Akin

Energy SPACs

Apr 12, 2016

Reading Time : **5 min**

By: Shar Ahmed

It was followed in March by KLR Energy Acquisition Corp. (NASDAQ: KLREU), which ultimately raised approximately $85.1 million in its IPO of units priced at $10 per unit. Each unit consisted of one share of Class A common stock and one warrant. KLR is sponsored by Gary Hanna, former CEO of EPL Oil & Gas Inc., and seeks to consummate an acquisition within 18 months of its IPO, with a "focus on the sector that complements [its] management team's expertise in the exploration, exploitation, operation and development of crude oil and natural gas wells and related infrastructure, and to capitalize on the ability of [its] management team to source, screen, evaluate, negotiate, structure, close and manage acquisitions of attractive assets or businesses in the U.S."

What are SPACs?

SPACs are newly formed shell companies, without any revenue or operating history, that raise proceeds in an IPO (and a concurrent private placement) for the purpose of acquiring control of, or merging with, one or more operating businesses, typically in a particular industry or market segment. The offering proceeds, with the exception of amounts reserved for working capital, are placed in a trust account, and funds can be withdrawn only under certain limited circumstances. If a SPAC fails to consummate an initial business combination (IBC) within the specified time frame, usually 24 months or less, it must liquidate and return to investors their pro rata share of the funds then held in the trust account.

Sponsors of SPACs are usually prominent industry veterans who believe that their business skills, reputation, experience and networks will help them to source attractive acquisition candidates, with the hope of completing an IBC with one or more such candidates in the limited time frame established by the SPAC's charter. Because SPACs rely primarily upon their sponsors and management team to accomplish their objectives, a commonly heard adage is that SPAC investors are "betting on the jockey and not the horse." The capital needed for a SPAC to pursue an acquisition is raised primarily through an IPO of units, each comprising one share of common stock and a warrant exercisable for common stock, and a concurrent private placement from the sponsors, which typically results in the sponsors and management team holding approximately 20 percent of the common stock of the SPAC immediately following the IPO.

SPAC units are typically priced at $10 per unit, with the attached warrant almost always issued "out of the money." A SPAC will trade as a single unit following the IPO, but, after a short period following the IPO, the common stock and warrants comprising the units will begin separate trading. At this point, holders have the option to continue to hold units or to separate their units into the component securities. Typically, fractional warrants will not be issued upon the separation of units, and only whole warrants will trade. In the case of Silver Run, upon the availability of separate trading, a Silver Run investor will need three units to receive or trade a whole warrant.

The SPAC's IBC must occur with one or more target businesses that together have an aggregate fair market value of at least 80 percent of the assets held in the trust account (excluding deferred underwriting discounts and taxes payable on the income earned on the trust account) at the time of the signing of the agreement to enter into the IBC. Typically, the SPAC will complete an IBC only if the posttransaction company owns or acquires 50 percent or more of the outstanding voting securities of the target or otherwise acquires a controlling interest in the target sufficient for it not to be required to register as an investment company under the Investment Company Act.

The rules of the listing exchanges generally require that at least 90 percent of the SPAC's IPO proceeds be deposited in an escrow or trust account. The IPO proceeds that are not held in escrow are generally available, along with any separate capital invested by the sponsor, for the SPAC to search for acquisition candidates and to pay its general operating expenses pending its completion of an IBC.

Because a SPAC is a newly formed shell company without any revenue or operating history, it automatically qualifies as an emerging growth company (EGC), a new category of issuer created as part of the "IPO on-ramp" under the JOBS Act. EGC benefits include scaled financial reporting; reduced disclosure and compliance requirements; and the ability to confidentially submit a draft registration statement to the Securities and Exchange Commission (SEC) for confidential, nonpublic review. The recently enacted FAST Act conferred even more benefits on an EGC, including a reduction in the time that an EGC must wait to begin its roadshow following the first public filing of its registration statement and omission of certain historical financial information otherwise required by the securities laws.

Why Now?

At their peak in 2007, SPACs completed 58 IPOs raising $10.7 billion and comprising 21 percent of the total deal value for the year. Offerings and deal values decreased significantly in 2008 and were minimal in comparison from 2009 to 2011. In 2015, SPAC IPOs returned to 2008 levels, with 20 offerings raising approximately $3.6 billion and comprising 11 percent of the total deal value for the year. However, prior to 2016, energy-focused SPACs were not common.

Given the distress in the energy industry, and often expensive rescue financing proposals offered by private equity firms, it is not surprising that energy-focused SPACs are now being formed to provide the energy industry with an alternative financing source. As public companies, SPACs will generally be able to offer greater amounts of cash and securities for energy assets and companies than other buyers and will appeal to those targets that have limited access to the capital markets in this current low-price environment, but are seeking the benefits of being public. As the energy industry continues to grapple with low prices, and many companies within the industry struggle to access traditional sources of capital, we expect other experienced business executives to pursue the formation of their own SPACs in an effort to be well-positioned to acquire quality energy assets at these distressed prices.

SPAC Challenges

However, while SPACs appear to be an attractive investment vehicle for investments in the energy industry during this period of distress, SPACs are not without their challenges, and strategies to mitigate these issues should be discussed with counsel. Some of the principal challenges of seeking an IBC with a SPAC include:

- Most SPACs have a limited time to consummate an IBC before they must liquidate and return trust account proceeds to investors. Accordingly, timing pressures can give a target negotiating leverage as a SPAC reaches its end life.

- SEC review of a SPAC's proxy statement at the IBC stage may be lengthy and complicated (initial comments – 30 days) and can include requests for additional disclosures and financial information.
- Shareholder approval for the IBC can be difficult to obtain.
- A SPAC could be pursuing more than one potential target until definitive documentation is signed, which may result in delays for the potential target in moving the process forward.
- Depending on deal terms, the outstanding sponsor's/IPO underwriters'/public warrant holders' warrants remain exercisable for five years post-business combination, creating dilution risk.
- Target company lockups and post-IBC conditions can be restrictive.

Notwithstanding these challenges, at a time when many energy companies are experiencing distress and difficulty accessing much-needed capital, the new source of capital that SPACs can offer could provide the energy industry with a much needed boost.

Categories

Oil & Gas