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9 Factors To Evaluate When Considering A SPAC

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For private companies interested in going public, being acquired by a special purpose acquisition company, or SPAC, is an alternative to a traditional initial public offering that is worth considering.

There has been an upward trend in special purpose acquisition company initial public offerings since 2009 in both deal count and dollar amount raised. Through mid-February 2019, there have been six SPAC IPOs, with gross proceeds of approximately $1.2 billion and an average IPO size of approximately $193 million. In 2018, there were 46 SPAC IPOs (representing approximately 24 percent of all IPOs that year) with gross proceeds of approximately $10.7 billion and an average IPO size of approximately $233 million. In 2017, there were 34 SPAC IPOs (representing approximately 20 percent of all IPOs that year) with gross proceeds of approximately $10 billion and an average IPO size of approximately $296 million. Many of these SPACs are seeking targets currently.

For a target company, being acquired by a SPAC will result in the target company becoming a publicly traded company. This can be especially attractive for private companies that are not obvious IPO candidates, either because the company does not have access to the capital markets (as is the case for many energy companies due to the recent issues in the energy capital markets) or because the target company faces specific issues that can be alleviated through the use of M&A tools (for example, employing an earn-out provision for a target company that does not want to take a discount on its valuation due to a potential contingency). Entering into a business combination with a SPAC, as an alternative to a traditional IPO, is, however, worth consideration by any private company looking to go public. The following is a list of factors to be considered when evaluating a business combination with a SPAC versus a traditional IPO.

Execution Risk

Companies that go public through an IPO face the risk that the market will not be receptive to the offering or will undervalue the company resulting in a failure to close the transaction. Companies that go public through a business combination with a SPAC face the risk that the SPAC's shareholders will not approve the transaction (assuming a shareholder vote is required) or that the shareholders will redeem equity in the SPAC at a rate that creates uncertainty regarding the amount of cash that will be available to complete the transaction or fund the purchase price. Redemption risk, however, can be mitigated

through a forward purchase arrangement with the SPAC sponsor or another investor that agrees to purchase equity in the amount of some portion of the redemptions or through a private investment in public equity, or PIPE, financing. Depending on a PIPE transaction for funding a SPAC acquisition will create market risk that is similar to IPO market risk.

Valuation

Valuation in an IPO is determined by the IPO's underwriters and market demand. In contrast, valuation in a business combination with a SPAC is determined by negotiations between the target company and the SPAC. However, it is important to bear in mind that a SPAC's shareholders must view the target company as appropriately valued in order to support the business combination. If they do not, the SPAC may see a large number of redemptions and/or may fail to get the required shareholder approval creating execution risk.

Cost

An initial business combination with a SPAC is sometimes described as less expensive than an IPO. The professional fees associated with an IPO and a SPAC business combination are typically similar (in each case the target company needs to be ready to meet public company governance and disclosure requirements), but there are no underwriting discounts paid by the target company in a SPAC business combination (the discounts are a sponsor obligation in the SPAC's IPO). However, the SPAC sponsor's 20 percent equity in the SPAC for its nominal capital contribution should be considered. In addition, the target company should consider the value of other contributions the SPAC sponsor can provide — things like more experienced management and sponsor connections — which could be beneficial to the target company and are typically not available in connection with an IPO.

Additional Economics

A SPAC sponsor typically ends up with 20 percent of the common equity of the surviving entity and warrants to purchase additional equity. While the SPAC sponsor would rather not give up any of these securities, some or all of them can be offered to the target company (or an additional financing source needed to fund the deal) as an incentive to enter into the business combination. There are no such incremental economics in an IPO.

Cash Exit

Going public through a business combination with a SPAC offers the possibility of a full cash exit for the seller of the target company. Even if the SPAC's IPO does not result in enough cash proceeds to cover all of the consideration paid in the business combination, it is not uncommon to fund a PIPE in connection with the transaction's closing to obtain the additional cash needed. Many recent De-SPAC transactions have not been full cash exits — either because of the large size of the target company or because of the desire to retain a portion of the SPAC's cash for operations. In a typical IPO, however, it would be highly unusual for the sellers of the target company to get a full cash exit.

Governance

For companies going public through a business combination with a SPAC where the target company will end up with a significant amount of equity in the surviving entity, an important issue will be the governance of the surviving entity after consummation of the transaction. The SPAC's sponsor will also

likely have a significant equity position in the surviving entity and will want to negotiate board rights and other governance protections between the two parties. Also, if additional cash is raised in connection with the closing, the PIPE investors may seek similar governance rights in the surviving entity. A company going public through an IPO may be able to avoid these governance issues.

Management

In a business combination with a SPAC, there is always a question regarding whether the SPAC's management team that raised the funds in the SPAC's IPO will end up displacing the target company's management. The SPAC's management team typically has public company and target industry experience and capital at risk in the SPAC and may intend to stay in place. If the target company management wants to continue after its business combination with a SPAC, it will have to address this issue in the negotiations for the business combination. In an IPO, however, management of the company typically remains in place after the completion of the IPO.

Limited Recourse

In the event a business combination with a SPAC fails to close, the target company will typically have no recourse against the funds in SPAC's trust account and may not be able to compel the SPAC to perform its obligations under the transaction agreement. Although termination fees are not common in SPAC transactions, in some instances the SPAC's founders or affiliated entities have agreed to reimburse the target company for its expenses in the event a transaction fails and the SPAC subsequently consummates a business combination with another company. In an IPO, there is no analogous means of seeking recourse in the event the transaction fails.
Timing.

Typically, there is not a significant timing difference between an IPO and a business combination with a SPAC. While the IPO of a SPAC is considerably faster than an operating company IPO (due to minimal disclosure as a result of no historical financial results to be disclosed or assets to be described), the acquisition by a SPAC of a target company takes a similar period of time as an IPO of the same entity would. The shareholder approval process (or tender offer) in connection with the business combination would involve audited financials, full disclosure regarding the target company and SEC review — similar to what is required in an IPO. However, if no shareholder approval is required, there can be a time advantage to a business combination since the SEC review of a tender offer is accelerated compared to the SEC review of an IPO or a proxy statement.

Regulatory Treatment

Upon completion of a De-SPAC transaction, U.S. Securities and Exchange Commission rules require the surviving entity to file a Form 8-K, sometimes referred to as a "Super 8-K," which contains all of the information that would be required in a Form 10 registration statement. In addition, due to a SPAC's former status as a shell company, the surviving entity after a business combination has to comply with additional SEC and stock exchange requirements, including:

- SPACs are considered "ineligible issuers" who are not entitled to use a free writing prospectus or any graphic communications (such as an electronic roadshow) in its IPO or in subsequent securities offerings within three years of filing the Super 8-K;

- SPACs cannot use Form S-8 to register management equity plans until 60 days after filing the Super 8-K; and
- SPAC shareholders cannot use Rule 144 to sell shares until one year after filing the Super 8-K.

Redemptions in connection with a SPACs initial business combination (which result in a reduction in the number of holders of the SPAC's equity) can cause the surviving entity to no longer satisfy the applicable stock exchange's continued listing requirements with respect to the required number of round lot holders (meaning holders of 100 or more shares of the SPAC's stock) — both in connection with its common shares and its warrants. If the SPAC is not able to remedy the situation, it will face delisting which could have materially negative consequences.

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