In the loop

May 2021

The SPAC spree: Current state

What you need to know

- The last eighteen months has seen increased IPO and SPAC activity.
- When deciding how to go public, private companies should consider the benefits and challenges of a SPAC transaction.
- Investors need to weigh the benefits and associated risks of investing in a SPAC to make the investment decision that is right for them.

2020 will forever be known as the year that brought us both a global pandemic and a historic presidential election. Amid those headlines, it was also the year of an active initial public offering (IPO) market through investment vehicles known as “SPACs,” a trend that has continued and even accelerated in 2021. Going public through a “special purpose acquisition company” has become extremely popular. Sometimes referred to as a “blank check” company, a SPAC is created with capital from its initial investors, undergoes an IPO to raise additional capital, and acquires a private company target that becomes a public company (or a subsidiary of one), often referred to as “de-SPACing.”

Typical SPAC transaction

While SPAC structures have existed for years, they have increased in popularity as a way for private companies to access liquidity via the public market. The SPAC spree has been largely driven by:

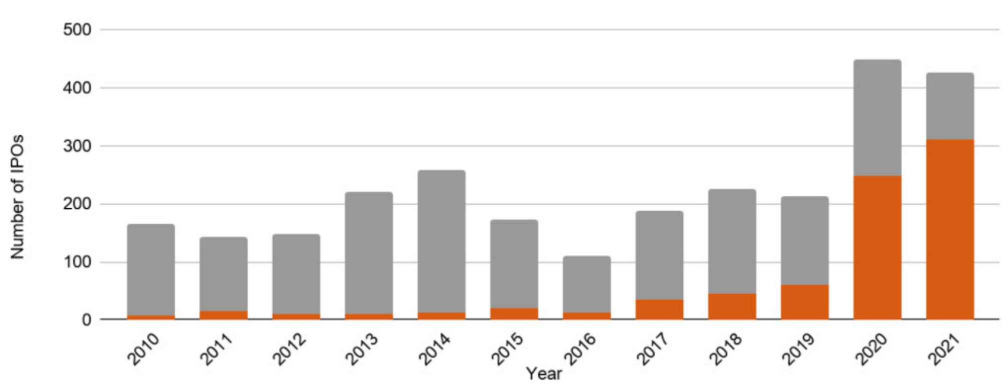
- The players: High-profile SPAC sponsors are entering the SPAC space.
- The private equity appeal: SPACs offer an exit opportunity for private equity owners looking to monetize a private company investment in a shorter timeframe than in a traditional IPO.

Private companies looking to go public through a SPAC transaction should consider all of the benefits and challenges before deciding whether merging with a SPAC is the right path for them. Additionally, potential investors in a SPAC should weigh the benefits against the risks associated with these investments before making any investment decision.

SPAC and US IPO activity

Traditional IPO SPAC IPOs

Source: SPAC Analytics (data through May 5, 2021)



Taking a deeper look at a SPAC transaction

SPACs are generally formed by a sponsor that has a nominal investment in the SPAC. In exchange for that nominal investment, the sponsor usually receives a 20% interest in the post-IPO company—commonly referred to as founder shares. The remaining interest in the SPAC is held by institutional investors (e.g., hedge funds) and the general public. However, investors might not know what company they ultimately will be investing in when they decide to invest because a target does need not be identified before the capital-raising phase of the SPAC IPO.

Following the SPAC's IPO, the capital raised by the SPAC is placed in a trust account, and the SPAC sponsor generally has 18-24 months to complete an acquisition or it will be required to liquidate and return the money to investors. Once a target company is identified and a merger is announced, the SPAC's public shareholders may vote to approve the transaction or redeem their shares. Once the shareholders approve the SPAC merger and all regulatory matters have been cleared, the merger closes and the target becomes a public company.

