SQUIRE PATTON BOGGS

Special Purpose Acquisition Corporations

Making Them Work for Their Merger Partners

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Without a doubt, the trendiest transactions on Wall Street during 2020 were the formation of special purpose acquisition corporations (SPACs) and the follow-on mergers that enabled private companies to achieve public company status without the rigors and risks of traditional IPOs or the shadiness often associated with reverse shell mergers.

Standard & Poor's Capital IQ reported that there were 294 SPACs formed in 2020, up from 51 in the prior year, and more than double the number of SPACs formed in the prior three years. Equally impressive was the list of prominent individuals associated with SPACs. Their credentials (or at least notoriety) conferred an aura of respectability upon this asset class, which it had not previously enjoyed. Recent SPAC sponsors have included alumni of Citigroup and Goldman Sachs, the former Chairman of General Motors, renowned investor Bill Ackman, Shaquille O'Neal, Billy Beane of "Moneyball" fame, and former House Speaker Paul Ryan. This parade of notables led Peter Atwater of Financial Insyghts to quip: "If you don't have your own SPAC, you're nobody."

The sheer volume of recent SPAC transactions, coupled with the improved pedigree of SPAC sponsors, suggest that they are overcoming the taint associated with their ancestors – the much-maligned reverse shell mergers of the early 2000's and discredited "blank check" public companies of the 1980's – and are moving more into the mainstream of the US capital markets.

Post-merger stock SPAC price performance suggests, however, that SPACs remain a somewhat unproven tool for private businesses seeking not just public company status, but also long-term wealth creation for their shareholders.

Yet, with only 9% of the 294 SPACs in the class of 2020 having found their merger partners, there is no doubt that the remaining 200+ companies that continue to seek a business combination present a target rich environment for a privately owned business, private equity portfolio company or orphaned division of a larger company seeking to be acquired. Indeed, Standard & Poor's Capital IQ reports that approximately US$170 billion resides within SPACs that must be invested within the next two years.

Given the prominence of SPACs on the current M&A landscape, it is important for the managers and directors of companies considering a SPAC transaction (and for those professionals who advise them) to understand how SPACs work, why they have achieved popularity, how their sponsors and original investors financially benefit, how SPACs are managed, the perceived benefits of SPACs, the pitfalls that the SPAC structure can create for acquired companies, and how to use the competitive environment facing SPACs to circumvent those pitfalls.

What Is a SPAC?

A SPAC is a publicly listed company created and designed to acquire one or more privately held enterprises. At the outset, a SPAC is a shell company with no operations or assets other than the cash contributed by its sponsors and raised in its public offering.

In its public offering documents, the SPAC will customarily define one or more areas of investment interest. Traditionally, this has been a stated intent to effect a single acquisition or "roll up" within an identified industry. More recently, several SPACs have enunciated socially conscious investment goals such as the desire to back minority-owned enterprises or companies pursuing sustainable business objectives.

Following its public offering, the SPAC's sponsors will work to complete one or more merger transactions consistent with the SPAC's stated investment intent, after which the combined company will continue the operations of the acquired private company (or companies) as a public company.

Under Securities and Exchange Commission (SEC) rules, a SPAC must place all proceeds of its initial public offering into an escrow account pending the acquisition of one or more operating companies via a merger approved in accordance with governing state law by the SPAC's shareholders. If no suitable merger candidate is found within two years, the initial investors in the SPAC receive their money back, with interest.

Due to these protective features and other regulatory and market-driven reforms, SPACs are distinguishable from the dodgy blank check IPOs of the 1980s. These changes have imparted a legitimacy to SPACs that has been enhanced by the participation of leading investment banking firms and celebrity sponsors, as well as by an increased number of quality companies choosing to go public using a SPAC merger.

These factors have also combined to make a SPAC transaction clearly preferable to a reverse shell merger with a former operating public company, which remains a suspect (or even tawdry) transaction in the minds of many market observers and participants.

What Has Fueled the Spate of SPACs?

Approximately US$93 billion was raised in SPAC offerings during 2020, according to Standard & Poor's Capital IQ. This compares with just US$55 billion raised in traditional IPOs during the same period and US$73 billion raised in all IPO and SPAC transactions combined in 2018 and 2019. KPMG reported in September 2020 that there were 25 SPAC offerings in the first nine months of 2020 in which SPACs raised a minimum of US$350 million, with at least nine SPAC offerings clearing over US$1 billion. During that same period, KPMG reported that 19 SPAC merger transactions with deal values between US$1.1 billion and US$11 billion had been consummated.

Several factors have driven the growth of SPACs. First, hedge funds (sometimes referred to as members of the "SPAC Mafia") have been flush with cash that they have been unable to deploy in ways that compete with the low risk returns that they have been able to achieve in SPAC transactions. These returns (and the absence of risk) are largely attributable to the traditional structure of a SPAC investment. In most SPACs, the initial investors purchase for US$10 a "unit" consisting of one share of stock and one warrant representing the option to buy up to one share of the SPAC's stock for US$11.50 at any time within five years of the SPACs merger with an operating company.

