Chapter 4
Special Purpose Acquisition Company – An Alternative to Traditional IPOs

1. An Introduction

The special purpose acquisition companies ("SPACs") also known as "blank check companies" have been emerging as a viable alternative to traditional initial public offerings ("IPO") to take companies public. The SPAC is a company with no commercial operations, that is formed strictly to raise capital through an initial public offering for the purpose of acquiring an existing company. Once the SPAC acquires a target company, the target company merges with SPAC and become a publicly-traded company on the stock exchange.

SPACs help companies go public a lot quicker (a few weeks to months) in less time with fewer fees compared to traditional IPO route. A SPAC usually has a time period of approximately two years to acquire a target company. If the SPAC fails to achieve the business combination within the specified time period, the SPAC will dissolve and return the funds to the investors.

Though SPACs have been around for decades but have become more common in the recent years specially in the United States ("US"). The number of SPAC IPOs and the funds raised through SPAC IPOs in the US have increased significantly in 2019 and 2020. There were 248 SPAC IPOs and ~$83.0 billion[1] were raised in 2020 as compared to $13.6 billion raised in 2019 which was more than four times the $3.2 billion raised in 2016[2]. In the US, SPAC IPOs have outpaced traditional IPOs during the first three months in 2021 as the preferred method for public fundraising as presented in the chart below.

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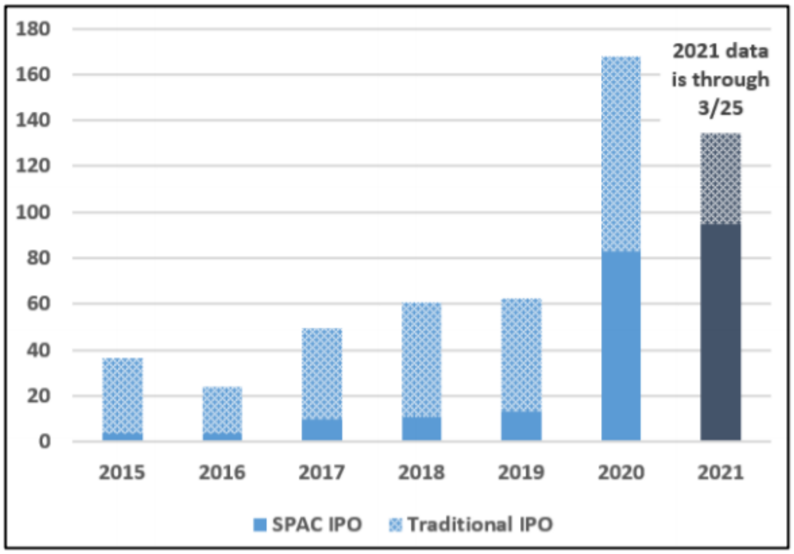
1 https://www.fe.training/free-resources/accounting/special-purpose-acquisitions-companies-spacs/

2 https://www.investopedia.com/terms/s/spac.asp

Figure 1. Funds Raised by SPAC IPOs and Traditional IPOs per Year ($Billions)



Source: CRS, based on data from Dealogic and the *Wall Street Journal*.

The recent spurt in the popularity of SPACs in the US has provided opportunities to Indian companies to list on the US stock exchanges. For example, ReNew Power Limited, India's leading pure-play renewable energy producer, has taken SPAC route to list on NASDAQ. In February 2021, ReNew Power and RMG Acquisition Corporation II (a SPAC listed on NASDAQ) announced the execution of a definitive agreement for a business combination that would result in ReNew becoming a publicly listed company on the NASDAQ[3]. Similarly, based on the information available in public domains, online grocery platform Grofers is also reportedly in advanced stages of exploring a SPAC deal. According to the news reports, venture capital firms Elevation Capital and Think Investments are expected to launch a SPAC focused on Indian technology companies seeking to list in the US[4].

