ZacharyScott

INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SPRING 2021

SPACs: Private Equity Goes Public

Apocalypse? Or, just an evolutionary stage for private equity?

by Mark Working & Dror Bareket

Everybody is talking about them. Lots of opinions. Most are related to whether SPACs constitute a good investment. With short sellers growing, many are betting they are not. Before coming to any conclusions about SPACs, it is important to separate the chatter about investment risk and understand how this might apply to an owner's decisions when approached by a SPAC.

BACKGROUND ON SPACS

A Special Purpose Acquisition Company, or SPAC, is purely a structure for raising capital and, as such, is neither inherently good nor bad. A SPAC is a company formed for the purpose of combining with one or more businesses. The unique aspect of a SPAC is that it is created to become a public entity and recent rule changes have contributed to their popularity. The founder forms the company, capitalizing it with enough to "take it public." In the IPO, funds are raised with the net proceeds, after paying expenses, held in a trust account until released to fund a business transaction. These initial investors earn warrants, or "free" equity, which has attracted early investors. There are some constraints on these funds. The SPAC has two years to find a target and negotiate a merger before having to return the trust funds to investors and, once a combination is negotiated, the transaction must be approved by SPAC shareholders. Shareholders who do not approve are bought out, with the remaining shareholders converting their trust account interests into shares of the public company, effectively making the target a publicly traded company.

Why doesn't the private company just go public itself? Speed, cost, and confidentiality. In some transactions, the target can become public within two to three months. A traditional IPO for the same business would be approximately twice as long. Because the SPAC has no history and very simple financial statements, and the sale of shares is considered "easier", the cost of the initial public offering (IPO) is lower than for an operating company to go through the same process. Disclosure of the target is not made public until after the transaction, whereas in a traditional process, disclosure is made public when the company files its registration statement with the Securities and Exchange Commission (SEC). Therefore, if the deal does not go through, all information is protected.

The sponsor is the key party to all of this. The sponsor creates the initial company, arranges funding for the IPO stage, finds the target, negotiates the combination, and arranges the transaction. For that, the sponsor receives warrants that are converted to equity in the public company. A "standard" promote interest is 20% of outstanding shares after the combination transaction. Most recent SPACs have been sponsored by private equity fund managers although there is no restriction on who can be a sponsor.

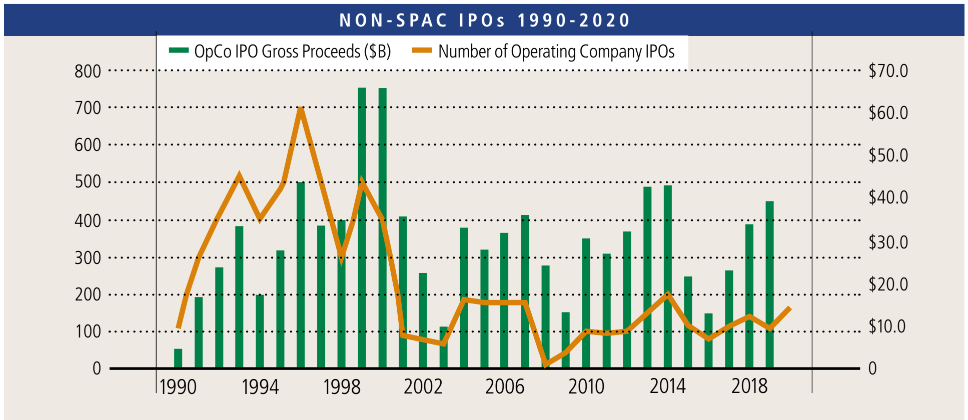
A Special Purpose Acquisition Company, or SPAC, is purely a structure for raising capital and, as such, is neither inherently good nor bad. A SPAC is a company formed for the purpose of combining with one or more businesses.

MARKET ACTIVITY

IPOs represent a market opportunity for a company to raise capital. When public equity markets are highly valuing company profits, companies that can access that market and have capital needs will try do so. It appears that is exactly what is happening now. Non-SPAC IPOs have been relatively stable in number for the last twenty years with the exception being after the bursting tech bubble in 2000 and the great reset in 2008, although the actual amount of dollars reached its highest point in 2020. SPACs, on the other hand, had not been a "real thing" until they started gaining popularity in 2017 and exploded in 2020, with the number of SPACs dwarfing non-SPAC IPOs, and the dollar amount of proceeds also exceeding that taken by non-SPACs. New SPACs have already equaled the 2020 number in the first quarter of 2021 and the pipeline is full.

The dynamics of going public through a SPAC have some unique attributes. First of all, the sponsors already have raised public capital and are motivated to spend it. We have commented numerous times about the pressure private equity has to invest committed capital. SPACs are private equity on steroids. When a SPAC undergoes its IPO, it cannot have a deal with a target lined up without triggering a different set of SEC requirements. Therefore, the clock is running when the IPO occurs. Two years pass, and the money is returned. It might seem like a long time, but it isn't to find, negotiate and close a deal. There are two other motivating factors for sponsors to find and complete transactions. The sponsor earns actual equity (approximately 20%) in the target once a deal occurs. This is in comparison to the private equity practice of earning 20% of the gain subject

NON-SPAC IPOs 1990-2020



(continued p.2)

to a minimum return threshold (usually around 8%) for investors putting up the money. The additional factor is that a SPAC is measured for the sponsor strictly on the single deal and not averaging into a pool of investments as with a typical private equity fund. All the gains from this investment are earned and any losses do not drag down other investments. A cynical observer might conclude the incentives could lead to "any deal is a good deal" because 20% of something is always better than 100% of nothing.

