SPACs in 2021 – the new model for private equity?

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As 2021 reaches its halfway point, we continue to find ourselves in the midst of a special purpose acquisition company (**SPAC**) frenzy.

Already by May this year, there were more than 300 listed SPACs generating gross proceeds of more than US$100 billion. To put this into perspective, that figure has already surpassed the total proceeds from SPACs in 2020 (in excess of 200 were listed, generating gross proceeds in the region of US$80 billion).

As SPACs enjoy another record year, a number of venture capital (**VC**) and private equity (**PE**) firms have shown increasing interest in incorporating SPACs into their investment and structuring toolkits. In many respects, the aims of SPACs and customary VC / PE strategies are very similar and firms are now seeing that SPACs themselves might offer multiple advantages over the traditional acquisition and investment holding structures utilised by PE.

This year has seen a number of PE backed SPAC launches, as well as announcements of proposed PE SPACs, which in total could amount to several billion dollars in IPO proceeds. If these SPACs prove successful, then the SPAC could become a major part of how PE does business over the next decade.

Unique opportunities

SPACS offer unique opportunities all round. For investors (particular those seeking hedging options), the redemption return on pre-acquisition SPAC shares offers a relatively attractive yield with minimal risk (given the security of the trust account and redemption rights). As pre-acquisition SPAC shares typically trade at a discount and carry the right to the accrued interest in the trust account, their pre-acquisition redemption yield is comparable to US Treasuries. SPAC units also carry features that give them clear advantages over Treasuries and similar hedges.

As SPAC units will eventually separate into their component securities, this means that an investor may redeem his shares to receive back his investment prior to an acquisition, but still keep his warrants or rights alive – this means, in effect, that units grant a free option to participate in the post-acquisition business, allowing investors both safety and a chance at the upside of any deal.

What has made SPACs particularly popular, however, is the opportunity they offer for those on the other side of the SPAC equation – potential targets. While the SPAC might be the purchasing entity, being acquired by a SPAC is actually a form of reverse takeover. Shareholders and management in the target will usually receive shares in the SPAC as part of the purchaser consideration (and in some cases become the majority shareholder group) and a number of members of the target's board will likely join the board of the listed entity. The target will therefore, in effect, reverse into the SPAC's listed status. Being acquired by a SPAC is therefore a real alternative to a traditional IPO for companies seeking to go public – and a number of those companies have actively courted SPACs as a potential conduit to market.

Traditional IPOs are still, of course, how many companies choose to go public, but that route is an increasingly expensive and time consuming process. Furthermore, in recent years, some of the pricing and valuation methods employed by bankers and underwriters in traditional IPOs have received adverse scrutiny. Taking a private company public via the SPAC route on the other hand can be managed on a faster timeline, for less cost and with more certainty around a company's valuation and equity capital raised.

The perfect storm

The record levels of SPAC activity witnessed today is partly the result of a "perfect storm" for SPACs in the US. Notwithstanding significant fluctuations during the first half of 2020, the US capital markets remained buoyant and many private business were still drawn to the opportunities a listing may bring. However, taking on the cost and time burdens of a traditional IPO and the inherent pricing / valuation risk noted above in the midst of a pandemic and an election year was less appealing. The alternative SPAC route to listing, by contrast, looked much more attractive.

The 2020 effect also comes after two strong years for SPACs in "ordinary times". 2018 and 2019 saw an increasing number of big name investors being associated with SPACs and a number of significant, high profile acquisitions by SPACs, including that of Virgin Galactic, electric vehicle maker Nikola Corp and Luminar (acquired by a Gores Group SPAC at a value of around US$3 billion).

The increased level of interest in SPACs as an alternative IPO route has, in turn, increased overall interest in SPACs, helped cement their improved reputation, and has led to the current IPO boom we now see.

SPACs and private equity

While some believe that the current popularity of the SPAC is fleeting, and based chiefly on current uncertainties and a yet still buoyant exchange, its foundations seem more robust and go back, at least in the case of this present incarnation of the SPAC, to the beginning of the last decade.

