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Spac Transactions In The United States

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SPAC TRANSACTIONS IN THE UNITED STATES

In 2020, amidst the sweeping changes in business and social behavior resulting from the COVID-19 pandemic, the surge in the activity of special purpose acquisition companies ("SPACs") emerged as one of the new and most prominent M&A topics in the United States. Although SPACs have existed in various forms since the 1990s, they have not featured so prominently in overall M&A activity until recently. In 2020 alone, SPACs raised a combined $83.4 billion from 248 IPOs and completed 64 mergers with operating businesses worth a combined $70.2 billion in equity value. To put this activity in perspective, SPAC IPO and merger values increased on an aggregate basis more than six times and nearly four times, respectively, in 2020 compared to 2019 ($13.6 billion across 59 IPOs and $19.6 billion across 28 mergers) and more than twenty times in each case compared to 2015 ($3.9 billion across 20 IPOs and $2.6 billion across 8 mergers). The dramatic rise in deal activity, however, is only part of 2020's SPAC story, which also involved shifts and developments in the types of sponsors forming SPACs, the ways SPACs are structured and how SPACs negotiate transactions in an increasingly competitive M&A market.

A Brief History of SPACs

SPACs as we know them first appeared in the U.S. capital and M&A markets in the 1990s, with certain of their structural features persisting through the present boom. SPACs then and now are shell companies formed by sponsors to raise capital in an IPO for the purpose of acquiring an operating business within a specified time period (typically 18-24 months). Over the years, a typical capital structure has emerged. At formation, sponsors usually purchase (1) whole warrants in the SPAC ("sponsor warrants") for an amount of cash equal to the IPO expenses, plus a specified amount for future operating expenses of the SPAC, and (2) shares of common stock of the SPAC ("sponsor shares") for nominal consideration equal to 20% of the post-IPO share count. In the IPO, SPACs generally sell units to the public consisting of shares of common stock ("public shares") and fractional warrants ("public warrants"). The IPO proceeds are then placed into a trust account until the time of a business combination (also called a "de-SPAC transaction") or liquidation of the SPAC if a deal is not completed within the specified time period.

Under U.S. Securities and Exchange Commission ("SEC") rules, SPACs cannot identify a specific target at the time of the IPO, though they may focus on targets in a particular industry or geography. As an inducement to IPO investors to park their cash in the trust account while the applicable SPAC searches for an unidentified target, SPACs grant IPO investors the right to redeem their initial investment under certain circumstances. Until 2015, this redemption was limited to a portion of the initial investment (typically 85%) upon liquidation or a vote by the applicable investor against a proposed de-SPAC transaction following its submission to stockholders for approval. Beginning in 2015, these features were broadened in the typical SPAC to give investors the right to redeem 100% of their initial investment, with interest, upon liquidation or a business combination, irrespective of whether they vote for or against a proposed transaction. In addition, today, SPACs generally permit IPO investors to retain their public warrants even if they have otherwise redeemed their public shares, though variations on this and other aspects of the typical SPAC structure have been introduced in response to certain critiques of the existing structure and competition among SPACs for targets.

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Key Trends in SPAC Transactions

Higher Profile Sponsors Are Hunting for Larger Targets

In the United States, one of the drivers of the surge in SPAC activity has been the flood of high-profile private equity firms, activist investors, former CEOs of Fortune 500 companies and other high-visibility investment, management and entertainment professionals into the SPAC market as sponsors, including sometimes as repeat sponsors of a series of SPACs. Their entry has had the pull-through effect of bringing bulge-bracket investment banks into the business of underwriting SPAC IPOs and advising on de-SPAC transactions. Together, the involvement of these high profile sponsors and underwriters has contributed to a change in perception of SPACs from a niche investment structure to what is now perceived as a mainstream alternative to traditional IPOs.

