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New Use Of SPAC Subsidiaries Offers Another IPO Option

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A potentially transformational shift is occurring in the market for special purpose acquisition companies, as operating companies begin to form their own SPAC subsidiaries to raise cash to acquire a target and take the combined business public—in effect at least partially removing the blank from blank-check companies.

Backed by Z Capital LLC, Affinity Gaming LLC is seeking to raise $150 million through a new SPAC subsidiary, Gaming & Hospitality Acquisition Corp., or GHAC. According to GHAC's Jan. 15 registration statement, Affinity Gaming and GHAC intend to merge Affinity Gaming with another company in the gaming and hospitality sector, taking the combined company public via the SPAC. Affinity Gaming's filing follows on the heels of the Jan. 14 initial public offering of Group Nine Acquisition Corp., a $200 million SPAC formed as a subsidiary of Group Nine Media Inc. digital-media holding company, for the purpose of merging Group Nine Media with the SPAC's target.

Will SPAC subsidiaries replace traditional IPOs?

These new captive SPACs may supplant traditional IPOs that are done for the purpose of raising capital to facilitate an acquisition strategy. The option of forming a SPAC subsidiary will likely be particularly attractive to private equity firms, which may already have an interest in forming a SPAC and may already be considering an acquisition strategy with respect to one or more of their portfolio companies.

By forming a SPAC subsidiary, companies can raise capital in the public market just as they do with an IPO, but without actually going public first or filing a lengthy registration. The GHAC registration statement contains only a one-page description of Affinity Gaming with no financial information. Disclosure related to the existing operating company will only be made in connection with the SPAC's initial business combination. Reduced disclosure on the front end, combined with the fact SPAC transactions already afford companies the ability to communicate more freely with investors and to market their transactions using forward-looking projections, make forming a SPAC subsidiary an attractive alternative to a traditional IPO.

The U.S. Securities and Exchange Commission's willingness to allow these captive SPACs to pre-identify at least one of their acquisition targets is a tremendous break from prior SEC policy and practice requiring that SPACs confirm that they have not engaged in any substantive discussions with a target company prior to completing an IPO. The rationale for the SEC's policy is that if a target company had been identified, the offering would be an IPO of the target company rather than a blank-check offering and disclosure regarding the target company would be required in the SPAC's registration statement.

The differential treatment by the SEC may be due to the fact there is no binding commitment between the operating company and the SPAC to merge with the SPAC's target. The fact that the operating company and the SPAC are owned by the same investors, however, makes it very likely, if not a fait accompli, that the SPAC's investors will end up owning the operating company, albeit as part of a combined company. Given these dynamics, the stock of these new captive SPACs may very well trade based on investors' appetite for the operating companies sponsoring these SPACs, even prior to an announcement of a business combination, and prior to disclosure of any meaningful information regarding the operating company.

How will captive SPACs impact the market for traditional sponsored SPACs?

If the trend of operating companies forming their own SPACs continues, the pool of potential target companies will shrink, making it more difficult for traditionally sponsored SPACs to complete business combinations. Not only could companies that would otherwise merge with a SPAC instead form their own SPACs but they may, in turn, acquire other IPO-ready companies as part of their business combinations. Competition for acquisition targets is already tight with approximately 270 SPACs currently searching for targets.

Proprietary SPACs may prove more attractive to acquisition targets to the extent they reduce or eliminate the cost of merging with a SPAC. A SPAC's sponsor receives founder shares in the SPAC, generally equal to 20% of the post-IPO common stock of the SPAC, as compensation—or promote—for forming the SPAC and completing an acquisition. The dilution caused by the sponsor's promote is a cost of merging with a SPAC.

It remains to be seen to what degree proprietary SPACs will seek to capture the upside from the sponsor promote. Affinity's GHAC SPAC currently contemplates that Affinity will receive the traditional 20% promote. In contrast, Group Nine Media's SPAC has disclosed that if it combines with Group Nine Media, it intends to forfeit all of its founder shares. The latter structure may ultimately prove more attractive to target companies.

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