CFA Institute

CFA Society India

INDIA INSIGHTS

ROUNDTABLE ON SPECIAL PURPOSE ACQUISITION COMPANIES

March 2021

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Introduction

Special purpose acquisition company (SPAC) issuances have surged in recent years, with 294 listings and $94 billion in 2021 to date, which is higher than the total 2020 figures of 248 listings and $83 billion.[1] The popularity of SPACs has attracted the attention of regulators around the world, including in Asia Pacific, that are contemplating introducing this structure. This popularity, however, also has brought the need for scrutiny on the complexity of the SPAC structure, governance issues arising from the potential misalignment in incentives between the sponsor and investors, and disclosures.

CFA Institute held its roundtable on SPACs on 25 March 2021. The roundtable saw participation from a diverse group of stakeholders including Indian investors, foreign investors representing global investment firms, securities lawyers, and proxy advisors.

The discussion covered five talking points: (1) whether the traditional initial public offering (IPO) structure is fit for purpose, (2) the advantages of SPACs over traditional IPOs, (3) whether the current boom in SPACs is sustainable given its poor track record in recent times, (4) investor protection measures needed to reduce potential misalignment of incentives, and (5) whether it is the right time to introduce the structure in India.

Following are the minutes of this discussion.

[1] SPACInsider.com, 25 March 2021.

Initial Thoughts

The participants provided initial thoughts at the outset. Some highlighted the similarity of SPACs with other concepts in India, such as fund managers launching new fund offers and subsequently doing control transactions, or reverse mergers likes McDonald's.

One participant said SPAC is a great structure for private equity (PE) investors, where Limited Partners (LPs) like pension clients can work with a sponsor to set up a SPAC and focus on a deal or two, which is convenient.

Others spoke about the complexity of SPACs, and the learning that is needed. One person remarked that SPAC combines capital markets and a M&A transaction into one. These complex structures have tax and exchange control considerations. Another person highlighted the complexity and learning required in compliance, risk modelling, and fund accounting aspects. Others highlighted how SPAC is changing initial public offering (IPO) markets, and the fact that there are strategic buyout, IPO, and SPAC options can be confusing for management.

Some participants expressed caution at the outset. For example, traditional IPOs have checks and balances, and while creativity must be allowed, this is balanced with investor protection considerations. Participants spoke about incentives and alignment in SPACs—banks get paid more in a SPAC transaction, whereas shareholders are not long-term shareholders, with holding periods less than 180 days (the share register changes every few months). Participants also highlighted the lack of diligence in SPACs compared with IPOs. In the Indian context, one participant remarked that the concept of promote (free shares) differentiates SPACs from other structures like RTOs. In the majority of companies (70% of BSE 500), the promoter can use up to Rs 1,000 crores (US$136 million) to invest in targets without shareholder approval, which could be unfair to minority shareholders.

Discussion Points

1. Are traditional IPOs fit for purpose?

The first talking point is whether traditional IPOs are fit for purpose, in terms of costs, timelines, pricing, and disclosures.

From the Indian perspective, one participant commented on earlier problems, with a lot of shell companies and frauds hitting the market. Since the merchant banking reforms in 2012, however, there have not been any blow-ups of that sort. The draft red-herring prospectus and red-herring prospectus are extremely comprehensive. To analyse companies that have been listed for less than five years, these documents are important sources of information on the risks facing the business and industry. Pricing has been cleaned up, a provision has been instated for a pre-IPO round, and an anchor book (in legal terms, the last private round before the issue closes) has been introduced to assure retail investors that institutional investors are driving the pricing. The timeline from the time of subscription to listing has been compressed to just seven days. Costs have come down as well because of digitisation, which makes it easier for a merchant banker to reach retail investors. The pricing is about 6–7% overall (and 1–2% underwriting costs), which is lower than in the United States where the cost of underwriting alone is about 6–7%.

Others agreed with the overall improvements in the IPO process, but raised concerns around the book-building process, which seems not to be working well, regardless of whether the issue is over- or under-subscribed. Some debate ensued about the overall timeline, with some arguing that the inordinate delays in SEBI's approval (stretching to several months) is due to company and merchant bankers not providing full disclosures in the first place. Others felt that this experience is similar elsewhere. The disclosures are overly long, and the plain-English prospectuses in US companies communicate better than the legalese in India, but broadly, IPO practices have converged across markets over time.

For international investors investing in Indian IPOs, one limitation might be due to the fact that many funds with the same fund managers are counted as multiple lines for the purpose of allocation. This creates, in effect, a limitation from the perspective of the number of lines as well as the overall allocation. Participants called this a double-layer of the limiting liquidity factor.