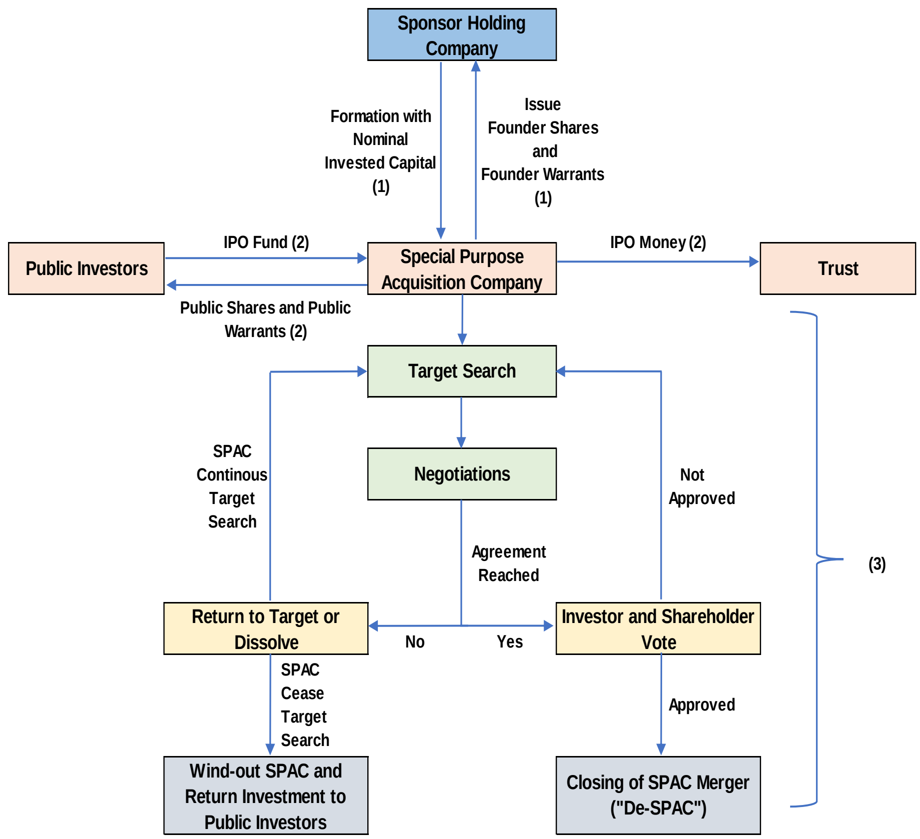
3 https://www.businesswire.com/news/home/20210224005431/en/ReNew-Power-India%E2%80%99s-Leading-Renewable-Energy-Company%C2%A0to-Publicly-List-through-Business-Combination-with-RMG-Acquisition-Corporation-II-in-8-Billion-Transaction

4 https://indianexpress.com/article/explained/what-are-spacs-and-why-are-they-under-the-scanner-7242646/

As SPACs are becoming a buzz word in the financial world, this article covers an overview of the SPAC structure, various instruments issued in SPAC structure and how to determine the fair market value of those instruments.

2. An Overview of SPAC Structure

The structure of a SPAC is presented in the chart below:



Step 1: Formation of SPAC

Generally, a SPAC is formed by an experienced management team or a sponsor also known as the founders. The founders provide the starting capital for the company for completing SPAC registration and IPO processing. The founders of the SPAC, purchase founder shares that entitle them to have approximately 20% ownership interest in the outstanding shares of SPAC, after the successful completion of the IPO. Along with the founder shares, the founders are usually subscriber to founder warrants. The founder shares and founder warrants are intended to compensate the management team, who are not allowed to receive any salary or commission from the company until an acquisition transaction is completed.

Step 2: Completion of IPO

A SPAC will go through the typical IPO process of filing a registration statement with the U.S. Securities and Exchange Commission ("SEC"), clearing SEC comments, and undertaking a road show followed by a firm commitment underwriting. In consideration to the IPO fund, the public investors typically receive the public shares that results in 80% ownership interest in the outstanding shares of SPAC after the successful completion of the IPO. Along with the public shares, public investors are also generally issued public warrants. The purpose of the warrant is to provide investors with additional compensation for investing in the SPAC.

According to SEC rules, a SPAC must keep 90% of its IPO gross proceeds in an escrow account on the date of acquisition.

Step 3: De-SPAC

After the SPAC has raised the required capital through an IPO, the management team has a fixed time period, generally 24 months, to identify a target and complete the acquisition. The period may vary depending on the company and industry. After the SPAC completes a merger, the previously privately held target company becomes a publicly listed operating company. This last step of creating the listed successor company is referred to as a "de-SPAC" transaction.

