Schulte Roth & Zabel

SPAC INSIGHTS

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November 2020

IPOs Surge While Market Tightens, But Opportunities Remain

Special purpose acquisition companies ("SPACs") grabbed the investment spotlight this year and remain among the most active investment classes in the market. While the SPAC model has evolved over the better part of the past two decades, SPACs have recently enjoyed an unprecedented surge in popularity as a result of a number of high-profile SPAC launches and subsequent business combinations. In this year alone, as of Oct. 9, 2020, there have been 138 SPAC initial public offerings ("IPOs") yielding $53.6 billion in gross proceeds — a record haul for new SPAC launches.[1] To put these numbers in proper perspective, from 2004 to 2018, approximately $49.1 billion was raised across 332 SPAC IPOs in the United States.[2]

Overview

Both the aggregate IPO proceeds raised, as well as the average SPAC IPO size, have jumped considerably in 2020. Not surprisingly, that type of success breeds imitation, and interest in prospective new SPAC IPOs remains relatively high. However, based on feedback we have received, demand for new SPAC IPOs appears to have tightened in recent weeks, potentially as a result of the large amount of IPO proceeds already raised in 2020. Accordingly, prospective sponsors may face increasing pressure to differentiate their proposed SPACs from other recent or proposed offerings. In contrast, we expect that potential SPAC investors may see increasingly attractive investment opportunities as the SPAC IPO market further tightens and sponsors become more flexible on terms. To that end, we have already seen movement towards incentivizing larger IPO investors through various economic incentives, including through access to sponsor-level economics.

In addition, we anticipate a significant uptick in proposed business combinations over the next six to 12 months, as the large number of recently launched SPACs look to complete acquisitions relatively quickly following their respective IPOs. As most SPACs seek additional third-party equity capital in the form of a PIPE transaction concurrent with consummation of a business combination, we expect to see a corresponding increase in PIPE investment opportunities as the number of business combinations increase. As a result, potential PIPE investors may see more attractive terms in the coming months as demand for PIPE-related equity financing increases within the SPAC space. We also continue to see new SPAC launches utilizing pre-wired PIPE commitment structures in the form of forward purchase agreements, both from third-party investors as well as the sponsor and its affiliates, as a means of pre-negotiating the terms of an eventual back-end PIPE in connection with a subsequent business combination.

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[1] *See* "SPAC News" here.

[2] See *SPACInsider* here.

Refresher on the SPAC Model

Structurally, SPACs are formed as blank check companies that raise equity capital through an IPO in order to complete a subsequent business combination with one or more target businesses within a set time period — typically, 24 months. All of the IPO proceeds are placed in an escrow account until completion of a qualifying business combination — generally having a value equal to at least 80% of the total amount of funds held in that escrow account. Shareholders may generally redeem their SPAC shares for their respective portion of the funds held in the escrow account at the time of a business combination, which provides an effective floor on the value of those shares. Finally, all of the escrowed funds are returned to shareholders in the event a SPAC fails to complete a business combination within the required time period.

From a SPAC sponsor's perspective, its economics tend to be tied to founder shares, which a sponsor receives at the formation of the SPAC for a de minimis initial investment, and private placement warrants, which the sponsor acquires prior to the SPAC's IPO as a means of funding both its upfront underwriting discounts and the operations of the SPAC over its lifecycle. Notably, the founder shares and private placement warrants become worthless if a SPAC fails to complete a business combination. In addition, because of the nature of the SPAC model, most sponsors place a strong emphasis on preserving available capital within a SPAC's escrow account at the time of a business combination, which in part has led to the prevalence of PIPE transactions in connection with business combinations.

New SPAC Launches Will Likely Need to Stand Out

Given the current logjam of pending SPAC IPOs, coupled with the large amount of capital already raised this year by existing SPACs, prospective SPAC sponsors will likely need to clearly differentiate their proposed SPAC from other recent launches, either by having a specific focus on a targeted industry with significant market appeal, showing an exceptionally strong sponsor group, or finding creative means to incentivize potential IPO investors. Typical "plain vanilla" SPACs will likely face significant delays in getting out to market given the current backlog. To that end, some sponsors may face pressure to contribute a larger amount of capital in connection with a new SPAC launch, in order to provide greater downside protection to IPO investors by increasing the relative percentage of IPO proceeds held in a SPAC's escrow account — potentially in excess of 100% of gross IPO proceeds. While the SPAC IPO market appears to have tightened significantly in recent weeks, the path towards an eventual IPO likely remains open for sponsor groups with the right targeted industry expertise or high-profile background that can set them apart from other prospective sponsors.

Look for Third-Party Investors to Get More Access to Sponsor-Level Economics

While third-party investors have historically participated in SPAC IPOs, increasingly larger investors have had the opportunity to also participate in SPAC sponsor vehicles — typically limited liability companies formed to hold a sponsor's founder shares and private placement warrants. Previously, such sponsor vehicle investments were tied to an investor funding a portion of the private placement warrants acquired by a SPAC's sponsor, in exchange for which it would also receive an allocation of founder shares. We continue to advise clients on such negotiated arrangements, and expect their use to continue to expand, particularly if sponsors of new prospective SPACs are required to invest an even higher amount of capital in order to attract IPO investors.

