Let's work together

Sale to a Spac has tended to be considered a last resort exit route for a private equity fund. Graham Defries and David Willbe of Dechert explain why the time has come to reconsider

Special purpose acquisition corporations (Spacs) are an established feature of the corporate landscape on both sides of the Atlantic. The investor protections key to the structure of Spacs makes them more attractive to investors weathering financial turbulence: Spac IPO activity tends to increase as standard IPO activity declines. This year the volume of Spac listings has increased in both the US and Europe.

The response to Spacs from private equity professionals has been either concern that they might compete for potential investments or to embrace the concept and launch a Spac, as Mark Ein, Nicolas Berggruen and Tom Hicks (among others) have done. With around $12 billion raised by Spacs last year, however, the time may have come for private equity houses to consider whether or not they could have other uses as potential exit routes or co-investment partners.

The anatomy of a Spac

A Spac is a corporate vehicle with a sponsor/management team and various investor protection mechanisms. It raises capital through a listing, typically by an institutional placing of units comprising one share and one warrant. A proportion of the funds raised is placed into a trust, and will remain unavailable to the Spac until it has identified a target acquisition and shareholders have voted in favour of the deal. From 86% on average in 2004, the emerging market standard is that 100% of the funds raised are placed in trust – the Spac's working capital and up-front fees being provided by the sponsor's risk capital of around 3% of the deal size and a proportion of the interest generated on the trust monies.

A 20% promote (on an pre-warrant dilution basis) is typically taken by the sponsor, on terms that it remains worthless (because the shares are escrowed and not entitled to a share of the trust monies) until a deal has been completed. The sponsor's return, both on its promote and its risk capital, is therefore inherently bound up with the completion of an acquisition. A Spac has a defined period of time during which to identify and complete an acquisition, which is usually 18 months to two years, after which the capital in the trust is returned to investors.

Although not a requirement of the Spac structure, the market standard is that the acquisition will be at least three and ideally four to five times the size of the trust fund in order to minimise the dilutive effect of the sponsors' promote and so drive the investors' returns. Following the acquisition, all of the Spac-specific structuring falls away so that the Spac becomes an ordinary listed company.

A willing buyer?

For a private equity fund seeking an exit from an investment, a sale to a Spac may be an attractive prospect. The sponsors are incentivised to find a good deal to present to their shareholders as quickly as possible, as the value of their promote depends upon completing an acquisition during the allotted time. The window of opportunity is further limited for US Spacs, which are subject to far greater regulation in this area than their European counterparts, with a four or more month time period required to prepare and circulate the necessary materials and hold the shareholder vote.

In order to fund the acquisition, Spacs use a mixture of cash from the trust fund, debt finance and a limited amount of newly-issued equity in the Spac. As the availability of affordable debt has fallen, so the proportion of equity used to complete acquisitions has risen. Even in high value deals, significant proportions of the purchase price have been funded through equity. In November 2007 Freedom Acquisition Holdings Inc closed the $3.4 billion acquisition of GLG Partners using $1 billion of cash (funded from its approximately $512 million IPO and a $570 million debt facility), with the $2.4 billion balance made up of new equity issued by Freedom.

The Freedom/GLG deal is near the upper end of the Spac range in terms of transaction size (both in terms of the price paid and price as a multiple of the trust monies) and therefore the number of new shares issued is far larger than normal, but in the current climate it is usual that some proportion of the consideration in any sale to a Spac will be paid in new equity. This is a principal reason why Spacs can continue to do deals in a market with limited access to affordable debt. In a more typical transaction, an acquisition four times the size of the Spac's trust fund might be funded by equity worth one and a half to two times the value of the trust monies. With share-based consideration issued at a suitable discount to the trading price of the Spac's shares to counteract dilution from the man-

"With around $12 billion raised by Spacs last year, the time may have come for private equity houses to consider whether or not they could have other uses as potential exit routes or co-investment partners"

agement promote, the seller might expect to end up with a stake of around 45%-55% of the Spac following the dilution effect of conversion of the Spac's outstanding warrants.

In a market where exiting investments via an IPO can be less attractive in terms of valuation and deal certainty, a sale to a Spac offers an alternative that achieves the desired result and provides much greater certainty as to valuation. The Spac's shareholders must vote to approve the deal, but there is a vested interest for the sponsors in persuading shareholders to approve the deal, and around 80% of Spac deals that have gone to a vote have been approved.

An investment partner?

Around 57% of Spacs are confined to looking for targets in specified industry sectors, and these Spacs are generally sold to investors on the basis of the experience and expertise of their management team to source and run a target company. A private equity fund seeking further exposure in a sector may find it an attractive prospect to co-invest alongside such a Spac, backing the Spac's sponsors on the strength of their track record to deliver value following the acquisition. Co-investment capital provided by a fund to assist in financing an acquisition will be attractive to the Spac's sponsors, who will wish to complete an attractive acquisition with as little new equity issuance (which will dilute their promote) as possible.

An interested investor could also procure more favourable terms for co-investment by assisting the Spac's sponsors in overcoming two aspects of the popular structure that have shown themselves to be potential issues for the Spac and its sponsors. Although it is unlikely that the provision of such capital would provide a substantial enough return for any private equity fund in and of itself, that provision could be offered as part of a deal that also contained favourable terms for a fund's co-investment in the Spac's target and/or a substantial stake in the Spac.

As the value of the sponsors' promote is inextricably linked to a deal being accepted by the Spac's shareholders, it is not uncommon for the sponsors to be 'greenmailed' by shareholders with large stakes threatening to vote against the deal unless a financial incentive is provided. An investor with the available capital to do so might make an offer to buy shares from presumed "no" voters and vote them in favour of the deal in order to circumvent this potential problem. Likewise, an investor might agree to the provision of capital to fund a warrant repurchase programme, which would alleviate the dilution of the sponsors' promote and the investor's stake.

The next step

Historically, some have suggested that a sale to a Spac would be the exit route of last resort for a private equity fund. With access to financing for traditional investment routes and exits via secondary buyouts more limited now, and with the IPO market often uncertain and offering weaker valuations, non-traditional routes may be worth exploring.

Spacs have called capital, a public listing to provide an attractive exit route from any investment, limited time in which to complete a suitable acquisition and sponsors who are heavily incentivised to complete an acquisition in time. With the Spac market trending towards bigger deals and higher quality in management teams and their advisers, the time to re-evaluate the Spac's usefulness may have arrived.