The SPAC should complete acquisitions reaching an aggregate fair market value of at least 80% of the value of the escrow account within the specified time period. If the acquisitions cannot be completed within that time, the SPAC must file for an extension or return the funds to investors. At the time of the de-SPAC transaction, the combined company also must meet stock exchange listing requirements for an operating company. The Nasdaq and the New York Stock Exchange are two common exchanges for SPAC listings.

Once target is identified, the SPACs typically need to solicit shareholders' approval for a merger and make appropriate fillings. Once, the shareholders approve the SPAC merger and all regulatory matters have been cleared, the merger will close and the target company becomes a public entity.

In the event, where the SPAC could not acquire a company before the lapse of the pre-determined period, the SPAC will be dissolved, and the IPO proceeds held in the trust account are returned to the public investors and the founders' interest in SPAC effectively expires worthless.

3. Instruments Issued in SPAC Structure

As presented in previous sections, various instruments are issued in the SPAC structure which include founder shares, founder warrants, public shares, public warrants.

In the IPO, SPACs are typically priced at a nominal $10 per share. Unlike a traditional IPO of an operating company, the SPAC IPO price is not based on a valuation of an existing business. The warrants issued by SPAC are also publicly traded and the exercise price of the warrants is typically $11.5 per share.

On the successful consummation of a business combination, the founder shares and founder warrants are convertible into SPAC's public shares that are traded on the stock exchange.

Though, the securities issued by SPAC are publicly traded, however, the fair market values of the founder shares and the founder warrants are not equal to publicly traded price of the respective securities especially before the acquisition of a target by SPAC. As previously discussed, the founders of SPAC through the founder shares and/or founder warrants are entitled to have a 20% ownership interest in SPAC. However, until the SPAC completes an acquisition, the fair market value of the founders' interest in SPAC is not equal to the 20% of SPAC's market capitalization because if the SPAC is not able to complete the acquisition within the specific time limit, the SPAC will be dissolved and the sponsors' interest effectively expires worthless.

Accordingly, various adjustments (as explained in the subsequent sections) are made for determining the fair market value of the founder shares and the founder warrants in SPAC until the SPAC completes an acquisition.

4. Valuation of the Founder Shares and the Founder Warrant in SPAC

From the period starting from the SPAC IPO till the date of business combination, the SPAC shares only represent an interest in a pool of capital placed in trust for the sole propose of making an acquisition within a specified term.

Accordingly, to determine the fair market value of the founder shares and the founder warrants in SPAC before the de-SPAC transaction, certain adjustments are made to the traded prices of the public shares in which the founder shares and founder warrants will be converted on completion of the de-SPAC transaction. The following three adjustments are generally made to arrive at the fair market of the founder shares and the founder warrants in SPAC during the period from the SPAC IPO through the business combination date.

- Forfeiture of sponsor's shares: As previously discussed, the SPAC's founders are generally entitled to receive a 20% interest in the SPAC. However, based on the historical trends of SPACs that have achieved business combination, the founders often forfeit a certain share of their interest in a SPAC as part of the business combination. Accordingly, while determining the value of founders' interest in a SPAC, an adjustment is required for the risk of any founder's shares/warrants being forfeited as part of the business combination transaction.
- Probability of successful business combination: A SPAC generally has 24 months from the IPO date to complete a business combination, after which the SPAC is liquidated, the cash in trust is returned to public shareholders and the founders' interest effectively expires worthless. Accordingly, the value of founders' interest is contingent upon the successful consummation of a business combination.
- Lock-up period: The founders' interest in a SPAC is subject to certain lock-up period after the consummation of the business combination. Accordingly, an adjustment for discount for lack of marketability is required to determine the fair market value of the founders' interest in a SPAC.

The determination of the fair market value of the founder shares and the founder warrants is explained with a practical example.

Key Facts (Hypothetical Inputs)

Traded Price of SPACs Public Shares as of the valuation date: $12 per share

Traded Price of SPACs Warrants as of the valuation date: $2 per warrant

# of Founder Shares in SPAC: 6,000,000

# of Founder Warrants in SPAC: 7,000,000

Step – 1: Valuation of the Shares Based on the Traded Price Before Adjustment:

As previously discussed, the founder shares are convertible into the publicly traded shares of SPAC after the successful consummation of a business combination. As the public shares and warrants of SPAC are traded on the stock exchange, as step 1, as a starting point, the value the founder shares and share warrants is computed based on the traded price of the public shares and warrants, respectively. This value is then appropriately adjusted for various adjustments factors as explained in subsequent steps.

