VALUATION NEWSLETTER

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VALUATION CONSIDERATIONS IN A SPAC TRANSACTION

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The newest vehicle used by investors; SPAC or "Special Purpose Acquisition Company" is possibly the fastest route to an IPO. Conceptualized in the 90s, SPACs have picked up in popularity in the past couple of years as the capital invested in private equity backed businesses have swelled to over $2 trillion and investors are looking for exits.

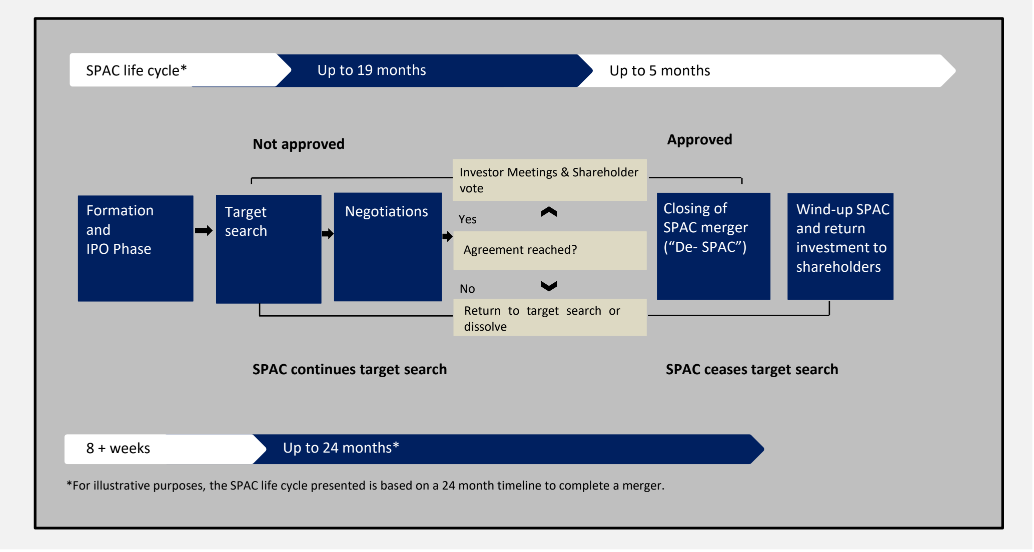
A special purpose acquisition company is an incorporated shell company, often referred to as a blank check company. Unlike an operating company that becomes public through a traditional initial public offering, a SPAC does not have an underlying operating business and does not have assets other than cash and limited investments (which include proceeds of the IPO). Such a business structure allows investors to contribute money towards a fund, which is then used to acquire one or more unspecified businesses to be identified after the IPO.

SPACs have become a popular vehicle for transitioning from a private company to a publicly traded company. SPACs, listed on recognized stock exchanges are formed for the purpose of acquiring a private company and thus making it public through merger in a much shorter time frame as compared to traditional IPO.

Overview of SPAC life cycle and timelines

A SPACs life begins with its initial formation, followed by its IPO, its search for a target, a shareholder merger vote, and, finally, the close of an acquisition. In case where the SPAC is unable to identify a target and close the acquisition in 18 to 24 months as predetermined, the initial investment would be returned to the investors. The SPAC process differs from that of a traditional IPO in that the target company (which eventually becomes the public company post-acquisition) is not involved in the formation of the SPAC or the IPO phases. However, the terms of the units offered in a SPAC IPO and the agreements the SPAC has with its sponsor and management team ultimately influence the value that target company investors extract from a SPAC merger.