We have also seen an increase in sponsors providing access to founder shares to third-party investors that commit for a large percentage of a proposed IPO. This has taken the form both of direct investments in sponsor vehicles, along with contingent allocations of founder shares, subject to

completion of a successful business combination. As the SPAC IPO market becomes more constrained, SPAC sponsors may become even more willing to part with a portion of their overall economics in order to close a successful IPO. As a result, based on our recent experience, larger SPAC investors may see a greater number of opportunities to gain access to sponsor-level economics in exchange for larger IPO allocations.

Similarly, we continue to advise clients in connection with the negotiation of forward purchase agreements with prospective SPAC sponsors. Given that it remains an important selling point for new SPAC IPOs, we expect to see third-party investors that are willing to commit to such forward purchase agreements to continue to receive access to sponsor-level economics, either through the allocation of founder shares, private placement warrants or both by a SPAC's sponsor. Notably, while forward purchase agreements with sponsor affiliates generally contain no opt-out provisions, those entered into with third-party investors still often provide a "first look" at any prospective business combination, along with a "veto" right that permits the investor to decline to fund its equity purchase under the agreement. As a result, while a third-party investor may lose its allocation of founder warrants as a result, it still retains the ability to decline to fund a forward purchase commitment. The terms of such forward purchase agreements and related sponsor equity allocations may become even more favorable to third-party investors as prospective new SPACs seek further ways to differentiate themselves from others in the market.

We See PIPE Investment Opportunities Continuing to Expand

Based on the level of activity we have seen recently, PIPEs remain a key component of nearly all successful SPAC business combinations. Given the larger number of business combinations we will likely see in the next six to 12 months as a result of the recent surge in SPAC IPOs, demand for similar PIPE financing arrangements will likely remain high. In addition, the terms of such PIPE structures may become more favorable as the number and relative deal sizes of such business combinations increase in the near term. For SPACs that have entered into forward purchase agreements with sponsor affiliates, though, the terms of such forward purchase agreements may limit the opportunities for third-party-sponsored PIPEs unless the commitment amount under such agreements falls below what may be required for a particular business combination.

Similarly, we have seen a number of clients enter into pre-IPO forward purchase agreements with new SPACs as third-party investors. The terms of such forward purchase agreements in some cases are not as attractive as they would be for a PIPE negotiated at the time of a subsequent business combination. The prospective SPAC's sponsor, however, will typically allocate a portion of its founder shares or private placement warrants to the third-party investor in connection with the execution of the forward purchase agreement, giving the investor access to sponsor-level economics as a result. Most third-party forward purchase agreements still contain a "veto" provision, allowing the investor to decline funding if they oppose a potential business combination, though the investor will accordingly lose any sponsor equity it may have received previously.

Look for Private Equity Sponsors to Take Advantage of the Recent SPAC IPO Boom

While the IPO route remains open for larger proven private companies, we continue to see interest from private equity participants in using the SPAC business combination process to divest, either in whole or in part, from existing portfolio companies. Particularly on the private equity side, certain portfolio companies may be ripe for transition to a public listing, but lack the necessary size or market heft to survive the traditional IPO process. In such cases, going "public" through a business combination with an

existing SPAC has increasingly been viewed as a viable alternative. We expect that to likely continue, if not accelerate, given the larger number of recent SPAC IPOs.

Notably, the market has already seen a number of SPACs negotiate to acquire one or more portfolio companies from a private equity sponsor. In cases where SPACs face looming business combination deadlines, we have seen private equity sponsors often have greater leverage to try to negotiate more favorable deal terms than would otherwise normally be available through a more traditional sale process. Given the large amount of SPAC capital now actively seeking potential business combinations, we anticipate that private equity sponsors will increasingly look at existing SPACs as a potential liquidity path for existing portfolio companies. That trend may further accelerate, to the extent potential SPAC acquirers prove willing to offer potentially more attractive deal terms than would other prospective private market acquirers.

Conclusion

Regardless of whether a manager is a prospective SPAC sponsor or merely a passive SPAC or sponsor vehicle investor, the recent SPAC boom and current changing market landscape provide both opportunities and challenges in the near term. In particular, while new SPAC IPOs may face headwinds in the coming months, strong sponsor groups and aggressive structuring will likely still provide a path forward for a smaller number of new SPAC launches. On the third-party investor side, we may see increasingly attractive terms for larger SPAC IPO investors, as prospective SPAC sponsors seek ways to offset market challenges. Similarly, we expect to see increasing demand for PIPE investors from the SPAC space generally, both in the form of traditional PIPE arrangements that close concurrent with a SPAC's business combination, as well as pre-wired PIPE commitments in the form of forward purchase agreements. Finally, we expect private equity sponsors to become larger players in the SPAC business combination space, given the large amount of SPAC capital raised recently, coupled with the increasing comfort level private equity participants have shown with the SPAC model generally.

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As market leaders in the alternative investment and investment management industries, SRZ represents more than 3,000 funds globally and has been at the forefront of SPACs — advising sponsors, asset managers and investors in connection with their SPAC investments, including sponsor vehicle investments, forward purchase contracts and back-end PIPE investments. SRZ is consistently ranked as the most active PIPE investor counsel year after year.[3] Members of our M&A and Securities practice have significant experience advising SPAC sponsors on all aspects of the SPAC lifecycle, from the formation and IPO process through completion of a subsequent business combination, and routinely counsel our private equity clients on possible sale transactions involving SPACs. If you have any questions concerning sponsoring, investing in or structuring a business combination with a SPAC, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[3] *See* "PlacementTracker Publishes Q3 2020 PIPE and Private Placement Markets League Tables," Nov. 4, 2020, available here.

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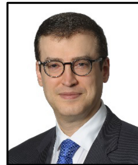

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