Table 1

Indicated Value of the Founder Shares and Founder Warrants in SPAC Before Adjustments as of Valuation Date

Particulars	Traded Price Per Share/Warrant as of the Valuation Date	# of Shares/ Warrants as of the Valuation Date	Value as of the Valuation Date (Rounded)
	A	B	(A) x (B)
Founder Shares in SPAC (1)	$12	$6,000,000	$72,000,000
Founder Warrants in SPAC	$2	$7,000,000	$14,000,000
Indicated Value of Investment in SPAC Before Adjustments			**$86,000,000**

(1) The conversion ratio of the founder shares to the common shares of SPAC is assumed to be 1:1.

Step – 2: Application of Relevant Adjustments for Forfeiture Risk, Business Combination Risk and Lock-up Period:

As previously discussed, the values of the founder shares and the founder warrants are subject to certain adjustments, as explained below:

- **Forfeiture of founder's shares/warrants:** As previously discussed, based on the historical trends of SPACs that have achieved business combination, the founders often forfeit a certain share of their interest in a SPAC as part of the business combination. Accordingly, an adjustment is made for the risk of any founder's shares/warrants being forfeited as part of the business combination transaction.
    - An article published by the Harvard Law School Forum on Corporate Governance[5] found that 30 of 47 SPAC business combination transactions had sponsor shares forfeited, made subject to forfeiture or vesting, forfeited with conditional re-issuance, or transferred to private investment in public companies ("PIPE") or debt investors.

[5] https://corpgov.law.harvard.edu/2020/08/17/update-on-special-purpose-acquisition-companies

- o According to an analysis by Stanford Law professor Michael Klausner and New York University School of Law assistant professor Michael Ohlrogge, the managers' promote is subject to further negotiations with the owner of the private company involved in a SPAC merger. While many SPAC managers receive the equivalent of 20% of a SPAC after its IPO, they have been awarded on average 7.7% of the company after a merger in deals between January 2019 and June 2020.[6]
- o According to an article published by Vinson & Elkins, in the merger transaction of Playa Hotels & Resorts, the sponsor agreed to cancel one-third of its founder shares and warrants. In the merger transaction of Broadmark Realty Capital, the sponsor agreed to forfeit 44% of its founder shares and 58% of its private placement warrants.[7]

Accordingly, based on the various market studies approximately 20% to 50% of the founder's shares or warrants were forfeited as part of business combinations in SPAC merger transactions. Accordingly, to capture the impact of the forfeiture risk, a downward adjustment of 20% is made to the value computed in Step 1, as presented in Table 2 below.

Table 2

Application of Adjustments for Forfeiture Risk

Particulars	Adjustment Factor	Founder Shares in SPAC	Founder Warrants in SPAC
Value of the Shares Before Adjustment for Forfeiture of Shares/Warrants (See Table 1)		$72,000,000	$14,000,000
Less: Adjustment for Risk of Shares/Warrants Being Forfeited			
Founder Shares in SPAC	20.0%	(14,400,000)	-
Founder Warrants in SPAC	20.0%	-	(2,800,000)
Value of the Shares After Adjustment for Forfeiture of Shares/Warrants		**$57,600,000**	**$11,200,000**

- **Probability of successful business combination:** A SPAC generally has 24 months from the IPO date to complete a business combination, after which the SPAC is liquidated, the cash in trust is returned to public shareholders and the founders' interest effectively expires worthless. Accordingly, the value of founders' interest is contingent upon the successful consummation of a business combination.

[6] https://www.reuters.com/article/spac-compensation-analysis-idINKBN28J1JX

[7] https://media.velaw.com/wp-content/uploads/2019/11/28180430/6013ceea-197e-433f-a4f6-1c1bb247a354.pdf

Some of the studies available in the public domain in relation to the probability of successful business combinations are presented below:

- Based on market studies published by McKinsey & Company,[8] approximately 80% to 90% of SPACs have successfully consummated mergers in recent times.
- According to an article published on reddit.com, almost 20% of SPACs failed to find a target and were liquidated.[9]
- According to information extracted from spacdata.com, out of ~966 SPACs, 90 (i.e., approximately 9.5%) are already liquidated, 421 SPACs are still looking for an acquisition target, 151 SPACs have announced an acquisition of target, and balance 304 SPACs have completed an acquisition.[10]

Based on the various market studies, approximately 80% to 90% SPAC are able to successfully achieve the business combination. Accordingly, a 90% success rate of the business combination is assumed as presented in Table 3 and Table 4 below.