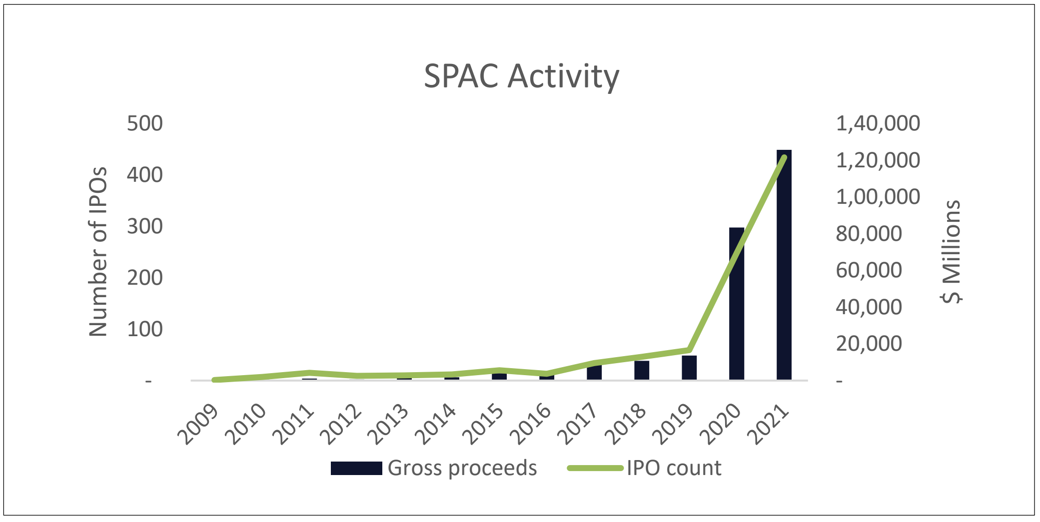
The phases of a SPAC's life cycle and a typical timeline are illustrated below:



Recent SPAC trends

SPACs have exploded as an alternate vehicle to take a company public without undergoing the same rigor as the traditional IPO process. The number of SPAC IPOs during 2020 was nearly four times the 2019 total, and the first quarter of 2021 alone has already exceeded the record high 2020 totals. In April 2021, the SEC issued new guidance related to SPAC warrant liability accounting and valuation. Given the proliferation of SPACs, the regulation and oversight around this ecosystem will likely continue to increase.

This notable uptick in SPAC activities has also come with a renewed focus on whether the securities issued by SPACs should be subject to fair valuation for financial reporting purposes. Auditors are now pushing back against the traditional approach of marking SPAC securities at cost.



Source: spacinsider.com

The capital structure of a typical SPAC entity includes several types of instruments from varied investors such as corporate entities, high net-worth individuals, alternative investment funds, and retail investors. The instruments included in the capital structure carry diverse rights and preferences in terms of lock-in terms, concessions, vesting and redemption periods and marketability.

Types of SPAC financial instruments :

There are three categories of SPAC financial instruments that may require independent valuations as assets or liabilities: warrants, founders' shares, and PIPE instruments.

Public warrants	**Founder shares**
Public warrants are issued to its public shareholders as a part of the SPAC unit during the SPAC IPO. The SPAC unit includes one unit of common stock and a fraction of warrant. The SPAC unit typically trades as a consolidated unit for a period of 52 days, after which the SPAC shares and warrant trade independently. The fair value of the public warrants is determined by observable trading prices in the period after these instruments are listed. For periods before public prices are observable, the fair value of public warrants is calculated using option pricing models.	When a SPAC is launched, the sponsor, and often its management team, pays a nominal amount for an equity stake in the SPAC, which is often referred to as "founders' shares" or the "promote." The founders' shares are intended to compensate the initial investors for identifying a promising target and consummating a merger. The founder shares are often subject to lock in terms, concessions and do not have any value unless the SPAC completes the merger. Often the fair value of the founders' shares are determined by starting with the publicly traded share price and applying a probability of success factor or the price implied by publicly traded warrants and then adjusting for the time (discount for lack of marketability) until conversion and completion of a lockup period, if any.
Sponsor/private warrants	**PIPEs**
Sponsor warrants are typically issued in a private placement to the SPAC's sponsor and its related parties. Private or non-listed SPAC warrants are valued by using option pricing models that use information observed or implied from the trading of the public warrants for the subject SPAC entity.	Following an announcement of a proposed business combination, the SPAC must offer its public investors a redemption option. This redemption option creates uncertainty regarding the cash available to the combined company post the business combination. Many SPACs have recently mitigated this concern by issuing new securities to institutional accredited investors in a PIPE transaction that is contingent upon the closing of the initial business combination. The capital raised in the PIPE transaction generally will be used to provide additional capital for the operating company to deploy following the consummation of the business combination. PIPE commitments are typically commitments to purchase shares of the combined entity that would be subject to a lock-up and thus not freely tradeable until the registration statement for these shares is filed and declared effective by the Securities and Exchange Commission. That lock-up necessitates a discount from the public share price of the SPAC due to the lack of marketability. Many PIPE investments are structed in the form of a financing commitment with a pre-determined contractual purchase price. These financial contracts can be subject to fair value adjustments when there are fluctuations in the public SPAC share price in the period between the PIPE commitment date and the PIPE funding date.

