SPACs: Reshaping M&A and IPOs for European Companies

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Special purpose acquisition companies (SPACs), also referred to as "blank check" companies, have reached record numbers in the United States, with 242 SPACs conducting an initial public offering (IPO) on either NYSE or Nasdaq Stock Market and 52 announcing an initial business combination or "de-SPAC" in 2020, up 320% and 156% respectively over 2019, according to the research firm Deal Point Data.

Although listings of SPAC entities on European exchanges have been much less common, the number of European companies choosing to go public in the U.S. by way of a de-SPAC transaction is on the rise. At least 16 U.S.-listed SPACs have announced or completed de-SPAC transactions involving European companies since 2015, according to Deal Point Data. These transactions offer European companies the opportunity to access significant liquidity without the execution risk that comes with an IPO and, in the process, become a U.S.-listed public company.

What Is a SPAC?

A SPAC is a publicly traded company created for the sole purpose of acquiring or merging with an existing operating company, often providing such company with an alternate route to a traditional IPO. Although SPACs can and have listed on many stock exchanges around the world, most SPACs list in the United States, with 298 U.S. listed SPACs holding approximately $92 billion in cash in trusts looking for potential business combination partners as of January 31, 2021, according to SPAC Analytics.

SPACs are typically formed by an experienced management team, referred to as "sponsors." The sponsors leverage their expertise, reputation and relationships to raise initial capital from public investors. The capital is invested for the stated purpose of identifying a target and, through a business combination with the SPAC (referred to as a de-SPAC transaction), taking the target public. Although at the time of the SPAC IPO an acquisition target is not known, investors rely on the sponsors' skills to identify the right target and create value for their investment through the business combination.

The public investors in a SPAC IPO acquire "units" made up of one share of common stock and a fraction of one warrant to acquire common stock in the SPAC. The units are priced at $10 per unit, with the strike price of the warrants set at $11.50 per share. A short period after the IPO (usually 52 days), warrants are separated from the common stock and each security trades on a stand-alone basis.

The sponsors invest in stock of the SPAC, known as "founder shares" or the "promote," that are convertible into 20% of the outstanding shares of the SPAC post-business combination. Such stock is a different class than common stock held by public investors and typically allows the sponsors, among other things, to elect the entire board of directors of the SPAC prior to the initial business combination. Sponsors also acquire warrants to purchase common stock, with terms similar to the warrants issued as part of the units issued to the public. The promote is intentionally designed to provide the sponsors with a significant return in the event of a successful business combination and becomes worthless in the event of a failure to effectuate an initial business combination within a defined period of time.

Cash equal to the gross proceeds from the IPO and the warrants purchased by the sponsor is deposited into a trust account for the benefit of the public shareholders that cannot be accessed until, or in connection with, the initial business combination. The SPAC generally must conduct an initial business combination valued at least at 80% of the value of the cash held in trust within a set period of time — usually 24 months — or the funds in trust must be returned to investors.

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Once they have identified a business combination partner, SPACs can and often do raise additional capital through a private investment in public equity (PIPE) process. Investors in the PIPE may include existing or new investors in the SPAC who commit to invest additional equity capital contingent on the closing of the initial business combination.

Many SPACs have specific investment criteria and investment focus, ranging from industries such as energy and financial services to more generic mandates such as seeking "value-oriented investment opportunities."

SPAC Acquisitions or De-SPACs

The life of a SPAC culminates in a de-SPAC transaction, at which point the SPAC transforms from a cash box vehicle run by the sponsors into a U.S. public company led by existing management of the target with the continued participation by the sponsors.

Prior to concluding a de-SPAC transaction, a SPAC is required to offer its public shareholders, in addition to the right to vote on the de-SPAC, an opportunity to have their shares redeemed by the SPAC for $10, using the cash in the trust account. This right acts as an important check on the ability of the sponsors to carry out a business combination. In practice, however, the sponsors usually only bring to SPAC shareholders business opportunities that are likely to receive shareholder support.

Structuring

SPACs and their initial business combination partners deploy a variety of structures to achieve a similar desired outcome: a publicly listed combined group benefiting from the cash injection of the now-released cash from the trust account and the PIPE proceeds, and the continuing operations of the target.

Structuring the combination of a SPAC with a European business may be complex and highly transaction-specific. It involves decisions around the optimal tax structure for both entities (and their stakeholders) in the business combination, the desired jurisdiction of incorporation and headquarters of the combined business, and the desired profile of the combined company as a U.S. public company (*i.e.*, does the combined company wish to qualify as a "foreign private issuer" under the U.S. securities rules and regulations?).

A structure that has been favored by many European de-SPACs involves placing a newly formed parent company above both the SPAC and the target, with the SPAC and the target being acquired by, or reverse-merging into subsidiaries of, the new parent company. Since each European jurisdiction has its own rules on business combinations and its own taxation regime, this structure needs to be analyzed for each proposed de-SPAC transaction and potentially revised to accommodate the specific situation. Also, a significant proportion of SPACs targeting non-U.S. incorporated targets are incorporated in the Cayman Islands, a jurisdiction that allows a number of corporate mechanisms for combining with European targets.

