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Generations Summer 2021 - Is the SPAC Boom Fading?

At the start of 2021, the number of special purpose acquisition company (SPAC) transactions was exploding, but by the end of the first quarter, registrations of new SPACs had slowed abruptly. This led many commentators to speculate that the market may be saturated

SPACs, also known as "blank check companies," have been around for decades. They are an alternative to traditional initial public offerings (IPOs). SPACs are created for the purpose of raising money in an IPO to acquire a private operating company. In the last year, the use of SPACs has grown exponentially, in many cases replacing IPOs in taking companies public. SPAC sponsors range from all-star athletes to family offices to hedge fund principals. The risks and rewards of SPACs vary at every step of the transaction and for every type of participant.

The Three Stages of a SPAC Transaction

There are three key stages of a SPAC transaction: formation, target identification and target acquisition (called a "de-SPAC transaction").

At the formation stage, a sponsor—typically an institutional investor with a track record or a private equity fund headed by a prominent investor—forms a corporation with the intention of conducting an IPO to raise funds from the public. At the time of the IPO, the SPAC does not have an operating business. Rather, the SPAC raises funds with the intention of later acquiring an operating business. Investors look to the sponsor to select a company to acquire.

The sponsor makes a nominal capital contribution to the SPAC and receives "Founder Shares," which are often accompanied by warrants. The SPAC then launches an IPO to raise capital from public investors. Units are sold for a fixed amount (typically $10.00 each). The units provide investors with one share of stock of the SPAC along with a warrant allowing the investors to buy a fixed amount of additional shares of the SPAC at a fixed price on a future date. The money raised in the IPO is placed in a trust while the sponsor locates a target company to acquire. At the end of the IPO, the Founder Shares held by the sponsor may represent as much as twenty percent of the SPAC's equity, despite the nominal cash contribution by the sponsor.

Following the IPO, the sponsor identifies a target to acquire. The sponsor will typically have between 18 and 24 months to deploy the capital raised in the IPO. If the SPAC does not identify a target within the designated period, the SPAC must liquidate. In a liquidation, the sponsor forfeits its Founder Shares.

Once a target is identified, the shareholders of the SPAC will have the opportunity to vote whether to acquire the target on the proposed terms. Investors that do not approve of the acquisition of the target can redeem their shares in the SPAC for a pro rata portion of the funds held in the trust account from the initial IPO, or they can sell their shares on the market. The announcement of the SPAC's potential target can cause SPAC shares to trade at a premium; however, the opposite is also possible. Sponsors waive the redemption right that protects the public investors. Investors who approve of the acquisition may also sell their shares in the SPAC and retain the warrants. In most SPACs, if the majority of shareholders fail to approve the target, the trust account for the SPAC is closed and the proceeds are returned to the shareholders on a pro rata basis.

The final stage of the SPAC transaction is the business combination, called the "de-SPAC" transaction. At this point, the SPAC may need additional funds to acquire the target and will typically use "PIPE" funding—private investment in public equity—to raise the additional funds. Once the business combination is complete, the target carries on its operations, albeit now as a public company with the SPAC investors as the principal shareholders.

Different Risks and Rewards for Different Players

A successful SPAC may result in a windfall for the sponsor, whose initial contribution may result in a significant equity stake in the resulting public company, entitling the sponsor to a handsome return for a small capital contribution. If a SPAC transaction is not completed and the SPAC is liquidated, the sponsor loses its initial investment and any expenses incurred in setting up the transaction. This potential loss may create an incentive for sponsors to complete the de-SPAC transaction regardless of the potential pool of targets available for acquisition, which could conceivably lead to less quality target choices. The public investors need to stay alert to the potential financial pressure on the sponsors created by this risk.

The public investors in the IPO will make a profit if the share value increases after the business combination. There is less of a profit margin for investors who purchase the SPAC shares at a premium after the initial IPO, but those investors still have a chance to enjoy a good return on the investment. Of course, all of these scenarios depend on the price of the SPAC shares increasing after the initial IPO or de-SPAC transaction.

The Future of SPACs

The SPAC boom has slowed over the past few months, with the number of newly created SPACs sharply declining since early 2021. Commentators have remarked that there are only a limited number of profitable private company targets to acquire, and it is not clear how many are still out there.

As a result, SPAC sponsors will likely expand their target search to companies outside the United States. SPAC transactions that involve international targets can trigger a host of additional legal hurdles to the de-SPAC transaction, including additional tax issues. Cross-border SPACs can implicate complex U.S. tax regimes, such as the controlled foreign corporation rules or the passive foreign investment company rules. With careful tax planning, SPAC sponsors and investors can navigate those hazards, but the cost and complexity of SPAC transactions may increase as more of these transactions go offshore.

The future is also likely to see more SPAC litigation. The recent SPAC boom has led to shareholders filing post-SPAC federal securities class actions, as well as state court merger objection litigation accusing directors of breaching their fiduciary duties by omitting material information about the targets or the de-SPAC transaction. Concurrently, the SEC has issued a series of statements and alerts addressing different parts of a SPAC's life cycle, with warnings to sponsors about their disclosure requirements and additional warnings to investors to carefully consider their SPAC-related investment decisions. We will examine SPAC litigation and SEC activity more closely in an upcoming newsletter.

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