Valuation requirements during the SPAC process

1. Valuation for alternative investment funds

   Often private equity and alternative investment funds make sizable investments in instruments of SPACs by way of public shares, PIPE investments or warrants. Additionally, in several cases portfolio companies of funds may be potential targets for SPACs, which would impact the likely liquidation/exit plans of the fund from such companies. Alternative investment managers must continue to rigorously and reliably estimate and report the fair value of all their investments on a timely and periodic basis. Alternative investment funds are required by FASB ASC Topic 946 to measure and report all investments at "fair value" as defined by FASB ASC Topic 820.

2. <u>Valuation for business combination</u>

   Upon the completion of the acquisition, the measurement and accounting of the business combination is required to be completed in compliance with ASC 805. If the SPAC is determined to be the accounting acquirer, acquisition accounting in accordance with ASC 805 will apply and the target company's assets and liabilities will require a valuation to be stepped-up to fair value. Valuation in compliance with ASC 805 would include the fair valuation of following:

   - Net tangible assets
   - Identifiable intangible assets
   - Deferred consideration
   - Continent consideration
   - Deferred revenue

3. <u>Valuation for potential SPAC targets</u>

   While the targets of SPACs are usually privately held companies, they need to provide financial statements that comply with requirements of Regulation S-X and U.S. GAAP requirements of a public business entity. This may be particularly impactful for target companies that have historically elected private company accounting alternatives as they are required to retrospectively revise their financials.

   Certain valuation requirements for restatement of financial statements would include:

   - <u>Fair valuation of intangible assets</u> if previously not recognized independently per private company accounting alternative. In order to present public company-compliant financial statements, acquisition accounting valuation analyses must be revised in order to determine the fair value of any previously un-recognized intangible assets.
   - <u>Goodwill impairment testing</u> if the company has elected to amortize goodwill per private company accounting alternatives. In order to present public company-compliant financial statements, the company must not only unwind any goodwill amortization but also retrospectively perform annual goodwill impairment tests.
   - Comprehensive valuation of the securities in order to meet financial reporting requirements in accordance with FASB ASC 718, to avoid any unintended IRC 409A tax consequences in cases where stock-based compensation grants that are substantially below fair value in a pre-IPO period.

4. <u>Valuation for tax compliance</u>

   SPAC units are generally granted to sponsors for a nominal consideration. Since the initial investment for founder shares is insignificant and can be worth substantially more after a successful merger. The founder shares may hence be treated as compensation under tax laws. Additionally, the tax treatment of warrants depends on the type of warrant issued, i.e., investment warrants with equity or compensatory warrants. For those warrants that are not considered compensatory, the investment warrant rules should apply. Compensatory warrants issued for services are taxed like compensatory non-qualified stock options, i.e., they are not taxed upon receipt as long as the warrants are priced at fair market value (which is usually the case). The exercise date of the warrant is the taxable event. Fair market value of founder shares and/or warrants is required to be determined for compliance with IRC regulations.

5. <u>Other valuation requirements</u>

   - Valuation of contingent consideration per ASC 805
   - Valuation of convertible notes per ASC 480 and ASC 815
   - Valuation of forward agreements

Estimating fair value for illiquid or non-traded investments requires experienced, informed judgment. Conceptually, investments in SPAC securities are no different than investments in traditional public or private debt and equity interests, yet the nuances of such investments at varying stages during the SPAC process must be carefully considered.

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