On experience in other markets, Hong Kong SAR's cornerstone investor concept is similar to the anchor investor concept in India. Its goal is to provide assurance to retail investor about the IPO valuation, with the only difference being the lockup period of six months in Hong Kong SAR (compared with one year in India).

From a US perspective, one participant remarked that SPAC is a fast way to get public and is very efficient. Twenty years back, most deals would go public; now, however, most are sold in private markets as M&A transactions. Given the regulatory environment, it is much harder to issue an IPO and a lot of deals are sold back and forth. US IPOs are expensive and time-consuming. Considering the ongoing reporting requirements, most firms choose not to go public. SPAC short-circuits and bypasses the complexity around going public. Thus, SPACs are an important innovation that have made IPOs available in a way they previously had not been. The option of redeeming the investment if you do not like the deal makes it relatively safe. While it is great for General Partners (GPs) (they get 20% of equity, not just profits), if you can back a great sponsor, investors are happy to do it.

2. Advantages of SPACs over IPOs

SPACs are better than IPOs (at least in the popular press) for the following four reasons:

1. *They are cheaper.*
2. *They provide valuation certainty.*
3. *They are the "poor man's private equity."*
4. *They are a vehicle for complex difficult-to-value businesses.*

Participants debated the advantages of SPACs over IPOs from the perspective of different players. One participant remarked that SPACs are a great deal for promoters, because the valuation they seem to get, compared with traditional IPOs, has been phenomenal in the past 18 months. Another participant remarked that targets still need to strike a balance. The IPO process is about building a book, but SPACs have a 20% promote and the resulting dilution is significant. Hence, targets need to value liquidity as much as valuation. Ultimately, quality matters: when the market plateaus, you will find out if the deal was as good as it sounded. For now, when serious investors are crowding in, we must pay attention.

SPACs also provide a great exit option for PE investors. In the past, many PE investors were getting stuck, but now things are a bit easier with SPACs.

Others noted the maturity and institutional quality of SPACs. SPACs have been in existence in the United States for more than 25 years. The distinguishing factor now is the institutional quality across sponsors, PIPE investors, and targets have all improved. Twenty years ago, only small shops, not Goldman Sachs, would bring this type of structure to the market. The target sectors were mining and commodity, which did not inspire investors to invest. The quality of operators today (e.g., Thoma Bravo) and PIPE investors (e.g., Fidelity) are of a higher quality.

In terms of costs and timelines, SPACs are cheaper with only 3% in underwriting costs (explained by the skinny prospectus, and a fairly simple process), and the sponsor covers this cost if the deal does not go through. Biological clocks (two years, for sponsors) ensures that the timelines are shorter and the de-SPAC process takes but 60 days.

Is it poor man's PE? The fees (e.g., 20% promote) are similar to PEs. But 50% of SPACs have PE sponsors like Apollo and khosla venture, whereas others are operators. The fact that one can redeem the investment just before the merger, however, makes it different from PE (where LPs have commitment).

One participant also noted a recent issue—that of SPAC merger proxy proposals failing because of retail investor apathy.

3. Is the SPAC boom sustainable?

In several instances, SPACs have underperformed post-merger. According to one study that looked at the post-merger performance of 47 SPACs during the period from 2019 to 2020, an average SPAC underperformed the IPO index (performance of newly listed companies) by 13% over a three-month period and whopping 33% over a six-month period. SPACs with high-quality sponsors (defined as large fund manager or former CEO or senior officer of a Fortune 500 company) performed relatively well compared with others, with the average SPAC in this cohort outperforming the IPO index by 25% and 0.4% over three-month and six-month periods, respectively.[2]

In this context, the natural question to ask is whether the boom is sustainable, or whether it is a matter of time before investors discern the best from the rest.

One participant thought it was just a matter of time, but it is possible that the failures seen to date have poisoned the well. Celebrity-sponsored SPACs are no different from celebrity VCs (Snoop Dog or Ashton Kutcher) or celebrity initial coin offerings (ICOs) in terms of exuberance. Some target segments also reflect this exuberance, like electric vehicles, battery technologies, and even air taxis. Many of these businesses have no revenue for the foreseeable future. From this perspective, they sponsor only with the partners they know, and define the universe of targets to go after in terms of growth and profitability. There's always exuberance, but there are profitable companies. We don't want to paint everything in the same brush.

Other participants pointed to the extreme amounts of dry powder currently in the market, and limited targets to "de-SPAC." There is a huge bifurcation between good and bad targets, and competition for high-quality companies is only going to become higher.