There are some who believe that a SPAC transaction, unlike a traditional IPO, allows a reprieve from liability related to the use of forward-looking statements or projections. In a recent **statement**, John Coates, acting director of the SEC's Division of Corporation Finance, questioned whether the safe harbor in **securities law** applies to SPAC transactions, stating that the claim about reduced liability exposure for SPACs is "overstated at best, and potentially seriously misleading at worst." In short, Coates said a SPAC transaction is not a "free pass for material misstatements or omissions."

What private company targets should expect in a SPAC transaction

Private companies and their owners should consider all of the benefits and challenges of a SPAC in deciding whether it is the right vehicle for them to enter the public markets.

Benefits

Access to capital and potential to sell a bigger stake in the company

SPACs give private companies access to public markets, particularly during times of market instability, and help open the door to permanent capital. A SPAC raises capital through an IPO prior to acquiring a private company target. If it needs additional capital to complete the transaction with the private company target, it may raise funds through various vehicles, including a private investment in public equity (PIPE).

Additionally, SPAC transactions typically allow private company owners looking for an exit strategy a chance to sell a larger stake in a company than might otherwise be possible in a traditional IPO.

Greater market certainty

Missing the right pricing "window" can have a significant impact on the success of a company's traditional IPO. With SPACs, target companies can negotiate a "locked in" price of their stock with the SPAC sponsor as part of their agreement and avoid the potential valuation hit that can happen with traditional IPOs in times of market volatility.

Flexible deal terms

In addition to the ability to negotiate the sale price of the company to the SPAC, SPAC transactions provide flexibility to negotiate other parts of the deal. For example, if investors decide to withdraw their capital before the acquisition closes, SPAC sponsors might agree to fund any cash shortfalls at the time of closing.

Access to experienced managers

Partnering with a strong sponsor may allow a private company target to benefit from its resources and experience. A seasoned sponsor may help when additional capital is needed. It may also tap into its network to build a strong management team for the target.

Challenges

Potential for increased cost

The "units" issued as part of the SPAC's IPO consist of a share of common stock and a fraction of a warrant to purchase common stock that becomes exercisable after the de-SPAC transaction is completed. With the dilutive nature of the warrants, the economic cost of a SPAC transaction may exceed that of a traditional IPO.

Possible loss of control

The private company and its owners may lose some control as the SPAC sponsor may negotiate representation on the board of directors and more active involvement in the post transaction company.

> The staff at the Securities and Exchange Commission are continuing to look carefully at filings and disclosures by SPACs and their private targets..staff are reviewing these filings, seeking clearer disclosure, and providing guidance to registrants and the public. They will continue to be vigilant about SPAC and private target disclosure so that the public can make informed investment and voting decisions about these transactions.
>
> – John Coates, Acting Director,
> SEC Division of Corporation Finance

Public company readiness

When a target company and a SPAC sign a merger agreement, it triggers the need for certain SEC filings that the SPAC must complete within a specified time period. While the shorter window may mean the private company becomes publicly traded sooner, the set deadlines may place a high burden on the private company and its management team since much of the information in the SPAC filings is that of the private company. Alternatively, a company intending to go public through the traditional process sets the timing for its IPO. This means a company going public via a SPAC will likely need to meet an accelerated public company readiness timeline when compared to a traditional IPO for substantially the same preparation, due diligence, prospectus drafting, and SEC engagement and oversight, including the following.

The target company will need to be in compliance with SEC reporting requirements, including MD&A, earnings per share, segments, adoption of new standards on public company timelines, and interim reporting (although, similar to a traditional IPO, the target company may qualify for reporting accommodations provided to a smaller reporting company or an emerging growth company in certain circumstances).

The annual financial statements will need to be audited, and interim financial statements may need to be reviewed, under PCAOB standards.

Accounting and reporting complexities

A de-SPAC transaction may result in a change in control. Determination of whether the target or the SPAC is the accounting acquirer may require judgment and can lead to different accounting models.

Pro forma financial information will typically be required to provide a comprehensive view of the de-SPAC transaction, including multiple redemption scenarios.

Additionally, a de-SPAC transaction typically requires multiple steps of legal or equity restructuring that could have tax implications.

