SPAC 2.0 update

Navigating high tides

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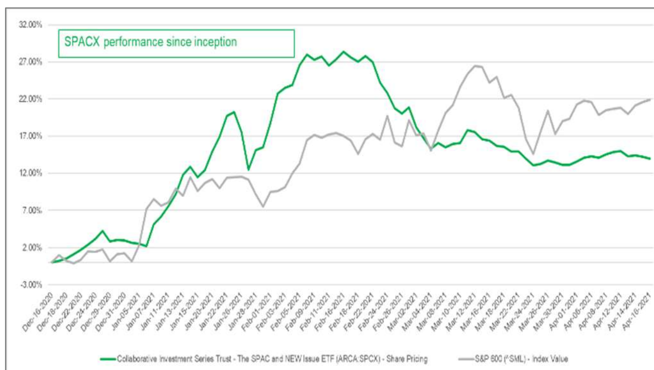
Introduction

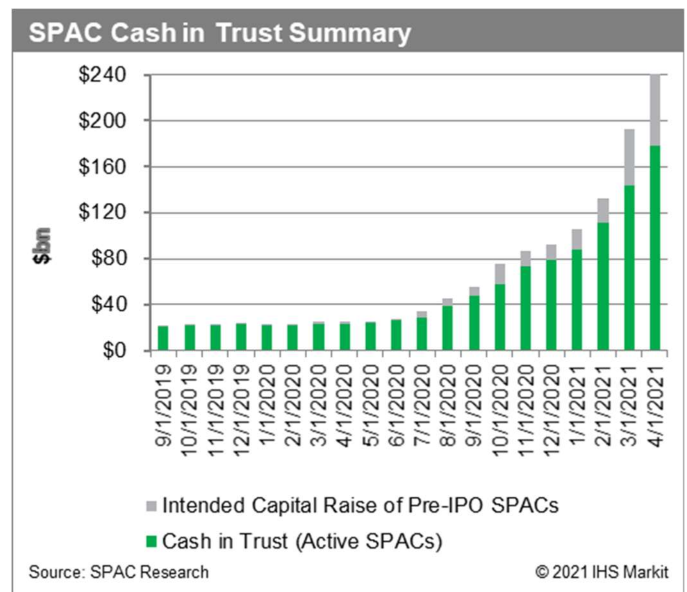
In our earlier report on Special Purpose Acquisition Companies SPACs 2.0 report we introduced the reasoning behind the frenzied growth of SPACS over recent quarters, their funding structure, and the roles of different players in these mechanisms. Since the time of writing (early January) the landscape has changed markedly.

This report explores the progress made and the additional challenges the market is now faced with.

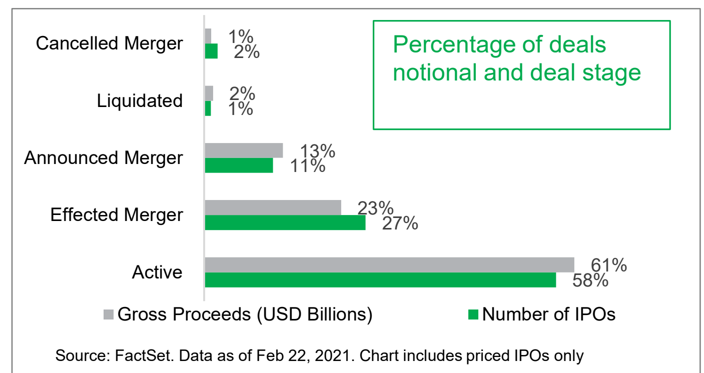
The IPO market was practically closed for the majority of H1 2020 as pandemic uncertainty set in, only to open again aggressively in H2 2020 even as risks around covid and concerns about the economic implications remained high. The volume of IPOs that have come to the market since, as well as historically high valuations in large caps, have led to fears of an IPO “bubble”, especially in Tech. The concerns for some have been compounded by the surge in IPOs via SPACs which made up around 50% of US IPOs in 2020. Concerns of oversupply and the quality of businesses coming to market through the SPAC mechanism have seen mixed relative performance, illustrated by the performance of the SPACX ETF product (ARCA:SPCX) versus the S&P600. Despite a retrenchment of the industry over the last few weeks this bellwether of the SPAC market has still shown reasonable performance in the first five months of its life.



Despite 2020 being a remarkable year for SPAC IPOs, with gross proceeds from IPOs exceeding the total from the previous decade, the market continues to break new ground in 2021 with $178bn in Trust and $64bn in Intended Capital Raise of Pre-IPO SPACs.



Based on a SPAC’s life cycle, we can generally consider SPAC’s status in five stages: active, announced merger, effected merger (approved by shareholders, conditions of the merger agreement are met and ticker updated), cancelled merger, and liquidated. Currently around 58% of SPACs are in the active phase of the deal process.