When the SPAC merges with its chosen operating company, the initial SPAC investor has the contractual right to redeem each share of stock that it purchased for US$10 plus interest, while retaining its warrants. This warrant "kicker" has the potential to become very valuable in the future, particularly given that the initial SPAC investor has no cost basis in is warrants whatsoever.

Second, SPACs generate significant economic returns for their sponsors who typically retain between 20-25% of the post-merger company in return for a nearly nominal initial investment (or a deeply discounted stock purchase price) in return for their time and efforts in forming the SPAC and shepherding its public offering.

Third, SPAC formation transactions (not to mention the follow-on mergers) generate substantial transaction fees for investment banks.

Fourth, the involvement of prominent sponsors and the increased willingness of quality companies, (including several high-profile "unicorns") to use SPAC transactions to achieve public company status have combined to make SPACs not only respectable, but fashionable.

Fifth, SPACs enjoy a kind of "regulatory arbitrage" that permits young and start-up companies going public through a SPAC to tout more frothy growth prospects than they could make in a traditional IPO by taking advantage of the "safe harbor" for forward looking statements that Congress made available to public companies in an effort to curtail groundless securities litigation.

Sixth, highly leveraged companies or those with "quirky" characteristics for whom the traditional IPO path is unavailable have been able to go public through SPAC transactions.

Finally, SPACs can be marketed to potential private company merger partners as a better and more certain way in which to go public, as discussed in greater detail below.

How Are SPACs Customarily Formed?

SPACs are typically formed by one or more individuals in collaboration with an investment bank who work to assemble a team, including a board of directors, who can execute the SPAC transaction. This core group will select legal counsel, an audit firm and perhaps an investor communications specialist to help execute the transaction.

The investment bank and legal counsel will drive the process of preparing the legal documentation and SEC and stock exchange filings associated with the SPAC. The investment bank will then assume the lead role in marketing the company to its initial investors.

During this stage, the SPAC sponsors usually lend money to the company to fund ongoing expenses until the offering provides funds to repay these advances.

How Are SPACs Managed and Governed?

At the time of formation, a SPAC is typically managed and governed by the sponsors who organized it and a small group of directors chosen with their knowledge of the industry targeted by the SPAC. This latter category of directors is intended to increase investor confidence in the integrity of the SPAC's management team and the ability of the SPAC to identify and attract a suitable merger partner.

Following its merger with an operating company, the management team of the acquired company will typically manage the business under the oversight of a board of directors composed of designees of the SPAC sponsor and designees of the acquired company, joined by independent industry experts mutually acceptable to those groups. It is not uncommon for the post-merger company to make substantial additions to the management team of the former private company to better execute the legal, financial, regulatory and market communications functions of a public company.

What Are the Perceived Benefits of SPAC Mergers Versus an IPO?

SPACs are marketed as a more certain and less time consuming way in which to achieve public company status. There is no need to perfectly time completion of the traditional offering within a so called "open IPO window," which experience has shown can close for reasons entirely out of the control of the offering participants, leaving a wake of unmet expectations and capital needs and a tsunami of transactions costs. This proved to be a key motivation in 2020 as companies seeking an IPO feared the volatility and uncertainty in the markets resulting from the COVID-19 pandemic.

Second, the traditional IPO entails valuation uncertainty until very late in the IPO process. Conversely, in a SPAC transaction, the company's valuation is set through negotiation with a single merger partner rather than by investor consensus following an arduous and time-consuming road show.

Third, founders and other large shareholders in the private company can often sell a higher percentage of their ownership in the company in a SPAC transaction than they could in a traditional IPO. They are often able to avoid or shorten the "lock-up" periods almost always required in an IPO.

Why Are SPACs Still Sometimes Criticized?

SPACs have an uneven track record of generating lasting value for their post-merger shareholders, including those shareholders of the merged company who accepted SPAC shares as consideration. A *Wall Street Journal* report from November 2020 states that the 107 SPACs that consummated mergers since 2015 have produced an average return on their shares of negative 1.4%. During that same period, that same report indicated that the average return for traditional IPO companies was positive 49%.

Another *Wall Street Journal* opinion published on January 6, 2021, reported that SPACs completing mergers between January 2019 and June 2020 lost, on average, 12% of their value within six months of those merger transactions, as compared with a roughly 30% increase in the Nasdaq index during that period. This negative stock performance contrasted starkly with a nearly 500% return on their investment enjoyed by the SPAC sponsors of those same companies due to their largely "carried" interest.

This misalignment of interests and returns has caused some to criticize the SPAC structure as inherently flawed. They observe that SPAC sponsors are motivated to seek the lofty returns available to them without having the meaningful "skin in the game" that would cause them to focus on the quality of their merger partner or ability of the combined company to sustain success in the public markets.

