, bank debt and additional rollover by target equityholders.

We expect that SPACs will continue to be a significant portion of the initial public offerings in 2016, especially if some of the larger SPACs that went public in 2015 complete their initial business combinations. This is expected to free up capital for the typical hedge fund SPAC investors for more SPAC investments. Additionally, in an environment of low interest rates and limited safe investment opportunities, we expect the popularity of SPACs to remain strong.