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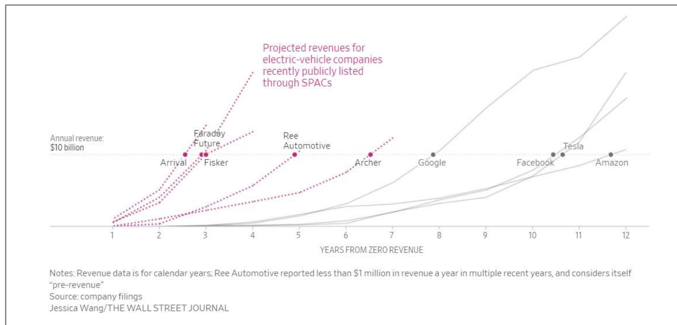
Concerns of false optimism

As a recent article in the Wall Street Journal pointed out it took Google eight years to reach $10 billion in sales, which was the fastest ever for a U.S. startup. In the current SPAC boom, five electric-vehicle companies planning listings are vowing to beat Google's record, in some cases by five to six years.



Notes: Revenue data is for calendar years; Ree Automotive reported less than $1 million in revenue a year in multiple recent years, and considers itself "pre-revenue"
Source: company filings
Jessica Wang/THE WALL STREET JOURNAL

Companies that list through SPACs face different regulations around forecasts than those that IPO since the de-spac process is officially considered to be one of mergers, rather than a public offering which faces a higher level of scrutiny from regulators. There are concerns that this not only leads to potential regulatory standard arbitrage but also a potential overhyping of the acquiree through speculative forecasts, ultimately impacting some retail investors. However, from the perspective of the Sponsor forecasting is an important aid to appropriately position a high potential business to investors.

The SEC's focus on SPACs has been ramping up. John Coates, the SEC's acting director of corporate finance, wrote a *public statement* with a critical eye on long-dated revenue projections for SPAC transactions and the application of safe harbor provisions. Coates also spoke on the need for increased disclosure and the similarities between a regular IPO and the "depac" go-public moment for an operating company. It's also noteworthy that lawsuits have been brought against SPACs alleging deficiencies and misstatements in Form S-4 that a SPAC has to file with the SEC to gain shareholder approval.

Importance of the PIPE

As the blank-check boom cadence rolls on, late VC or growth-stage companies are increasingly bombarded by SPAC sponsors competing to take them public. Good quality private companies can have their pick of Sponsors. However, founders, management teams and boards of the companies considering the SPAC route are increasingly sensitive to the ability to raise a PIPE as well as the valuation offered and the operational experience of the Sponsor. The de-spac often involve an additional sleeve in which additional capital is attracted, often to the tune of hundreds of millions of dollars, through private investments in public equities (PIPE) transactions, or private investments in public equities which are critical to getting a reverse merger executed.

PIPE investors, large institutional fund managers, are invited by underwriters (under NDA) to perform due diligence on the company and decide if they want to participate in the PIPE transaction. The sleeve of capital clearly allows a SPAC to merge with a larger target. It also serves as a guarantee that there is enough capital to support the reverse merger in case a large chunk of SPAC investors decide to redeem upon the shareholder vote which must take place to cement the transaction. Hence, the ability to lean on a strong PIPE can be literally existential for some deals. If the PIPE capital does not form, it typically indicates not enough institutional investors agree with the private company valuation, in which case the valuation needs to change or OIDs need to be offered to sweeten the deal else it could collapse. With concerns of oversupply, PIPE investors are becoming increasingly selective, and first-time sponsors need to build strong relationships with underwriters and serial PIPE investors to comfort a high quality acquiree.

The 2020 SPACs that contained PIPEs had average returns of 46% a month after closing their deals. Morgan Stanley Research data indicated that those without PIPEs saw less than half the level of gains (21%) over the same period. According to a recent SPAC study by Stanford Law School and the New York University School of Law, about a third of the SPACs in the 2019-2020 merger population who issued shares in PIPEs sold those shares at a discount of 10 percent or more from the IPO price. While this price movement is interesting to note, one must also consider the price action once PIPE lockups expire, as this can put significant downward pressure on the share prices as the float is suddenly expanded and the PIPE investors look to downscale their position.

SEC warrants comments

On April 12, 2021, the SEC issued a new *Staff Statement* on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (SPACs). Warrants, which are typically

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issued for SPACs when units begin trading, could be reclassified by the SEC.

SPAC units typically represent a common share of the SPAC and a portion of a warrant for the SPAC. Such warrants typically are part of the incentive for the Sponsor. U.S. Generally Accepted Accounting Principles (GAAP) include guidance that entities must determine whether warrants in an entity's own stock should be classified as equity of the entity or as an asset or liability. While SPACs have typically classified warrants on their balance sheets as equity, under certain circumstances, the SEC has highlighted that GAAP would require certain warrants to be classified as a liability and measured at fair value and hence then updated to reflect changes in market conditions and reported in earnings. This could even require the SPAC obtain an independent valuation as at the IPO date and then restate misstated financial statements!

