SPAC insights: Sellers' market

The large number of SPACs looking for merger targets is giving rise to a sellers' market. Today, a private company may find itself being wooed by several SPACs at once. But while all the attention may be flattering, too many choices makes it harder for a company to identify the right SPAC partner to go public with. This heightens the importance of carefully vetting SPAC suitors and negotiating favorable terms for a potential deal.

Diligencing SPACs

Companies now have more SPACs to choose from than ever. KPMG research shows that in 2020 a record 250 SPACs raised $76.2 billion—an amount nearly matched in just the first quarter of 221, when 229 new SPACs raised $68.6 billion. Most of these SPACs must make acquisitions in the next two years. Key questions companies should ask themselves when these SPACs come knocking include:

- **What is the reputation of the SPAC?** Not every SPAC is of the same quality. Is it backed by a successful team of well-known investors? Have they sponsored multiple SPACs?
- **Who are the sponsors/anchor investors?** Do they have a long track record of creating value, partnering with and potentially serving as board members for the merged company? Are they private equity, venture capital or hedge fund investors with brand names? Long-term anchor investors can be symbiotic, but also can limit the churn in shareholders.
- **Do they have prior SPAC experience?** If not, do they have significant prior M&A experience?
- **What industry experience do they have?** What sector focus do they have? Do they have the ability to bring expertise to management, post-merger? Historically, SPACs targeted traditional industries such as energy, travel, and industrial, but now the focus is on potentially disruptive and high-growth sectors such as technology (software, cloud-based service providers, collaboration tools, analytics, etc.), telecom, electric vehicles, online gaming, healthcare, and fintech, among others.
- **Do they have the ability to raise PIPE[1] (private investment in public equity) investments?** PIPE investors, who are often long-term institutional investors, are needed to fill gaps in capital to close the merger. PIPE transactions also help validate the valuation of the target company.
- **How do they account for warrants?** Warrants are issued to SPAC sponsors and investors to purchase common stock after a SPAC merger as a potential upside for them. Not only is this dilutive for other shareholders, but it may also need to be accounted for as a liability rather than equity upon issuance and subsequent measurement periods[2]. Reviewing this as part of the SPAC's balance sheet may be insightful for accounting and economic considerations.

[1] PIPE is the buying of shares of publicly traded stock at potentially a price below the current market value per share directly from the company.

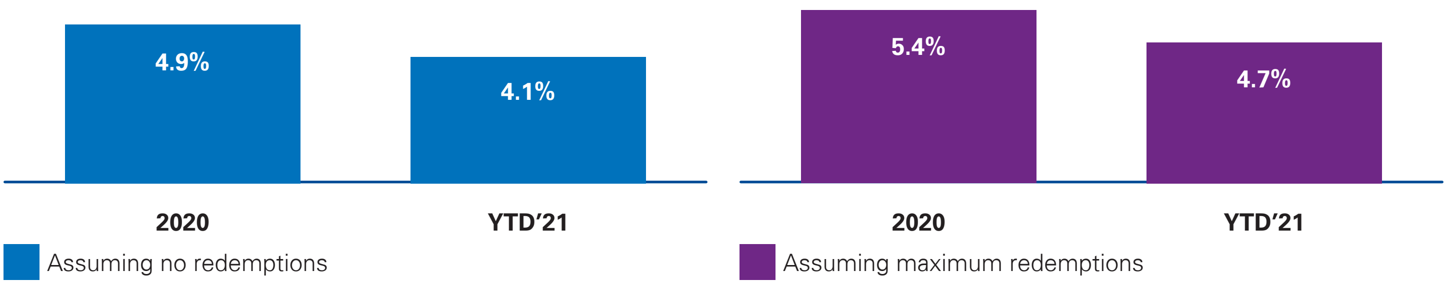
[2] See Securities and Exchange Commission, "Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")," April 12, 2021.