Table 3
Probability Weighted Value for the Founder Shares

Scenario #	Scenario Description	Probabiltiy Factor	Value Indications (See Table 2)	Weighted Value
1	Business Combination – Successful	90%	$57,600,000	$51,840,000
2	Business Combination – Unsuccessful	10%	-	-
	Probability Weighted Value for the Founder Shares in SPAC			**$51,840,000**

Table 4
Probability Weighted Value for the Founder Warrants

Scenario #	Scenario Description	Probabiltiy Factor	Value Indications (See Table 2)	Weighted Value
1	Business Combination – Successful	90%	$11,200,000	$10,080,000
2	Business Combination – Unsuccessful	10%	-	-
	Probability Weighted Value for the Founder Warrants in SPAC			**$10,080,000**

- **Lock-up period**: The founders' shares in SPAC are subject to certain lock-up period after the consummation of the business combination. Accordingly, an adjustment for discount for lack of marketability is

8 https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/earning-the-premium-a-recipe-for-long-term-spac-success

9 https://www.reddit.com/r/SPACs/comments/icya8v/a_beginners_faq_guide_to_spac_warrants

10 https://spacdata.com/index.php?lang=1&link=home

required to determine the fair market value of the sponsors' shares in the SPAC.

Generally, on conversion into the public shares of SPAC, the founder shares held by the founders will be locked up until one year after the completion of the business combination.

The warrants become exercisable on the later of (a) 30 days after the completion of the initial business combination or (b) 12 months from the closing of the IPO. In addition, they are not transferable, assignable, or saleable until 30 days after the completion of the business combination.

Accordingly, in order to capture the impact of the lock-up restrictions on the fair market values of the founder shares and the founder warrants, discount for lack of marketability is applied.

The adjustment for lack of marketability can be computed using the following empirical discount studies and methodologies:

- Restricted Stock Studies
- Put Option Pricing Models
  - Chaffe Protective Put Method
  - Finnerty Average Strike Put Method
  - Ghaidarov Average Strike Put Method
  - Longstaff Lookback Put Option Model

Based on the above studies and methods, and the term of lock-up period, the discount rate generally ranges between 15% to 20%. Accordingly, a downward adjustment of 15% can be made to capture the impact of lack of marketability due to the lock-up period.

Table 5
Application of Discount for Lack of Marketability

Particulars	Adjustment Factor	Founder Shares in SPAC	Founder Warrants in SPAC
Indicate Values of the Shares Before Transfer Restrictions		$51,840,000	$10,080,000
Less: Discount for Lack of Marketability	15.0%	(7,776,000)	(1,512,000)
Concluded Fair Market Values of the Shares Held by the Founders in SPAC		**$44,064,000**	**$8,568,000**

The table below summarize the total adjustment applied in determining the fair market value of the founder shares and the founder warrants in SPAC. Due to the adjustment factors discussed in this article, the concluded fair market value of the founder shares and the founder warrants is ~39% lower than the starting value based on the traded price of the securities of SPAC.

Table 6
Summary of Adjustments

Particulars	Founder Shares in SPAC	Founder Warrants in SPAC
Indicate Values of the Shares Before Adjustment (A)	$72,000,000	$14,000,000
Indicate Values of the Shares After Adjustment (B)	44,064,000	8,568,000
Total Adjustment (C=A-B)	**$27,936,000**	**$5,432,000**
Total Adjustment (%) (D=C/A)	**39%**	**39%**

5. Conclusion

While India has not taken an official regulatory stand on allowing the listing of SPACs here, the Security and Exchanges Board of India (SEBI) has reportedly formed a group of experts to study the feasibility of bringing SPACs under the regulatory ambit[11].

Accordingly, once the SPAC structure are allowed to be implemented in India, there will be opportunities for valuation professionals to value various instruments issued by the SPAC and the concept given in this article will be helpful to compute the fair market value of the founder shares and the founder warrants in SPAC.

Given the increasing popularity of SPACs globally, we may need not to wait for a long before we could see the implementation of the SPAC structures in India!!!

[11]https://indianexpress.com/article/explained/what-are-spacs-and-why-are-they-under-the-scanner-7242646/