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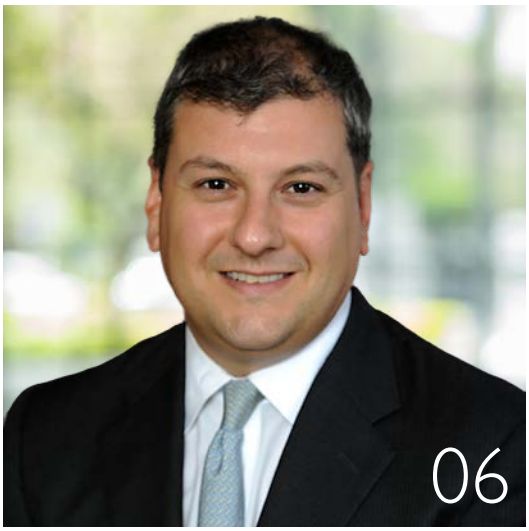
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INSIDE THIS ISSUE…

04 SPACS MARKET RE-GROUPS UNDER CLOSER SCRUTINY
By A. Paris

06 GPS TO LOOK FOR DIAMONDS IN THE ROUGH WITH SPAC DEALS
Interview with Jeremy Swan & Cindy McLoughlin, CohnReznick

08 ADVICE AND EXPECTATIONS – STEPS TO A SUCCESSFUL SPAC DEAL
Interview with Zac McGinnis, Riveron

11 DIRECTORY





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SPACs market re-groups under closer scrutiny

By A. Paris

Following a year of high exuberance, the market for special purpose acquisition companies (SPACs) has slowed since peaking in mid-February 2021. Now, with the US Securities and Exchange Commission (SEC) changing accounting rules and vowing to keep a close eye on the market, the momentum behind these vehicles has reduced. But despite the market cooling off, the space remains attractive as the increased scrutiny can lead to better quality structures with more robust due diligence on behalf of sponsors, to the benefit of the investors.

"Since the beginning of 2020, SPACs have raised a collective USD167 billion in new capital from investors. Just three months into 2021, SPACs have already exceeded the amount raised in the entirety of last year. January–March saw 258 SPACs raised, with an aggregate value of just over USD83.3 billion," outline Winna Brown, EY Americas Financial Accounting Advisory Services and Private Equity Leader and Pete Witte, EY Global Private Equity Lead Analyst.

This searing pace of growth may have been dampened by the announcement by the SEC regarding accounting and reporting considerations for warrants issued by SPACs. The new guidance suggests that warrants issued to investors are liabilities rather than equity, for accounting purposes. This is a significant change.

"SPACs warrants have always been treated as equity. It has been the accepted practice for eight years across around 600 SPACs. Now that it's changed, those companies need to restate their financial statements which is a huge headache," says Zac McGinnis, managing director, Riveron.

However, despite this, signs suggest the market will continue to be attractive. "With recent IPOs trading above USD10, it suggests investors are likely ready to allocate again once the warrants-as-liability situation is settled," writes SPAC Research in its late April newsletter.

According to Brown and Witte: "Whether or not new SPAC issuance continues this blistering pace is, at this point, effectively immaterial. With more than USD166 billion

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>
> Duncan Lamont, Schroders

in trust (and another USD59 billion that is pre-IPO, according to SPAC Research), SPACs have a tremendous amount of assets that must be deployed over the next two years."

Advantages to investors

There are several benefits to investors considering allocation to a SPAC. Duncan Lamont, Head of Research and Analytics, Schroders comments: "Because investors in a SPAC IPO have the option to redeem their shares for what they paid for them plus interest, they essentially have a money back guarantee. In addition, they have a warrant, which may turn out to be worth a lot if the SPAC is a success. The warrant is akin to a risk-free bet on the success of the SPAC."

A paper by Michael Klausner and Michael Ohlrogge at the New York University School of Law notes: "Commentators have described SPACs as 'poor man's private equity,' suggesting that retail investors invest in SPACs as bets on the sponsors' skills in identifying and merging with attractive private companies to brings public."

However, the authors claim this characterisation of SPACs is off the mark. "SPAC shareholders are overwhelmingly large funds, rather than retail investors," they write. The industry has seen a number of large well-known hedge funds throw their weight behind SPACs – names like Falcon Edge Capital, Pershing Square Asset Management and Millennium Management.