Negotiating details

Sellers in today's market should be aware that they may have the upper hand since buyers likely outnumber targets. They have leverage to negotiate, and they should use it in the following areas:

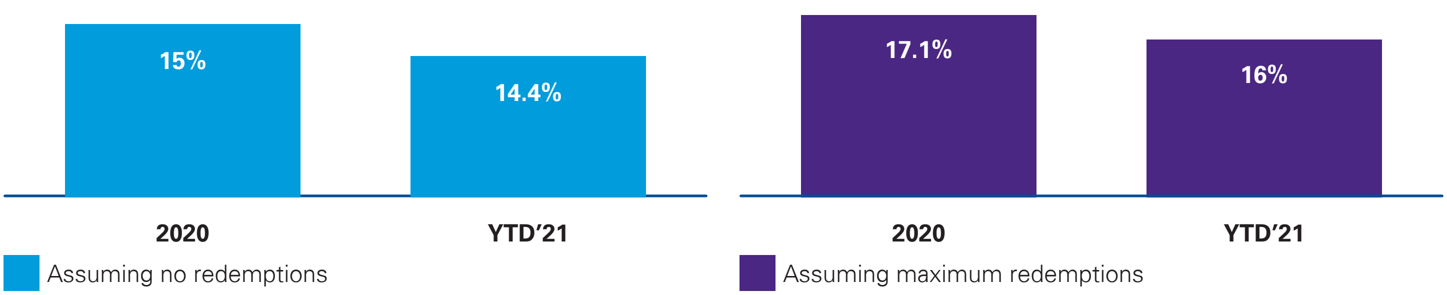
- **Founder shares:** This "promote" is the amount of equity in the merged entity that goes to SPAC sponsors and related parties (historically around 20 percent for both SPAC sponsors and PIPE). But sellers may be in a position to give up less equity as deal value increases. Some recent deals saw promote amounts equate to around 5 percent of the combined entity after the deal closes. When comparing a sample of deals from 2020 to 2021, the average promote appears to be dropping, likely due to higher deal values requiring sponsors to give up more equity to attract PIPE investors (Exhibit 1). In some of these cases, the sponsors may still get a bigger slice if the combined entity's share price performs well, creating an incentive for the sponsors and aligning interests.

Exhibit 1. Average sponsor & related parties (promote) percentage share, 2020 vs. 2021[3]



- **PIPE funding:** A minimum cash balance including proceeds from PIPE financing must exist prior to the SPAC merger. This cash balance is determined in the negotiation process (Exhibit 2). This can be a major hurdle for SPAC mergers because holders of public shares have the right to redeem their shares before completing the merger.

Exhibit 2. Average PIPE percentage share, 2020 vs. 2021[3]



- **Warrant structure:** Strong investor demand for SPACs means warrant coverage is falling. The exchange ratio used to be one warrant for one share of stock but now, 3-for-1 or more is common.
- **Earnouts (contingent consideration):** Earnouts, where additional shares or cash may be issued post-merger to SPAC sponsors or the seller's shareholders if certain targets are met, were structured in over half of SPAC mergers completed in 2020.[4] In most cases, additional shares vest after the combined company stock meets or exceeds certain price thresholds within a set time-period; multiple tranches with increasing price thresholds are common. Vesting of earnout shares leads to dilution of existing shareholders—sellers should carefully consider the terms of earnouts and their downstream effects.
- **Safety nets:** The SPAC sponsor may be obligated to compensate the seller's expenses if the merger fails: for example, the SPAC shareholders' failure to approve the merger.

[3] Percentage share of the combined entity after a SPAC merger. Transaction data for 2021 is for YTD through March 12. A sample of 45 and 41 SPAC merger deals were analyzed for 2020 and 2021, respectively.

