

Two Paths, One Destination? How De-SPACs and IPOs Can Both be Fruitful

Given the frenzy of SPAC activity in the last 12 months, and what appears to be at least another 18 to 24 months of continued unprecedented volumes of SPAC deal-making based on the number of SPACs currently in the market, it is worth pausing to consider some of the real and meaningful distinctions between the two processes as more and more companies contemplate which path to follow toward the promise of the opening bell, according to Sidley Austin's Josh DuClos and Martin Wellington.

By Josh DuClos and Martin Wellington

Given the relatively low volume and lack of diversification (in terms of industry, enterprise value, capitalization and otherwise) of companies pursuing de-SPAC transactions prior to the current SPAC boom, sufficient data is not yet available to facilitate meaningful studies of what, if any, long-term trading success and valuation differences may exist between companies that have listed via a conventional underwritten initial public offering (IPO) and those that have made their public debut via a de-SPAC merger.

However, given the frenzy of SPAC activity in the last 12 months, and what appears to be at least another 18 to 24 months of continued unprecedented volumes of SPAC deal-making based on the number of SPACs currently in the market, it is worth pausing to consider some of the real and meaningful distinctions between the two processes as more and more companies contemplate which path to



Josh DuClos and Martin Wellington of Sidley Austin JON DIDIER/Courtesy Photo and Howard Wong/Grace Image Photography/Courtesy photo

follow toward the promise of the opening bell.

On the one hand, a conventional IPO is a relatively linear affair—the Company hires underwriters, counsel and other advisors, drafts and confidentially files a registration statement to tell its story to the public, and briefs the underwriting sell-side research analysts on the business model and prospects. After clearing SEC review, the company

flips its registration statement public and, in tandem with the banking team, markets, prices and closes the IPO. Many companies take their time with the traditional IPO process, often six months or more, preparing and transforming at each step along the way not just to complete the transaction, but also to operate as a public company.

The de-SPAC process, by contrast, is in many ways the reverse, as it

begins with an IPO: that of the SPAC itself. Only after that initial IPO does the SPAC look for and find an operating company target and agree in principal to “buy” it at a fixed valuation (although in substance, in most de-SPACs today, it is really the target buying the SPAC given the relative valuations and resulting pro forma capitalization of the combined public company). After striking a deal with the operating company, the SPAC often seeks to validate the agreed valuation and shore up the combined company balance sheet by confidentially marketing its stock, and implicitly that of the operating company, confidentially through a private investment in public equity, or PIPE, transaction, to large institutional investors like hedge funds, pension funds and other sophisticated investors.

Finally, the SPAC announces the transaction to Wall Street, often with nothing more than a filed merger agreement and the high-level investor deck that the SPAC used to market the PIPE. Notwithstanding that it will be months before the acquisition actually closes (and in some cases, even months before an actual registration statement is filed for the public to see), the shares of the empty shell SPAC then trade as though they were shares of the soon-to-be public operating company.

These very different paths to the same public market also diverge in terms of both regulatory regimes and market practice in meaningful ways that companies should consider when weighing the two options against one another.

Financial Results and Projections

In the conventional IPO, companies typically limit their financial disclosure in public marketing materials to

historical financial information only. Meanwhile, the underwriters do their sell-side research to develop their own forward looking financial models and use those models in selling the deal to accounts when building the IPO book. This bifurcated approach to marketing is designed to help the Company and the underwriters avoid direct disclosure of, and the related scrutiny and accountability for, the Company’s forward looking financial projections.

In the de-SPAC, by contrast, the company provides investors its own projected operating results, often for as long as five years or more down the road, when marketing the PIPE. In the context of such marketing, the company agrees to “cleanse” the potential PIPE investors of what will constitute material non-public information they receive in the marketing process once the deal is announced so that those investors can be free to trade in the SPAC’s stock. To do so, the SPAC publicly files those projections at the same time the de-SPAC is announced, and that filing becomes part of the official record on which liability is taken.