Warrants

The SEC staff recently issued **a statement** that highlighted certain features in SPAC warrants that may result in the warrants being classified as liabilities (rather than equity) and remeasured to fair value each reporting period through the income statement. To the extent SPACs have not appropriately considered the accounting for warrants, they may need to correct their financial statements, possibly slowing down the IPO or merger transaction.

Investor considerations

SPAC transactions come with their own set of benefits and risks to investors. Before investing in a SPAC, it is important to know what this type of investment involves, what rights or protections investors have, and what capital is at risk throughout the various stages of the SPAC merger.

Benefits

Protective rights and additional profit opportunities for early investors

The capital raised by the SPAC from investors is placed into escrow and earns a small amount of interest while the SPAC sponsor searches for a target. Investors in the SPAC IPO also receive warrants in the SPAC as part of the units purchased, enabling them to participate in the upside, something later investors do not receive.

If the SPAC sponsor is unable to find a target company in the allotted time frame, or if investors are unhappy with the chosen target, shareholders may redeem their original investment.

Ability for some investors to get in on the ground floor

SPACs offer individual retail investors a chance to participate in a private company going public. In a traditional IPO, companies raise money from institutional investors and retail investors may miss out on the chance to participate. With a SPAC, anyone can buy in since the SPAC often trades publicly before a deal is even announced.

Voting rights

While investors in the SPAC IPO cannot choose the target company, they can choose to either vote in favor of the target selected by the SPAC sponsor or vote against it. This ability to have input differs from the structure often used in a venture capital pool where investors place their money in a "blind pool" to be invested at the sole discretion of the venture capital group.

Risks

Potential for increased cost

The primary source of a SPAC's potentially high cost is the dilution inherent in the SPAC structure from:

- the sponsor "promote"—typically 20% of the post-IPO equity in the newly-formed public company in exchange for a nominal investment,
- warrants purchased by early investors, allowing them to economically benefit even if they redeem their initial investment shares,
- shares received by target company shareholders to incentivize them to agree to the merger, and
- redemptions from shareholders (One recent study showed that a median of 73% of SPAC IPO proceeds were returned to shareholders as a result of redemptions during 2019 and the first half of 2020.[1]).

SPAC sponsor

Since most target companies are not identified until later, early investors are investing in and relying on the sponsor, not on the to-be-identified target company. But SPAC sponsors can have conflicts of interest and their economic interests in the SPAC may not align with investors. The sponsor can turn a significant profit, regardless of how well the company does after it acquires a target.

Quality of the target company

The SPAC transaction relies heavily on the sponsor, who is incentivized to identify a target company and close an acquisition. Given the time constraint placed on a sponsor to find a target company within 18-24 months, the sponsor may need to accelerate the timeline to find a company to acquire. Additionally, as the SPAC space is becoming increasingly crowded and competitive, the ability to identify viable target companies is becoming more challenging. Investors might find their money going into a merger with a lower quality target company that is not initially as fully prepared to become a public company.

1 "A Sober Look at SPACs" by researchers at Stanford University and New York University School of Law, October 2020 (revised April 2021)

The future of SPACs

There continues to be a large investment of capital in existing SPACs seeking targets and a growing number of private equity firms, venture funds, and other sponsors forming SPACs. Currently there are 257 SPACs in the IPO pipeline and 559 that have completed their IPO and are either searching for a target or have announced an acquisition.[2] So will this SPAC popularity continue throughout the remainder of 2021 and beyond? Only time will tell.

For private companies, deciding how to go public is a strategic decision. With the possibility of variation in deal structures and sponsor relationships, private companies and their owners should consider the benefits and associated risks before concluding that merging with a SPAC is the right path forward for them.

And investors will also need to weigh the benefits and risks associated with SPAC transactions before deciding whether to invest in one. Not all SPACs are created equal, and careful consideration should be given to each potential opportunity.

To have a deeper discussion, contact:

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2 SPAC Analytics, viewed May 5, 2021