

TO SPAC OR NOT TO SPAC – KEY CONSIDERATIONS FOR MID-SIZED PRIVATE EQUITY MANAGERS

ABOUT THE SPAC PROCESS (PART I)

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SPAC initial public offerings (IPOs) were all the rage in 2020, and they have picked up even more steam in 2021—reaching new heights. Private equity sponsors have emerged as key players in the SPAC sponsorship space, and their participation is accelerating.

Special purpose acquisition companies (SPAC) are not a new form of investment vehicle. Also known as “blank check companies,” SPACs have been around for years, and their use by private equity sponsors has increased in recent years. With over 256 SPAC IPOs representing approximately US\$79.2 billion of capital raised, calendar year 2020 was a record-setting year for SPAC issuers. In the first 10 weeks of 2021 alone, an additional 258 SPACs have gone public, shattering prior full-year issuance records and in the process raising US\$76.7 billion, and the trend shows no signs of abating. The participation of private equity sponsors also has accelerated, with a number of well-known private equity managers sponsoring SPACs in the last several months.

However, as the private equity sponsor interest in SPACs has increased, so has the need to address the specific considerations surrounding the formation and use of a SPAC within the construct of a sponsor's existing private equity fund and business. This is especially true for mid-sized and emerging managers (collectively, mid-sized managers), where there is a slimmer organizational structure, fewer key investment decision-makers, and a narrower range of distinct business lines and investment strategies. Mid-sized managers interested in launching a SPAC need to thoughtfully analyze their existing fund arrangements and carefully balance a number of business considerations.

This alert provides an overview of some key considerations for private equity mid-sized managers in assessing whether to launch a SPAC. Please be on the lookout for additional alerts that will address other aspects of launching and operating a SPAC issuer and sponsor.

WHAT IS A SPAC, AND WHY LAUNCH ONE?

A SPAC is a public company launched for the purpose of acquiring an operating company through a business combination transaction. The SPAC may and often does have a specific target sector, industry, or objective, but a SPAC cannot be launched in order to effectuate a pre-negotiated deal with a specific corporate target. A SPAC has a limited time horizon, typically 18 to 24 months, to find a company and complete an acquisition. The SPAC raises funds through a sale of its units in an IPO, and the SPAC sponsor typically retains 20 percent of the post-

IPO SPAC equity. The sponsor will need to provide the at-risk capital for the IPO transaction costs, since 100 percent of the IPO proceeds are placed in escrow until the closing of the business combination.

There are a variety of reasons why a mid-sized private equity sponsor would look to sponsor a SPAC. In launching a SPAC, a sponsor can access an additional source of permanent capital through the public markets, including retail investors. A SPAC can also effectively serve as a co-investment vehicle that is lined up and available well in advance of finding the target company. The use of a SPAC also allows a fund sponsor to invest in a target company that is larger than it would otherwise be able to invest in on its own or without taking on leverage, thereby increasing the pool of potential investing opportunities in this current highly competitive deal market. In addition, the ability to retain 20 percent of the post-IPO SPAC enhances the potential returns achieved in the eventual transaction to the SPAC sponsor and, depending upon how the arrangement is structured, to the private equity sponsor's existing private equity funds and its investors. The SPAC has a significantly shorter time period to a liquidity event for the sponsor, as compared to a typical time frame for a private equity fund. In addition, the SPAC exit or business combination typically involves a single acquisition rather than the multiple investments and dispositions that a private equity fund will make.

FUND-RELATED AND BUSINESS CONSIDERATIONS IN LAUNCHING A SPAC

There are a number of important considerations for a mid-sized private equity sponsor in assessing whether to sponsor a SPAC. Launching a SPAC for the first time requires a careful review of the existing funds' governing documents on numerous levels. This is especially so for mid-sized managers and managers with narrow business strategies, where the use of a SPAC may not have been considered when negotiating the fund documents.

One key consideration is whether the formation and operation of a SPAC is permitted under the fund governing documents. For instance, there may be questions about whether a SPAC would be considered an affiliate of the fund, and if so, what the consequences are of that affiliation. The sponsor also needs to consider whether a SPAC would be considered a successor fund or a co-investment vehicle, which in turn may raise questions regarding the timing of a SPAC launch, the need to offer co-investment participation to investors with potentially applicable participation rights, and other questions.