However, not all agree retail investors play a small role in the SPACs space. Earlier in 2021, the Americans for Financial Reform and the Consumer Federation of America outlined concerns regarding retail participation in the SPACs market.

The letter, addressed to Maxine Waters, chair of the House Financial Services Committee said the boom in SPACs is: "fuelled by conflicts of interest and compensation to corporate insiders at the expense of retail investors." The think tanks gave recommendations on how to better protect retail interests.

Interest in SPACs continues to be considerable. The letter to Waters notes: "This is likely due to the attention drawn by the relatively few SPAC mergers that have earned outsized returns. The widely touted performance of shares of SPAC-launched companies such as Virgin Galactic and Draft Kings helps feed the myth that SPAC investing provides a route for ordinary investors to profit from access to high-tech investments that are typically limited to venture capitalists hedge funds, and other institutional investors."

Lamont draws attention to this popularity: "Celebrities such as NBA star, Shaquille O'Neal, MLB star Alex Rodriguez, and popstar Ciara, have all launched SPACs. This is where the risk lies. So much so that the SEC has even put out an alert, warning investors: "It is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment."

One consequence of the earlier market sell-off and potential slow down encouraged by the SEC scrutiny has arguably been a flight to quality.

Strong outlook for company roll-ups

Another change expected is the rise in several companies banding together.

In the view of Cindy McLoughlin, Managing Partner, CohnReznick, this is a key element in the future of SPACs. She explains the reasons driving this development: "There are only so many companies which are of the necessary size to go into a SPAC. There is however, another tier of companies which are in growth mode but are too small to do an IPO or a SPAC on their own. Therefore, I expect there to be opportunity of some roll-ups which can help companies get to the magnitude which warrants going into a SPAC."

One recent example of this is the Greenrose Acquisition Group, which De-SPACed in March 2021, making deals to buy four cannabis firms in March 2021.

"The companies we are bringing to market fully align with Greenrose's core objectives," CEO Mickey Harley said in a statement. "We are targeting strategic assets in several key states that present opportunities for further consolidation as we seek to deepen our presence, particularly in the West."

Another high-profile SPAC called Power Brands was created to build a global conglomerate of sustainable and digitally focused beauty brands. The company states its objective "to create a next-generation consumer holding company by combining exceptional brands and leadership teams in beauty, wellness, and consumer-related industries to create long-term value for our shareholders."

This is one of the few SPACs founded by women. It got off to a strong start in the de-SPAC stage with a USD276 million IPO. ■

GPs to look for diamonds in the rough with SPAC deals

Interview with Jeremy Swan & Cindy McLoughlin

Last year witnessed the meteoric rise of special purpose acquisition company (SPAC) deals. But, as regulators take a closer look at this development and fewer deal-ready companies are available for acquisition, the industry could see a slow-down in momentum.

"This latest iteration of the SPACs market is a lot more mature, and the industry is starting to see bigger names putting their weight behind it. There is growing market acceptance of SPACs for a whole range of reasons," outlines Jeremy Swan, Managing Principal – Financial Sponsors & Financial Services Industry, CohnReznick.

He says that from a financial perspective, a SPAC arrangement can be very attractive for general partners (GPs) because a smaller amount of money needs to be put to work up front: "As the sponsor of the deal, PE firms can walk away with a 20 percent stake in the business for a smaller upfront investment than a comparable PE transaction. In addition, the exit period also has the potential to be much faster than the typical 10-year private equity fund. This means managers have the opportunity to get a significant return in a shorter period of time."

However, Swan suggests that the rise of SPACs could be causing some conflict between GPs and limited partners (LPs), who have been raising a few issues in this regard: "Some have expressed concern about SPACs taking time and energy away from the private equity fund to which they committed capital. They are paying the management fee and want to understand how much time the management team is spending on the SPAC that they are not invested in.

"This has been resolved in multiple ways. Some GPs have siloed their SPAC operations or set up specific teams to manage this part of their business. Others have also figured out ways for LPs to participate and co-invest in the SPAC. Whatever option the PE firm chooses to take, the crucial element is to make sure their communication is transparent and LPs know where they stand."