SPACs first boomed in the 1980s but became mired in some of the financial scandals of the last years of the decade. A better regulated SPAC market grew and blossomed in the first decade of the 21st century (with SPACs accounting for almost 25% of all US IPOs in 2007) but this fell victim to the "Credit Crunch" and Great Recession of 2008. The current resurgence in SPAC activity started in 2012 and has seen steady year on year growth since then. That steady growth is based primarily on the real tangible advantages of SPACs over more traditional investment structures and methodologies.

SPACs can certainly provide general investors access to investments in acquisitions, buy-outs and other types of investment transaction which might otherwise be restricted to PE or VC funds. But those same funds themselves are now looking to use SPACs in their own strategies. While the philosophy and goals behind a SPAC and typical PE or VC acquisition and management structure are not dissimilar, SPACs arguably have a number of key advantages over some of the traditional structures used by PE and VC firms for investment. For example SPACs offer:

1. Limited risk and certainty of return during their pre-acquisition phase - investors have the security and certainty of the return liquidation from the funds held in the trust account if the SPAC fails to complete an acquisition or the investor does not want to participate in one.
2. Greater liquidity: SPAC investors benefit from the liquidity of publicly-traded securities and the ability to control the timing of an exit.

3. High incentivisation: pending an acquisition there is typically no cash compensation paid to the SPAC's management team.
4. Additional leverage: including additional securities, such as warrants, in SPAC issued units gives investors the ability to leverage their initial investment by enabling them to invest more capital at pre-determined price (premium to the IPO price), even if the investor elects to receive back its capital in a pre-business combination redemption or tender offer.

These advantages have led to a number of PE firms now incorporating SPACs in their toolkits. In September 2020, for example, Apollo Global Management (a major PE player with over US$400 billion assets under management) registered a new SPAC which plans to raise US$750 million. Apollo's move followed a summer of SPAC related activity by established PE firms, including: RedBird Capital's launch of a SPAC in August that aimed to acquire a professional sports team; Solamere Capital's announcement that it planned to raise up to US$300 million for a new SPAC; and reports in late August 2020 that TPG Capital was planning a pair of SPACs focusing on tech and social impact deals.

SPACs and offshore

While most US listed SPACs are incorporated using Delaware corporations, for non-US sponsors (founders) seeking targets outside the US, a SPAC incorporated outside the US might be an appropriate alternative as it may offer a more efficient post acquisition structure and remove any additional US tax, legal or regulatory implications that may arise simply as a consequence of using a US vehicle.

The SEC, NASDAQ and other relevant US exchanges allow for rules concessions for non-US issuers which qualify as "Foreign Private Issuers", and for foreign entities to follow more flexible "home country rules" – thus allowing overseas concerns to access the US markets and be listed there, without being subject to the full panoply of US legal and regulatory strictures.

NASDAQ and other leading US exchanges (and those in the UK) allow listings by SPAC entities formed in most of the leading offshore jurisdictions, including the British Virgin Islands and Cayman Islands.

BVI and Cayman are favourite jurisdictions based on several factors, including the particular suitability of their company law to SPACs; limited additional regulatory compliance requirements; tax neutrality; and the close similarity between aspects of BVI/Cayman and Delaware company law – which allows for an easy translation of existing standard legal forms and investor understandings from one jurisdiction to the other.

Notable BVI and Cayman SPAC IPOs of the past year include Kismet Acquistion One Corp (US$ 250 million), Eucrates Biomedical Acquisition Corp. (US$ 100 million), ARYA Sciences acquisition vehicles III and IV (worth US$143 million and US$130 million, respectively), ITHAX Acquisition Corp (US$240m) and Aries I Acquisition Corporation (US$143m).

BVI SPACs, in particular, have pioneered novel SPAC features such as "rights", "fractional warrants" and the ability to extend SPAC life spans. The first India focused SPAC in recent years was a BVI company, as was the SPAC that resulted in the first ever NASDAQ listed Chinese finance business in 2016. And in 2018, a BVI SPAC, National Energy Services Reunited Corp, completed a unique simultaneous double business combination when it acquired two Middle Eastern oil businesses with a combined value over US$1.1 billion.

Going forward

SPACs have been enjoying steady growth for some time and the conditions that have fuelled the current boom look likely to exist for the foreseeable future. Given the advantages SPACs can offer, private equity firms will likely continue to play a starring role in the SPAC market and help to sustain SPAC growth going forward.

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