The shift into the mainstream has been accompanied by increases in the average size of SPAC IPOs and the pursuit by sponsors of larger acquisition targets, especially in the technology, health care, leisure and hospitality, energy transition and financial services sectors. In 2020, SPACs raised, on average, $336.0 million of IPO proceeds (up from $230.5 million in 2019 and $195.1 million in 2015) and acquired businesses worth, on average, $1.1 billion in equity value (up from $700.2 million in 2019 and $327.1 million in 2015). The largest de-SPAC transaction to date, the $16 billion acquisition of United Wholesale Mortgage by Gores Holding IV, was announced in 2020 and completed in early 2021. Currently, the average de-SPAC transaction has a target company enterprise value that is five times the SPAC's equity capital, driven by a combination of the increase in proceeds from larger IPOs and the ability of today's sponsors to attract additional sources of capital to finance de-SPAC transactions.

SPACs Are Turning to External Capital Sources to Complete Deals

In 2020, SPACs frequently sought additional financing beyond their IPOs. This need has arisen, in part, to fund acquisitions of larger targets, offset the depletion of trust account funds from stockholder redemptions and/or place additional cash on the balance sheet of the combined company if so desired by the parties involved in the transaction. SPACs' options for additional financing include, among others, private investments in public equity transactions ("PIPEs"), forward purchase agreements (whereby an IPO investor commits or has the right to purchase newly issued shares at the time of a de-SPAC transaction) and committed debt financing. Of these and other options, PIPEs have emerged as the most popular source for external capital. In 2020, 69% of de-SPAC transactions (comprising 44 deals) were supported by PIPEs, with an average PIPE size of $288 million (compared to an average initial trust amount of $296 million for the subset of de-SPAC transactions supported by PIPEs).

The use of PIPEs, however, is by no means an exclusive path. SPACs often negotiate with one or more financing sources in parallel to their negotiations with targets. In light of this dynamic, PIPEs are sometimes combined with other sources of equity financing, such as forward purchase agreements, or alternatives to additional financing, such as the entry into non-redemption agreements whereby SPAC stockholders waive their right to redeem. In 2020, within the cohort of de-SPAC transactions supported by PIPEs, 14% (6 deals) involved forward purchase agreements and 7% involved non-redemption agreements (3 deals).

Although redemption rights continue to create uncertainty for targets given their potential impact on the trust account cash available to complete a de-SPAC transaction, redemptions have recently declined on

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a mean and median basis relative to prior years. In 2020, the mean and median redemptions of shares then outstanding for the applicable SPACs were 38% and 25%, respectively (compared to 55% and 72%, respectively, for de-SPAC transactions completed between 2016 and 2019), though it is worth noting that the redemption decision in any particular transaction is based on deal-specific facts and circumstances that are likely independent of the factors contributing to the overall trend.

Competition Is Impacting Deal Terms

While multiple factors influence any M&A negotiation, two in particular have impacted or have had the potential to impact de-SPAC transactions. These factors are: (1) the ticking clock that is the specified period by which SPACs must complete a de-SPAC transaction and (2) the increased competition between SPACs, which given the recent surge in SPAC IPOs are significantly more likely today to compete against other SPACs than in prior years. As of mid-March 2021, there were approximately 500 active SPACs, nearly 400 of which were seeking targets and approximately 100 of which had announced de-SPAC transactions. By comparison, the current number of active SPACs is more than double the number of all SPACs that completed IPOs in the ten years prior to 2020 (226 IPOs between 2009 and 2019, with an average of 20 IPOs per year).

Against this backdrop of competition, SPAC sponsors often face pressure to forfeit all or a portion of their shares or warrants and/or to impose vesting conditions on their shares to limit their dilutive effect on post-closing stockholders (including target stockholders and/or other equity investors providing additional financing). In 2020, sponsors forfeited shares or warrants and/or accepted vesting conditions on their shares in 59% of de-SPAC transactions. Within the subset of de-SPAC transactions involving forfeiture (38 deals), 47% required forfeiture of shares and warrants, 40% shares only and 13% warrants only. For de-SPAC transactions with vesting (24 deals), 46% required vesting of 5 years or more and 17% tied vesting to the combined company achieving certain share price milestones following consummation of the de-SPAC transaction.