IMPLICATIONS FOR PRIVATE COMPANIES

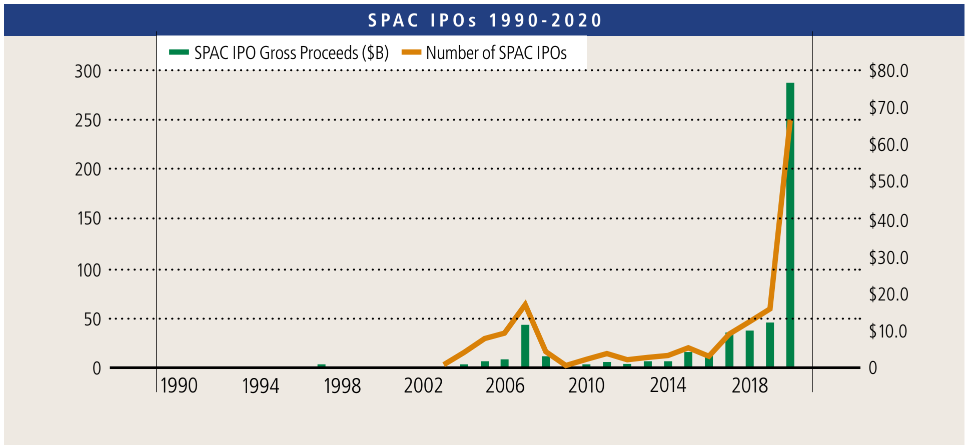
An IPO is a good tool to raise new capital, provide a liquid market for all shareholders,

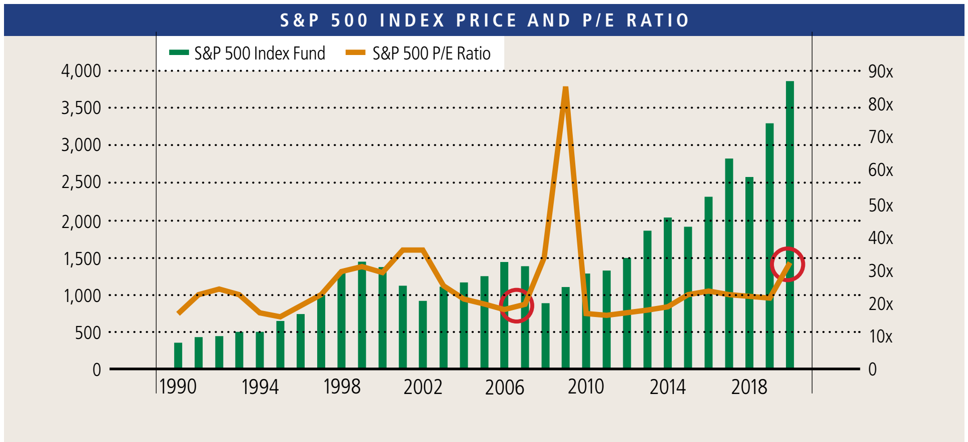
SPACs are simply a tool to be used to access a capital market. When used by capable and disciplined investors, there is no reason that it can't and won't lead to a good result for all parties.

and take some chips off of the table. If the additional reporting and scrutiny from being a public company don't outweigh the benefits, the question is "how much of the company's shares need to be given up in exchange for the capital raised (either to buyout existing shareholders or fund the company's future growth)?" When there is a large diversion between how public and private equity markets value operating performance, this market deserves attention.

SPACs are simply a tool to be used to access a capital market. When used by capable and disciplined investors, there is no reason that it can't and won't lead to a good result for all parties. Rain is needed, but sometimes leads to floods. Similarly, some SPACs will be misused by inexperienced or incapable investment managers to the detriment of SPAC investors.

Nevertheless, if merging with a SPAC allows a company and its owners to achieve their liquidity and capital objectives, it is still a good option to consider. An old adage of equity market observers is that "when the equity window opens, it is time to back up the truck." **ZS**





ZacharyScott

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101
ZacharyScott.com

ABOUT ZACHARY SCOTT

Since 1991, Zachary Scott has assisted owners of privately-held businesses in the greater Pacific Northwest to plan and execute major business or ownership transitions by offering sell-side M&A and acquisition and investment advice. For more information on Zachary Scott, go to **ZacharyScott.com.**

Ben Adams
206.838.5526
badams@zacharyscott.com

Brian Bergsagel
206.838.5527
bbergsagel@zacharyscott.com

Frank Buhler
206.224.7383
fbuhler@zacharyscott.com

David Goldstone
206.838.5521
dgoldstone@zacharyscott.com

William Hanneman
206.224.7381
bhanneman@zacharyscott.com

Ray Rezab
206.224.7386
rrezab@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

David Working
206.224.7850
dworking@zacharyscott.com

Mark Working
206.224.7382
mworking@zacharyscott.com