[2] M. Klausner, M. Ohlrogge, and E, Ruan, "A Sober Look at SPACs" (Stanford Law and Economics Olin Working Paper No. 559, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919.

Whether local jurisdictions in south and southeast Asia allow their local targets to get listed offshore will put an additional filter on available deals.

Last, there is a moral hazard. SPAC market is a hot space; sponsors put up some money, but it is modest (typically $6–10 million). With 20% interest, the potential upside in a $500 million deal could be $60–70 million. So, even a bad deal is infinitely better than no deal. Having a high-quality and disciplined team, even one that decides not to do a deal might be important.

From the Indian perspective, one participant noted that Indian promoters can do a deal without shareholder approval up to the investment limit. India is a promoter-oriented economy, but regulations do not allow promoters special treatment. There is a scenario in which—unless you allow promoters to receive promote shares—new SPACs would be formed with the promoter getting the promote shares to take over his or her own company, which would be problematic.

4. Investor protection measures that need to be built into SPAC structure

SPACs are a good concept, but the incentives between the sponsor and investors may be misaligned. Promote (free) shares, comprising 20% of post-issuance, represent significant source of dilution. But there are additional sources - redemptions not only increase costs as a percentage of issue size (a 3% underwriting on $200 million is effectively 6% if $100 million is redeemed during merger) but also represent another source of dilution.

Redeeming investors frequently get to keep their warrants in the same proportion as other investors. This not only is dilutive but also increases their likelihood of voting in favour of the transaction even while redeeming their shares, a strange phenomenon.

Following are three of the governance and disclosures concerns:

1. *Sponsors frequently enter into shareholder agreements and side-deals to reduce redemptions, attract new investors, and increase the chances of success. These deals may be dilutive for existing investors.*
2. *Sponsors vote on the proposals to approve the transaction they found or to extend the deadline, which makes it more likely the merger will go through.*
3. *The redemption process, at least in the United States, is based on either shareholder approval or tender offer. Tender offer provides more leeway to sponsor to consummate a deal compared with shareholder approval.*

Given these concerns, is it necessary to introduce terms that would counteract some of the issues?

Participants remarked that while the vote to approve the transaction seems strange, the underlying desire is to not have failed SPACs, which also could mean losing the warrants (i.e., redeeming investors get to keep their warrants). When asked if that means we should also ensure that redeeming investors do not have the same level of warrants as nonredeeming investors (to remove that incentive), one participant remarked that this is happening in rare instances, such as Bill Ackman's Pershing Square tontine SPAC structure. That transaction was large, however, and for new sponsors, warrants might be essential to attract investors.

On the question of whether a minimum cash needs to be delivered as a percentage of IPO proceeds, participants said the PIPE deals, which are back-end structures, have large institutions look at the deal and back-stop redemptions, so money is usually available to close the deal.

On the question of dilution, one participant remarked he would prefer smaller SPAC issuances that have a potentially lower dilution than a large SPAC issuance.

Lastly, we asked whether sponsors should vote to approve the transaction (or vote to approve a merger deadline extension), given that their 20% is essentially free and they have a clear interest in getting the deal approved (at the risk of losing their investment/upside). Although we did not get a definitive response, one participant admitted that the odds are stacked for approving the deal. Only a simple majority is needed in the United States, where sponsors make up 20% and the remaining 31% would be obtained from hedge funds, which rarely reject a deal.

5. Is it time for India to introduce SPACs?

Currently, investors can make allocations in Indian equities, AIFs, and LPs. It is not SEBI's mandate to make US SPACs merge with Indian companies, which is a separate issue on exchange control and taxation. Based on your experience outside India, however, does it make sense to have a SPAC product?

One participant replied "why not." India has an opportunity to set a standard, and not just follow regulations elsewhere. The question is whether we can align the incentives and the disclosures better—for example, in an IPO, we do extensive due diligence and get the information for investors. Do we make poor man poorer, or do we democratize the opportunity? We hope it is the latter.

Another participant noted that you can introduce the structure, as long as there is uniformity among various avenues.

From an international perspective, SPACs are popular in the United States because they provide access to high-growth companies for listings. Like the United States, India has a lot of high-growth companies which they are not listed yet. There is a venue for these companies to list and SPACs might be the answer, other than the traditional IPO. For SPACs to succeed in India, however, both sides—investors with capital, and as well as targets to merge with—are needed. Lastly, like the United States, which took 25 years to become what was perceived to be an overnight success, the segment will take time to mature in India in terms of institutional quality.

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