In addition, SPACs have used earnouts for target stockholders to bridge valuation gaps. In 2020, 53% of de-SPAC transactions had an earnout. Unlike traditional earnouts, which are often based on financial performance metrics or specified business milestones, earnouts in de-SPAC transactions are typically tied to stock price performance. The earnout consideration can be cash, equity or a combination thereof. Among 2020 deals with earnouts, the most common consideration was the issuance of new common stock, with the average earnout constituting approximately 15% of the total equity value of the de-SPAC transaction. The length of earnout periods within this cohort varied. Of the 34 deals with earnouts, 44% had an outside date of five or more years, 36% had an outside date of three or four years and 20% had an outside date of some other duration.

Perception of Economic Misalignment Is Driving Structural Innovation

A common critique of SPACs is that the typical structure creates economic misalignment among sponsors, IPO investors, target and other long-term stockholders with respect to the de-SPAC transaction. In the typical structure, sponsors are incentivized to complete a transaction within the specified time period because their sponsor shares and warrants will be worthless unless a de-SPAC transaction is consummated, but have limited incentives tied to the long-term performance of the combined company. IPO investors can redeem their shares upon a de-SPAC transaction, but retain their

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public warrants. In turn, these features decrease the availability of SPAC equity capital to fund the deal, while increasing the cost of that equity post-transaction due to the potential dilutive impact of the warrant overhang.

Sponsors and underwriters have introduced structural variations to address these issues of economic misalignment. To date, the variations have included reducing the amount of sponsor shares issued or eliminating them altogether; imposing performance-based vesting on sponsor shares at the IPO stage; restricting stockholders and their affiliates from redeeming an amount of shares above a specified threshold; and causing redeeming stockholders to forfeit their warrants. Notable examples of new variants that are in the active market are Pershing Square's SPAC (no sponsor shares; warrants are forfeited if shares are redeemed); Morgan Stanley's SAIL℠ structure (reduced sponsor shares; stockholder redemptions are limited); Evercore's CAPS™ structure (reduced initial sponsor shares; additional sponsor shares are subject to performance-based vesting); and Morgan Stanley's SCALE structure (sponsor shares are subject to performance-based vesting).

Litigation Is on the Rise and Other Issues

There have already been a number of lawsuits related to SPAC transactions and it seems likely that the number of lawsuits will continue to increase over time. Many of the recent cases related to SPAC transactions have alleged inadequate, false or misleading disclosures in securities filings. In addition, de-SPAC transactions are not immune from the same strike suits that most public-company M&A deals attract, and observers should expect an increase in the number of strike suits challenging the adequacy of de-SPAC transaction proxy disclosures.

It is also worth noting that certain trends in the governance of combined companies created by de-SPAC transactions have run counter to policies supported by proxy advisory firms, large institutional investors and the SEC. As public companies continue to take steps to have larger, more diverse non-staggered boards of directors, the boards of directors of combined companies created by de-SPAC transactions in 2020 were frequently staggered (70% of such boards) and smaller on average than S&P 500 boards of directors (8 vs. 11 directors), often with SPAC representatives holding multiple seats (2 or more in 56% of such boards).

Conclusion

SPAC activity has ebbed and flowed in the past in the U.S. capital and M&A markets, but never before to the heights achieved in 2020. While some observers have characterized the surge as a "bubble", SPAC activity has shown no signs of slowing down in 2021. Between January and mid-March 2021, more than 360 SPACs filed for IPOs, which means regardless of whether SPAC IPO activity continues at its current pace, SPACs as buyers will likely remain a fixture in the U.S. M&A market for at least the next couple years while time remains within the specified period they have to complete de-SPAC transactions or liquidate.

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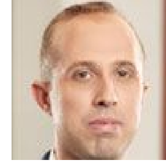

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