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2020 – the Year of SPACs

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For merger and acquisition (M&A) and capital markets dealmakers in the United States, 2020 has been the year of the special purpose acquisition company (SPAC). SPACs have taken the corporate world by storm, with 230 new SPACs making their initial public offering (IPO) debut and raising over US$77 billion and 104 SPAC business combinations signing and/or closing in 2020 alone. The so-called "third way" (referring to an alternative to an M&A exit or an IPO) continues to have significant effects on both the M&A and IPO markets, and there is now an increasing number of cross-border transactions being announced, indicating that companies outside the U.S. are paying attention to the trend and considering merging with a U.S. SPAC to become publicly listed on a U.S. stock exchange.

The SPAC business combination is a hybrid of a private-growth financing, strategic M&A process, and IPO. For early and development-stage life sciences companies in particular, the certainty and flexibility a SPAC business combination allows with respect to both valuation and financing offers an attractive alternative to these more typical transactions.

A SPAC is a blank check shell company that raises money from public investors for the sole purpose of identifying a private operating company to acquire. Given that the SPAC has no operations of its own, the transaction effectively results in the IPO of the target operating company, which will become the successor public company.

Given that SPAC transactions are generally financing events to fund the operating company's balance sheet, they involve predominantly equity consideration and have limited secondary cash-out components for company stockholders. Additionally, the companies SPACs are acquiring are increasingly two to seven times (or more) the size of the SPAC by enterprise value. The result of these facts is that the operating company's shareholders most often retain a significant majority of the pro forma public company's stock and control of the public company (this is one reason many refer to these as "reverse mergers" or "back-door IPOs").

When the SPAC raises its own IPO, the SPAC's sponsor (often a private equity, venture, or hedge fund) receives a "promote," or fee, in the form of nonredeemable common shares (and often warrants) in the SPAC in exchange for putting up a modest amount of "at-risk" capital to fund the SPAC's operations (e.g., M&A transaction costs and Securities and Exchange Commission reporting costs).

In exchange for their investment, a SPAC's public shareholders receive a unit composed of a redeemable common share and often a warrant (or fraction thereof).

The key defining feature of U.S. SPACs is the fact that when a public SPAC investor is asked to vote on an acquisition of a private operating company, it is separately given the opportunity to either keep their money in the transaction (effectively investing in the operating company's IPO) or redeem its investment in full (plus interest). The two decisions are entirely delinked (and the presence of a warrant often means SPAC deals are most often approved by vote, regardless of redemption levels), and the redeemable capital invested by public shareholders sits in a protected trust account until a target company is acquired, to be used solely to fund that acquisition and any shareholder redemptions.

Given the potential that the SPAC's trust funds are redeemed — a decision not made until days before the closing of the transaction but predictable generally by the trading price of the SPAC stock post-merger announcement and pre-closing — the majority of SPAC mergers also involve a third-party financing component (generally a private investment in public equity, or PIPE equity financing) to ensure that the cash the operating company is looking to raise is maximized in the deal. Like the SPAC market itself, the SPAC PIPE market has also been booming and has been an important fuel of the current SPAC fire, allowing de-SPACed public operating companies to begin trading with fixed negotiated valuations and significant growth capital on their balance sheets, regardless of SPAC shareholder redemption levels or the usual pricing volatility inherent in a traditional IPO process.

Given that a SPAC transaction is structured through a front-end negotiated merger, companies are able to go public with these fixed negotiated valuations amidst a volatile stock market. Unlike a traditional IPO, operating companies in a SPAC deal also explicitly market to the public using five years of financial projections that are publicly filed, creating a significant opportunity for earlier-stage companies to attract growth investment based on future projections from the public, rather than solely private markets.

Additionally, target operating companies have increasingly realized that there is room to negotiate when it comes to a SPAC sponsor's economic interests, and what you see is not necessarily what you have to get. This creates flexibility compared to a traditional IPO bank fee structure, allowing operating companies to negotiate the level of dilution experienced by shareholders in the process.

When compared with a traditional M&A exit, many business combination parties have begun to move away from the typical terms you would see in a private, more liquidity-based M&A transaction toward more so-called public company-style agreements. This means a SPAC business combination will often come without any of the onerous indemnification or purchase price adjustments provisions one would typically see in a private M&A transaction, providing more valuation certainty and less economic risk for operating company stockholders.

SPAC business combinations are attractive in large part because of the flexibility they offer to finely tune deal terms to tailor outcomes to a particular company's specific financing, liquidity, and operational objectives. With 221 SPACs currently in the market searching for companies with which to partner in the next 18 to 24 months (SPACs have a limited life span in which to do a deal), this is a SPAC seller’s market. Companies looking at SPAC deals today can extract more value from, and dictate more of the terms of, these transactions than ever before.