Moreover, because of the redemption rights of the initial SPAC shareholders, the promise of ready access to capital to fund the growth of those companies acquired by SPACs has sometimes been elusive. The same *Wall Street Journal* study found that the group of SPACs studied had less than US$6.75 per share in cash at the time of their mergers, despite the US$10 value ascribed to their shares at that time of the merger.

SPACs also present themselves as a less expensive way in which to achieve public company status. While this may be true in some cases, in a typical SPAC, the dilution associated with the 20% or more share of the company retained by the sponsors can make the "all in" costs of the transaction quite high.

Some recent SPAC offerings have recognized these problems and have attempted to address them through lower sponsor-related dilution and covenants requiring minimum cash on closing. These measures may become the market norm going forward, driven by the need for an individual SPAC to compete against hundreds of other SPACs seeking a merger partner before time runs out and they are forced to refund their IPO proceeds. In addition, an operating company with a strong story may be in a position to negotiate for better terms as the remaining crop of 2020 SPACs face the prospect of returning their funds to their original investors.

In short, better deals for SPAC shareholders and merger candidates may prove to be a competitive market driven cure for the ailments plaguing SPAC performance in the past. It could also play out that, as better quality companies use SPACs to achieve public company status, the performance gap between SPAC companies and traditional IPO companies will narrow.

Key Considerations for Companies Considering a Sale to a SPAC

The owners and managers of a company considering a SPAC transaction should carefully consider a number of factors, including:

- Has the company fully assessed the risks and rewards of a SPAC transaction in comparison to a traditional IPO or sale to a private equity sponsor or other private buyer?
- Does the seller have a solid understanding of the company's potential public market valuation in an IPO? Is the seller in a position to make an "apples to apples" comparison on what can be achieved in a SPAC transaction, an IPO or a private sale?
- Is an IPO of the company even feasible, given its size, growth prospects and leverage profile?
- What are the goals of the transaction? Can all of them they be achieved through a SPAC merger? Are any important goals unaddressed? Can they be achieved with a different transaction form?
- How experienced are the SPAC's sponsors? Do they have a track record of successfully completing a SPAC transaction? Of building long-term shareholder value after the merger? Do they have sector-specific expertise?
- Is there a good cultural "fit" with the SPAC sponsors and those who they will place on the combined company's board of directors following the merger? What due diligence can be done with former business partners and associates of these individuals to make that judgment?
- How will the combined company board be composed after the merger?
- Does the target company have individuals within its ranks who are well-suited and prepared for public company board service? Does the seller need to recruit individuals who will "hold their own" with the directors appointed by the SPAC sponsors and otherwise effectively represent its interests on the SPAC board.
- Is the company prepared for the intense and time-compressed due diligence process associated with a SPAC merger?
- Can the company weather a failed SPAC transaction? Can it absorb the transaction costs, delay the financing aspects of a SPAC merger and still remain viable?
- Does the target company have a team of advisors that can smoothly and competently handle such a transaction?
- Does the target company have (or can it readily attain) sufficient audited historical financial statements in line with company expectations?
- Can the company make all of the disclosures required of a public company?
- Does the selling company have appropriate internal control structures? Is it in a position to document and certify that those internal controls are in line with a public company Sarbanes Oxley reporting?
- Does the company have the sophisticated budgeting and tax planning capabilities required of a public company?

- Has the acquired company sufficiently invested in its IT structure and cybersecurity given both the enhanced attention it will be receiving and the required SEC disclosures in those areas?
- How robust are the selling company's processes for closing the books, budgeting and forecasting? What would be required to enhance the company's compliance reporting and disclosure mechanisms?
- Will the combined company have the necessary legal, financial, investor relations and other personnel required to successfully operate a public company, or can it readily assemble them?
- How much cash will the combined company need following the merger? What measures should be put in place to assure that sufficient cash will be available following the likely redemptions by the SPAC's original investors.

Conclusion

SPACs are essentially a "ready-made/off the rack" alternative to the bespoke approach of a traditional IPO. They offer identifiable timing, transaction certainty and other benefits. They also present a number of complexities, costs and risks that must be understood by any target company evaluating a SPAC as an alternative to private sale or an IPO.

Assembling a team of professionals who have prior experience with SPACs is a crucial first step. Researching potential SPAC partners for the suitability of a "fit" will also be an important threshold activity. A clear-eyed discernment of the operating company's capabilities, short-term needs and long-term goals should be made as a foundation for making the right choice of sale options. No SPAC company is guaranteed a successful future or strong market following simply by virtue of its public listing, and thoughtful planning for post-merger market communications, and perhaps an early traditional capital raising transaction that will spotlight the company, can make a meaningful difference.

With several hundred SPACs motivated to find marriage partners within the next two years, the opportunity for any quality private company to mate with an ardent SPAC clearly exists. Whether that is the right opportunity is a matter to be thoughtfully considered.

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