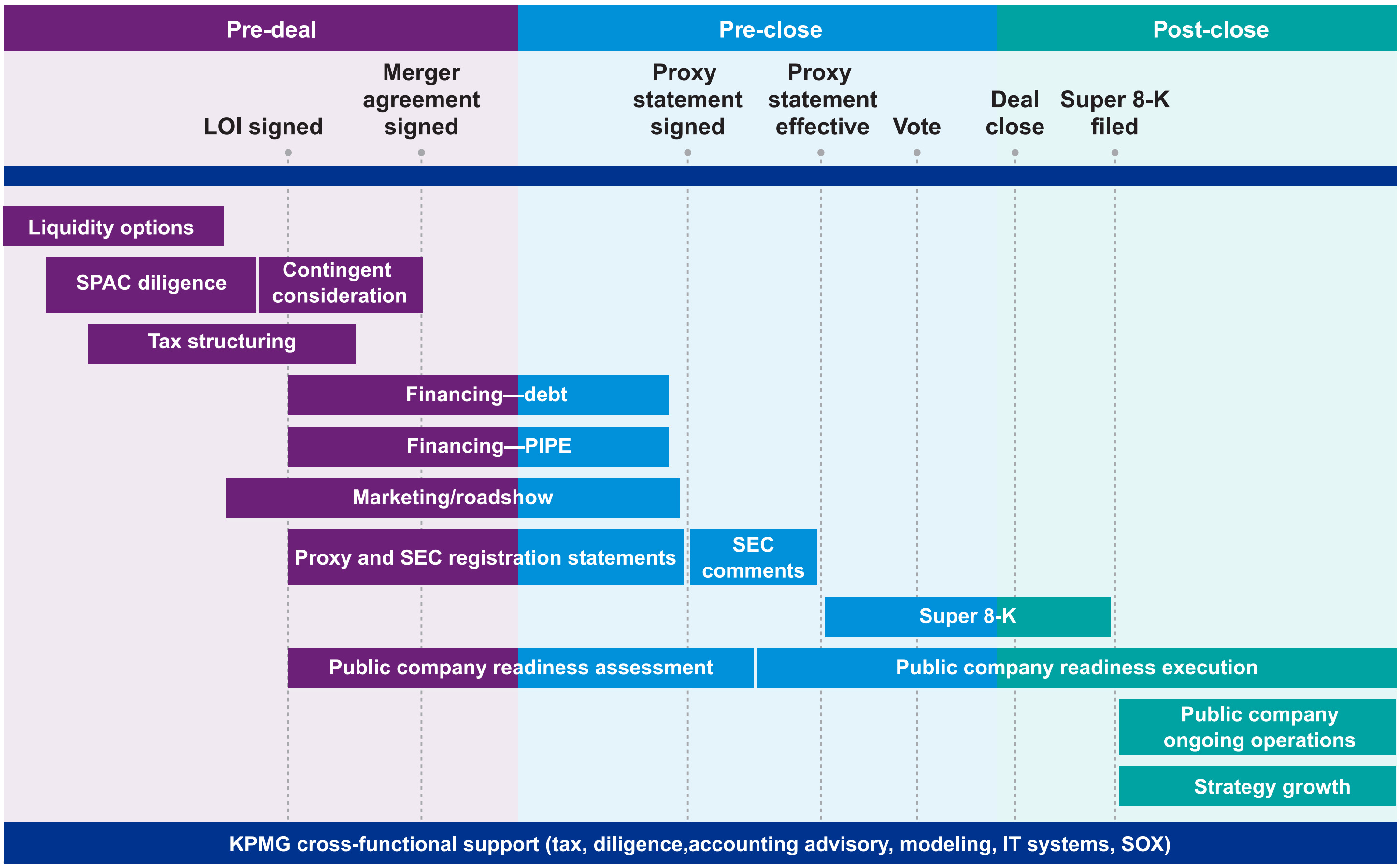
[4] Freshfields, "2020 De-SPAC Debrief: A comprehensive review of all de-SPAC transactions that closed in 2020," January 2021.

Bottom line

Not all SPACs are created equal. In matchmaking your company with the right SPAC partner, you need to tick off as many negotiation points that will help you succeed in your new life as a public entity. To do so, you must get the details right. Try to work them out as collaboratively as possible but at the same time, don't shy away from utilizing market trends going in your favor.

SPAC transaction lifecycle

A SPAC has a typical lifespan of 18-24 months, but completing a merger with a SPAC can take as little as six months after the signing of an initial agreement. This paper focuses on the pre-deal phase of SPAC diligence. But across the lifecycle of a SPAC transaction, many other issues will arise. For more on these, visit the KPMG SPAC Intel Hub.



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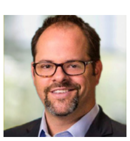

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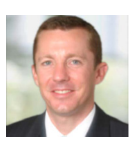

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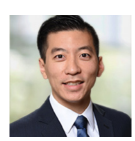

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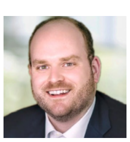

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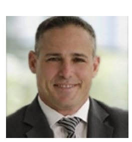

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