Benefits of Being De-SPACed

From the perspective of the target company, the economic and practical effects of a de-SPAC transaction are in many ways similar to those reached by conducting a traditional IPO with a large primary component. The cash from the SPAC can be (and often is) used in the operation of the business of the combined company (like primary offering in an IPO) or can be (often to a lesser extent) used to buy out existing shareholders of the target (like a secondary offering in an IPO). The de-SPACed target then has access to U.S. capital markets in a manner similar to an entity having conducted a traditional IPO.

The price discovery process of a de-SPAC transaction favors high-growth targets for two reasons. First, these companies often need cash (which SPACs are able to provide in abundance) to grow, and thus these targets benefit the most from a combination with, effectively, a "cash box." Second, these companies often rely on their projections for a substantial part of their valuation. Unlike a traditional U.S. IPO where forecasts are not given to new investors, as part of the PIPE process, the SPAC and the target share projections with the new investors and publicly disclose such projections in connection with the de-SPAC transaction. Targets must be prepared for heightened scrutiny relating to these publicly disclosed projections and the target company's ability to achieve them in the future. All of this preparation requires cost and infrastructure investments at an early stage but can provide a target with maximum flexibility and potentially make it more attractive to a SPAC buyer. This can provide for a more accurate valuation for companies that base their high valuations on future prospects rather than current profits or are in industries that are rapidly transforming.

Although there may be cost savings in a de-SPAC as would be the case in a U.S. IPO, these savings are often offset (and sometimes exceeded by) by the cost of capital from the warrants and sponsors' shares in the SPAC. In order to address these costs and make themselves more appealing to potential targets, initially, some SPAC sponsors renegotiated the terms of their "promote" in the context of the actual de-SPACing transaction; now some SPACs have begun reshaping the terms around the promote and warrant structures from inception.

A de-SPAC also enables the target to largely de-risk the fundraising part of the transaction at the moment the initial business combination is announced. Since the SPAC IPO cash is already held in trust and the PIPE financing is usually subject to very limited conditions precedent at the time of announcement, the success of a de-SPAC transaction is not directly dependent on the performance of capital markets, absence of political turmoil or other risks that may (and often do) derail or postpone a fundraising effort, including an IPO.

Downsides of Being De-SPACed

Although SPACs and their targets no longer carry the notoriety they once did, SPACs continue to be associated with high-growth, pre-profit targets, and many companies prefer the cachet that comes with a traditional IPO. Furthermore, a SPAC shareholder base may be more transient than the shareholders acquired through a marketed IPO process. The SPAC structure itself incentivizes SPAC shareholders to exercise their warrants and sell the shares post-acquisition. But SPACs will argue that the PIPE process adds stable, hand-selected investors that are interested in the long-term prospects of the company.

In addition, the U.S. Securities and Exchange Commission (SEC) treats companies that have gone public via a SPAC differently than it treats companies that have gone public via a traditional IPO, often looking through the de-SPAC structure. This can have a variety of impacts on the combined entity from an inability to use Rule 144 (commonly used by affiliates to sell shares) for 12 months following de-SPAC, to potentially requiring three years, rather than two, of audited financials in the business combination documentation filed with the SEC. There are also limitations on de-SPACed entities using the SEC's automatic shelf registration process, which can make both primary and secondary public offerings more cumbersome and expensive.

Special Issues for European Targets

Complex tax and U.S. securities regimes make U.S. SPACs combining with European targets a delicate affair. From a tax perspective, it is often inefficient for U.S.-incorporated SPACs to acquire non-U.S. targets, as the earnings of the non-U.S. target become subject to the U.S. tax regime. European targets are less likely to face structuring hurdles in combining with non-U.S. SPACs than with U.S. SPACs. However, there are a number of innovative structuring approaches allowing U.S.-incorporated SPACs to conduct successful de-SPAC transactions with European companies.

Also, if the transaction is structured from an accounting perspective as a reverse recapitalization, the SEC has stated that the resulting entity will be considered a U.S. domestic issuer without the disclosure and corporate benefits that typically accrue to a foreign private issuer. Careful structuring and advance planning may allow European targets in a de-SPAC combination to retain their foreign private issuer status, where it would otherwise be available.

Final Considerations

SPACs have become an increasingly common mechanism for companies, particularly high-growth companies, to access the public markets in the United States. Companies considering future capital needs now typically weigh all available options at once: a business combination with a SPAC, a traditional IPO and traditional liquidity transactions, such as an acquisition by a private equity fund or strategic buyer, or remaining private and funding with further private financing rounds. Whereas 2020 was the year of the SPAC IPO, 2021 is positioning itself to be the year of the de-SPAC, with many European companies in prime position to take advantage of the wave of capital raised in 2020 and that is expected to be raised in 2021.

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