Preparation is critical

From the perspective of the company the SPAC is targeting, Cindy McLoughlin, Managing Partner and SPAC services leader, CohnReznick, gives her view on how these companies can best prepare themselves for the SPAC process.

"I often see companies that are not ready to be a public company. Whether they're going into a SPAC or taking the IPO route, the end game is going public, and when it happens, it does so very quickly. Companies are sometimes not prepared for that.

"Companies choosing to go into these SPAC deals need to understand the risks associated with them. They need to be prepared for the disclosure and reporting requirements they are going to have to comply with."

In McLoughlin's view, the logistical compliance nature of the historical financials is the most challenging element of the process. This is often a stumbling block for most target companies wanting to go into a SPAC. To get ahead of it, she advises: "Not only do companies need to be ready to provide PCAOB-audited financial statements, but they must be ready to file quarterly financial statements. I recommend clients start doing hard quarterly closes, not just their year-end close ahead of any deal. Once they go public, companies will need to have those numbers comparatively, and going back in time to recreate what is needed and present financials in a compliant manner is a big undertaking."

She also stresses the importance of having the right resources and experts available: "In addition to working with firms like ours, companies often need to hire other people internally, and we recommend they do that at an early stage. Having the right internal people with the technical acumen who have been through this process can make a real difference."

Although the end result of a SPAC process is the company going public, McLoughlin points out that the process is not only quicker and less costly than a traditional IPO, but also more discreet: "Companies choosing the SPAC route will not need to tell the world their financial information until they're sure the deal will go through. This is an advantage in case the deal doesn't happen and allows them to pivot without perceived tarnish of the valuation."

This might change depending on regulation, but as things currently stand, operating companies have the opportunity to tell their story their way. They can also talk about projections, which is something they wouldn't be able to address in a traditional IPO process.

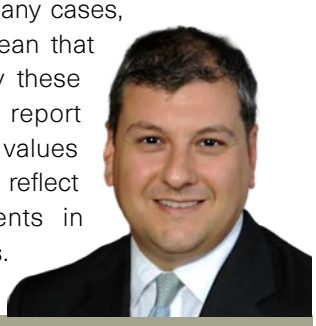
Retail opportunity; slower outlook

SPACs also provide private equity firms with one thing they've always been clamouring for: a way to tap into the retail market.

Private equity managers have always wanted to access retail investor dollars, and the appetite has also been there from the investor perspective. Swan comments: "SPACs are a liquid version of a private equity deal for retail investors. The level of risk they are exposed to depends on the level of disclosure and diligence provided. However, not every SPAC deal is done with the same rigour of due diligence as a private equity deal, so this may lead to greater risk for the retail investor."

This growing retail access to private equity has led to increasing focus on SPACs on behalf of the Securities and Exchange Commission (SEC). New guidance that sets out how accounting rules apply to key elements of these companies could disrupt the industry's trajectory.

In fact, a chilling effect on new SPAC issues followed when the SEC recently set forth its views on the accounting for warrants containing certain specific features that, for most SPACs, were previously classified and accounted for as equity instruments. In many cases, this new interpretation will mean that the SPACs must now classify these warrants as liabilities and report them at their estimated fair values at each reporting period, and reflect the corresponding adjustments in their Statements of Operations.



Restatements of previously filed financial statements may be necessary.

In addition, certain types of Working Capital Loans typically provided for by the sponsors might contain conversion features that need to be analysed for embedded derivative considerations. SPACs may want to revisit Forward Purchase Agreements with sponsors to subscribe for additional shares concurrent with a business combination, depending on how the agreement is structured; it could potentially trigger additional accounting considerations. Last but not least, while most warrants have similar terms, "all warrants are not created equal," so management and their accounting advisors should be sure to execute a thorough analysis of existing terms to determine appropriate accounting.

Discussing the outlook for the SPACs market, McLoughlin notes that the SEC holds the reins: "If they start tightening the rules, then the market dynamics will change. It will most likely slow the market down somewhat, which is not necessarily a bad thing and will highlight the importance of quality over quantity."