Another important consideration is the sponsor's devotion of time requirements to the existing funds and other investment vehicles it manages. For a mid-sized manager, the key individuals with contractual time obligations to existing funds are likely to be involved in the deal sourcing and operation of the SPAC. If existing fund provisions limit or prohibit key decision-makers from participating in the SPAC's activities, the sponsor will need to decide either to seek investor consent or to consider alternative staffing options with respect to investment professionals who can operate the SPAC, such as the retention of operating partners.

In all instances, early and proactive communication with investors is important. Communication with existing limited partners is, of course, required in the event that the private equity manager's sponsorship of a SPAC requires investor consent under the fund's governing documents. In cases where the approval of limited partners or the limited partnership advisory committee is not required, sharing details regarding the launch of the SPAC and how it will be operated within the structure of the private equity sponsor's existing business promotes transparency and can allay questions about the sponsor's commitment to the existing funds. For private mid-sized managers with a more concentrated investor base, transparency and openness takes on even greater significance.

The SPAC's investment mandate also implicates a number of issues for the private equity sponsor. In instances in which the SPAC will be targeting companies that are within the investment strategy of the sponsor's existing private equity funds, the sponsor will need and want to confirm that the SPAC's activities will not violate the sponsor's obligations to allocate investment opportunities to the existing funds. Even if they do not directly pose any issues, there may be gray areas with respect to specific investment opportunities that require the sponsor to weigh whether to give the opportunity to its existing funds or to the SPAC. Furthermore, to the extent that the SPAC's investment activities may overlap with those of portfolio companies owned by existing funds, the sponsor will need to assess the potential for conflicts of interest and the impact of such competing commercial activities on existing portfolio investments.

REGULATORY CONSIDERATIONS IN LAUNCHING A SPAC

There are a range of regulatory considerations that a mid-sized manager needs to consider prior to launching a SPAC. The sponsor's existing compliance program will need to be reviewed and assessed, regardless of whether the firm is Securities and Exchange Commission (SEC)-registered or is an exempt reporting adviser. Adjustments will likely need to be made to the sponsor's current compliance procedures and practices to account for the distinctive activities of the SPAC, including the fact that the sponsor will now be involved in the operation of a publicly traded vehicle. ADV filings will also need to be reviewed in order to determine whether any disclosures or other changes are warranted.

Disclosure obligations will require particular care and attention. For instance, the private equity sponsor will need to take care that any SPAC-related public disclosures and statements do not amount to "advertising" in a manner that might impact the ability of the sponsor's existing private investment vehicles to rely on the federal securities laws' private placement exemptions (most typically under Rule 506(b) of Regulation D of the Securities Act of 1933, which prohibits public solicitations). At the same time, the SEC's Division of Corporation Finance in December 2020 released guidance for SPAC sponsors on numerous disclosure matters, including potential conflicts of interest that may arise where the SPAC sponsor and its personnel have unrelated and potentially competing business activities, where the SPAC sponsor's financial incentives may differ from those of SPAC shareholders, and numerous other issues. Moreover, with the new chair of the SEC taking the helm, there may be additional attention paid to this area.

While the SEC's guidance was directed to SPAC sponsors generally and not private equity sponsors in particular, it raises important disclosure considerations for private equity sponsors and highlights the careful balance that sponsors need to strike between disclosures regarding the sponsor's private equity business and existing managed funds, as well as the need to avoid statements that the SEC may perceive to be public solicitation of those funds.

CONCLUSION

SPACs can provide attractive capital-raising and investing opportunities for private equity sponsors and potentially for their funds and their investors. This is particularly true for mid-sized managers, where the popularity of private equity and the robustness of the private markets generally has led to an increasingly crowded field chasing a finite set of investment opportunities. Taking advantage of the hot SPAC market requires the private equity sponsor to approach the potential formation of a SPAC with thoughtful planning and careful analysis of the various legal, compliance, and commercial considerations with respect to its existing private equity business.

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