Making a virtue of necessity, the SPAC and company then use those same projections in more broadly marketing and soliciting approval of the deal from both the SPAC’s public holders, who have redemption rights they can exercise—even while voting to approve—if they don’t like the deal, and the company’s private investors. Depending on one’s point of view, this dynamic in the de-SPAC either affords superior transparency to the market on the real basis for the Company’s valuation (and facilitates a better understanding and marketing process for particularly high growth companies), or it opens the door to opportunities for aggressive

SPACs and operating companies to target investors with potentially risky and speculative future projections.

Price Discovery and Initial Trading

The underwriters in conventional IPOs sell principally to large institutional investors using a model designed to create upward trading pressure in the aftermarket. Oversimplified, the goal is to market to a large number of institutions and build a book of demand at least several times larger than supply, then give each institution somewhat less than its desired allocation at the initial public offering price, thereby leaving some room for quenching their thirst for more in the aftermarket. A portion of the supply is reserved for retail, and still another portion is available to fulfill demand through the over-allotment, or green shoe, option. While there can be no guarantee of a successful deal, as institutions go into the aftermarket to further build out their desired positions the resultant demand is expected to drive up the price somewhat, without having left too much money on the table at IPO pricing. Fundamentally, this is a bottom-up pricing model.

In the de-SPAC, by contrast, price discovery is a two-step, top-down model where parties first seek to divine market value using M&A valuation paradigms, such as comparable M&A transactions, comparable company trading data and discounted cash flow analyses. In step one, the valuation is fixed, and is not subject to market volatility. Current dynamics see SPAC buyers competing over a limited inventory of targets, which has driven up many of those initial M&A valuations. In step two, the

SPAC buyer and target together seek to sell the PIPE to ensure the newly public company will be adequately capitalized after taking into account possible redemptions by SPAC stockholders and the working capital needs of the Company.

In so doing, the parties conduct a sort of limited price discovery with a group of institutional investors to see if the agreed M&A valuation passes the smell test—or more precisely, represents an attractive enough discount to public company trading comparables to convince PIPE investors that there will be some modest, but immediate, appreciation once the deal is announced and starts publicly trading. However, step two can sometimes, particularly in a cool or saturated PIPE market, see downward pressure on the M&A valuation. Because the SPAC's pre-announcement holdings are generally concentrated in the hands of a small group of funds (and, increasingly, some retail), the initial trading market for a SPAC is often dominated by a small group of holders reacting to the momentum generated by the announcement of the deal and the broader public investor interest in getting into the stock before the final closing.

Perhaps ironically, the disparity in the overall disclosure and execution regimes for de-SPACs versus the conventional IPO process is driven by the securities laws themselves. Specifically, the conventional IPO is centered on the principal that no offers or sales can be made until the company has published an SEC-vetted and effective prospectus that complies with all of the applicable SEC rules. By contrast, under SEC Regulation M-A, public companies

are encouraged to share relevant historical and projected operational and financial information about M&A transactions with investors at and following the moment of announcing an M&A deal.

Moreover, under that regime in the de-SPAC context, the securities laws provide companies the benefit of a safe harbor for forward looking statements, such as financial projections, while this safe harbor is not available to companies doing a conventional IPO. As a result, the market for the target company's shares in a de-SPAC is set before—and sometimes very long before—analysts and the public see the SEC-vetted prospectus disclosure that has historically been viewed as the cornerstone of the conventional IPO process.

Both approaches to going public are designed to ensure a level informational playing field for all investors and a system of accountability for statements made by requiring them to become part of the SEC filing record. However, taking a private company public through a merger with an already-public empty shell effectively turns that traditional IPO disclosure and offering regime on its head.

While the outcome may be ironic or counterintuitive, it is not at all clear that this is a bad thing. To wit: notwithstanding years of SEC effort, it remains the case that in the conventional IPO, the most crucial information needed to price the transaction—informed expectations about the company's future prospects—remains shrouded from the retail public and is only shared in private between research analysts and institutional buyers.

In de-SPACs, the Company is able to—and does—wear that data on its sleeve, and all market participants are afforded equal access to it. While there is clearly room for debate as to the relative disclosure and procedural merits of the de-SPAC versus the conventional IPO, it seems equally clear that both processes have potential virtues and potential vices—for all market participants. Only time will tell if both paths can truly lead to the same outcome of long-term public trading success. In the meantime, companies should choose the path that works best for them and the story they are looking to tell to their future investors.

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