According to Swan, it is getting harder for GPs to find quality deals, which means companies that are ready for a SPAC deal. "They're having to look at some of the second-tier opportunities. This means those deals are going to take longer. GPs need to find those diamonds in the rough that can get ready for the process quickly.

"Many of the companies picked up in earlier SPAC deals were ready to go public – they could have gone down the IPO route if they wanted to. The companies available now need more work, which will automatically slow the timeline. Therefore, we can expect to see around 30 or 50 percent of deals actually being done." ■



Jeremy Swan
Managing Principal – Financial Sponsors & Financial Services Industry, CohnReznick

Jeremy Swan is the National Director of CohnReznick's Financial Sponsors & Financial Services Industry practice and also leads the efforts of the Firm's M&A Consulting Services practice. Jeremy is responsible for management of CohnReznick's Financial Sponsors and Financial Services Industry practice which includes all work conducted at the firm level, fund level, and across portfolio companies. Jeremy serves as the lead and/or relationship partner for many of CohnReznick's largest private equity firm and portfolio company engagements, managing teams across service lines and maintaining a single point of contact at the private equity firm level. With more than 20 years of experience advising financial sponsors and emerging private and large, multinational portfolio companies, Jeremy has extensive experience working with financial sponsors as both an investment banker and a consultant. He has expertise in mergers and acquisitions, IPO readiness, financing transactions, post-acquisition integration, and operational and financial due diligence.

Cindy McLoughlin
CPA, Managing Partner, SPAC Practice Leader, CohnReznick

Cindy McLoughlin, CPA, leads CohnReznick's SPAC practice. With more than 25 years of experience, she has expertise providing audit services to mid through large-sized companies typically backed by private equity. Before joining CohnReznick, Cindy was the partner in charge of the audit practice of a large, national accounting firm in Long Island, New York where she led numerous engagements and served as the concurring partner on the audits of several large public companies. She also held responsibilities there as an internal audit quality reviewer. Cindy has received countless accolades including the Achievers' Award from the Long Island Center for Business and Professional Women, the Corporate Leader award from Long Island Women's Agenda, Top 40 under 40 from Long Island Business News', and was also named one of Long Island's Top 50 Most Influential Women in Business.

Advice and expectations – steps to a successful SPAC deal

Interview with Zac McGinnis

Following the global outbreak of the Covid-19 pandemic in March 2020, the private capital industry saw a significant build-up of dry powder. Special purpose acquisition companies (SPACs) provided an outlet for these funds. However, sponsoring firms need to consider several factors to be well-prepared for launching a successful SPAC.

Zac McGinnis, Managing Director, Riveron, comments on the opportunity SPACs provided, particularly in the context of 2020: "A SPAC offered investors a vehicle to take advantage of the built-up dry powder. This type of investment is based on investors' trust in a management team. When investing in a SPAC, investors are trusting that management team to use their money in their best interest and to complete the task within 24 months.

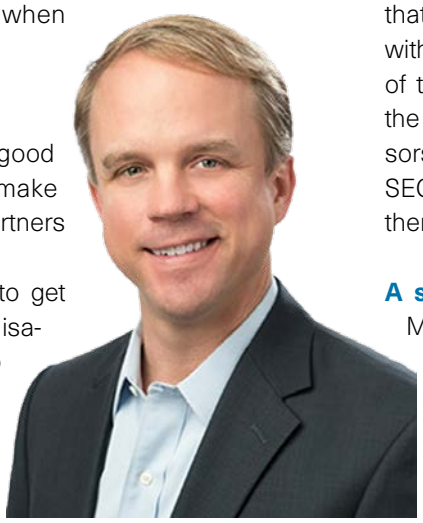
"However, SPACs have opened the public up to a new level of risk. Investors who haven't navigated the SPAC lifecycle before could risk losing everything. They may not understand this when investing in a SPAC, which is a downside of these types of vehicles."

This additional risk underscores the importance of robust advice and support when making financial decisions.

Access to advice

It's not just retail investors who need good advice. SPAC sponsors also need to make sure they are working with the right partners to help them through the process.

The sponsors' primary challenge is to get target companies healthy, from an organisational perspective, to allow them to go public. However, in addition to accounting, cash management and internal controls, McGinnis outlines: "It is crucial to get the entire organisation to march to the same beat and that takes a lot of time."