SPACs should take action immediately in connection with the new SEC Staff Statement and confirm with their auditor the current accounting treatment of warrants issued in connection with their SPAC and initial registered offering is appropriate in light of the new SEC Staff Statement.

> "We recently evaluated a fact pattern relating to the terms of warrants that were issued by a SPAC. In this fact pattern, the warrants included provisions that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the warrant. Because the holder of the instrument is not an input into the pricing of a fixed-for-fixed option on equity shares, OCA staff concluded that, in this fact pattern, such a provision would preclude the warrants from being indexed to the entity's stock, and thus the warrants should be classified as a liability measured at fair value, with changes in fair value each period reported in earnings." John Coates / Paul Munter SEC public statement 12 April 2021

Sponsor promotes

There has been innovation regarding one of the most controversial components of the SPAC structure, the promote. As a way to further incentivise investors and private companies, some SPAC Sponsors have moved away from the standard 20% promote in which they receive 20% of SPAC shares at a discount and promotes in some cases have been as low as 10% (NYSE: AJAX). The largest SPAC in the market from Bill Ackmans Pershing SPAC does not have a typical promote and will receive sponsor warrants rather than sponsor promote shares. Meanwhile Evercore have created "proprietary" SPAC promote structures that are designed to create better alignment between the Sponsor and public market investors. Despite the fantastic potential upside for Sponsors observers need to remember that (i) if a deal is never completed everyone can walk away from the SPAC after two years whilst the Sponsors loses their initial investment and (ii) many Sponsors sink significant additional capital into the new-co.

Valuation considerations

Considerations for PIPE valuation

Once a target company is identified and a merger is announced, market participants have enough information to consider the transaction on a more fundamental basis. As such, the public share price of the SPAC will incorporate market views on the business combination, structure, and likelihood of consummation. Consequently, during this stage the valuation approach generally becomes similar to other PIPE investments, where a discount for lack of marketability (DLOM) is considered. In determining an appropriate DLOM, the first question to think about is what is the expected time to exit? In the case of a SPAC PIPE, the exit timeline is generally based on the expected merger close date combined with the time required to complete the registration process. It is common to consider multiple exit scenarios within the valuation, weighting the likely outcomes. Another aspect to take into consideration is volatility. How do I appropriately measure future volatility? There are several items to consider here, including the use of implied versus historical volatility, volatility time horizons, and whether it is more appropriate to use the volatility of the underlying security or a basket of comparables.

Consideration for Founder shares and Sponsors

Revolves around the determination of the potential exit dates for holders of the shares based on various price hurdles and timing restrictions. The movement of stock prices are unpredictable and countless potential outcomes exist; this indicates one should simulate many thousands of scenarios or price paths to find when price hurdles could be hit, or conditional restrictions could be relaxed. These dates are then utilised as inputs into two valuation approaches, a discount for lack of marketability approach and discounted cash flow approach / cost of capital approach.

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Sponsor shares are generally convertible into common shares, thus, similar to a PIPE, publicly traded of common shares of the SPAC should provide a starting point for a valuation. However, sponsor shares generally include layers of additional price-based hurdles and time-oriented lockup periods that are applied to distinct blocks of shares that could be released upon contingent completion. How should a provider incorporate the various restrictive layers into a valuation methodology? A robust valuation methodology should be able to adequately simulate the potential paths to liquidity based on the mechanics of the sponsor share lockups and determine a restriction period based on a probability weighted expected outcome. The resulting restriction period can then be utilized as inputs into other valuation approaches, such as a DLOM approach and discounted cash flow approach / cost of capital approach.

Consideration for Warrants valuation

The valuation of warrants should take into consideration the issuance price or, if prices are not specifically detailed in agreements, employ similar strategies as the Sponsor and Founder Shares. Given the presence of a price hurdle, liquidity restrictions, and expiration, it is prudent to generate a wide array of potential price paths over numerous simulations in order to encompass an exhaustive list of scenarios. Once the price paths are determined, the lifting of liquidity restriction can be incorporated and either a theoretical exercise can be implemented when appropriate or an option pricing model employed.

Final thoughts

The long-term outlook for SPACs is still highly uncertain but one thing is clear: the new SEC Chair Gary Gensler has focused on this topic early in his term and this has already created headwinds for SPAC Sponsors. Gensler is seen as a progressive with a track record of large-scale reform at the Commodity Futures Trading Commission and it is widely accepted that investor protection is higher on the agenda after the rise in meme stocks and SPACs. The future of the SPAC market is also a challenge for a key player in its ecosystem, Private Equity. On the positive side, avoiding a costly IPO process to take a company public and potentially lessening the burden of finding secondary buyers for portfolio companies. However, assets are also being bid-up with many industry participants claiming SPAC sponsors are less valuation sensitive than traditional strategic buyers or secondary Private Equity funds. The reality is that with $178bn in Trust and $64bn Intended Capital Raise of pre-IPO SPACs, and roughly five IPOs coming to market each day in 2021 there is some way to go until the SPAC story becomes clearer.

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