Having competent attorneys and other third-party partners is critical for sponsors to be best prepared for the SPAC process. "The right strategic advisors can help sponsors decide which path to take and what benefits each route could offer. Most sponsors are very good at raising capital among institutional investors but they may not be fully prepared to handle the back office organisation necessary to get a company ready to be publicly traded," McGinnis notes.

The importance of making sure the team around the sponsor and the target is right should not be underestimated. This eco-system can also help manage the sponsors' expectations of the SPAC process. McGinnis explains: "Given the simplistic nature of a blank cheque SPAC company, many sponsors think audits can be done very quickly. So, the fact that it takes three or four weeks sometimes comes as a surprise.

"Although the nature of the entity is blank cheque in nature, the process still resembles that of a traditional IPO in the US. However, with a SPAC, there is an additional time crunch of two years to complete an acquisition from the IPO date. Similar to a traditional IPO, sponsors need to take certain steps to file with the SEC and obtain a team of advisors to guide them through the process.

A strong sense of identity

McGinnis warns sponsors not to be unduly influenced by the time constraints: "Sponsors should remain strong in the identity they set for themselves at the beginning of the process. They sometimes might be tempted to change the

way they define themselves to expedite the deal but changing tack this way is very disruptive. It can cause confusion and time delays and potentially lead to the deal collapsing."

In addition, the diligence and disclosures provided in preparation for a SPAC deal expire. Therefore, the process needs to move at pace to effect a business combination with an operating company within 18 to 24 months. McGinnis gives an example of what can happen if this timeline is not adhered to: "We had one client whose clock expired and had to return all their investors' capital because they weren't able to close a deal. So, the repercussions can be fairly dramatic if the sponsor is not well prepared to move ahead with a transaction."

To alleviate this potential problem, McGinnis suggests: "Sponsors can start shopping early – as much as they are allowed to, legally. They can start thinking about what target companies they will need to perform due diligence on. For example, sponsors can undertake desktop reviews of target companies' financial statements which can help to realise maximum value of the investment. This way, the sponsor's approach can be more diversified at an early stage and have more information to make the right decision when the time comes."

McGinnis also notes how the extraordinary volumes witnessed in the industry means there are various factors which can impact a sponsor's ability to get a deal done: "It's important to set expectations early on to avoid disappointment at a later stage. Given the number of SPAC deals going through the industry, most sponsors cannot expect to be at the front of the line. The market will drive their timeliness and attractiveness."

"As long as interest rates remain low and companies can create financial arbitrage on a deal then the market for SPACs is going to be strong. We are also noticing teams of advisors at some of the major CPA firms starting to favour these as models which could be another indicator as to why this has become an attractive business opportunity."

Regulatory surprises

The recent regulatory review of SPACs by the SEC could change the vehicle's trajectory, to some degree. These changes impact the accounting policy for the way warrants are treated, which means companies need to consider amending previously-filed audited and unaudited financial statements. McGinnis highlights: "It ultimately means companies may have to go back and restate their previously issued financial statements and this is a huge headache.



"Surprising changes like these can be a challenge for SPAC sponsors. Such reviews turn standard processes on their head which could make firms worry what other regulatory shocks could be around the corner, especially given the market is becoming more attractive."

The unintended consequence of the regulatory rehaul, however, has been a spirit of camaraderie in the industry. McGinnis observes: "It's exciting to see law firms getting together to come up with a solution to this, as opposed to competing against each other. Through our experience collaborating with other third-party advisors and sponsors, we know this helps to create a more seamless process and increase deal success. Every player is affected by this and it is in everyone's interest to find a way to handle it." ■

Zac McGinnis
Managing Director, Riveron

Zac McGinnis has 20 years of global experience in accounting advisory and audit roles, including capital raising assistance, SPAC mergers, carve-out and pro forma financial statements, business combination and divestiture matters, fresh start accounting and reporting, IPO readiness, GAAP change and IFRS conversions, and audit assistance. Zac has served clients in a variety of industries, focused primarily in energy and including multinational publicly traded companies, private-equity portfolio companies, and privately-held institutions. Zac is based in Houston and has spent the majority of his career in Houston, Tokyo, and Amsterdam.


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