Asking the Experts

SPAC Securities Valuation

What types of SPAC securities would typically require fair valuation?

This notable uptick in SPAC activities came 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.

While SPACs typically issue similar types of securities, individual SPAC securities may have nuances that impact value. A detailed review of terms is critical to set up the proper valuation framework and supportable input assumptions.

SPAC securities that commonly require fair valuation are PIPE commitments, founder shares, and sponsor warrants.

- PIPE commitments are typically commitments to purchase Class A shares 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 Class A share price due to the lack of marketability.
- Founder shares are considered "at-risk" capital, as holders generally do not receive any proceeds if the SPAC does not complete a business combination and instead liquidates.
- Sponsor warrants often strike as out-of-the-money, similar to public warrants that are typically issued by a SPAC. Sponsor warrants would expire worthless in a SPAC liquidation, similar to the public warrants.

What is the valuation framework for these types of securities, and what are some of the unique factors impacting fair value?

Valuation models for these securities typically begin with the public share price. However, these private securities are materially different from the public shares, and the valuation models need to reflect those differences.

First, the most notable difference is that at-risk securities typically only have value if an acquisition is successfully completed. The probability of not closing a deal should be considered for at-risk securities.

Second, sponsor shares and warrants are sometimes subject to concessions (such as giving up some of the shares or subjecting a portion of the shares to an earn-out) by the sponsor to entice the seller to agree to a proposed business combination. The possibility of concessions could result in a further discount from the publicly traded security price.

Third, private securities are typically not freely tradeable until converted to public securities, and even then, certain lock-up provisions could apply. As such, the lack of marketability may result in a discount from the public share price.

The application of these concepts varies by the type of security in the structure. For PIPEs, a discount for lack of marketability could be applied against the publicly traded price.

Public shareholders are entitled to receive proceeds from the trust if a SPAC liquidates, whereas founder shares are not. The difference in treatment in the event of a liquidation requires an additional discount for these classes of at-risk capital. Additionally, sponsors have historically been willing to give up or restructure some of their shares as an earn-out in order to ensure the business combination goes through; the possibility of such a concession merits an additional discount for this type of capital.

Similar to founder shares, sponsor warrants are typically subject to potential concessions and lock-up agreements. Also, sponsor warrant values should be reconciled with public warrant prices (to the extent they exist and trade separately), and differences should also be considered. For example, public warrants are often redeemable upon the public stock hitting certain price targets, but sponsor warrants generally are not. Also, public warrants and sponsor warrants may have different maturity dates.

The valuation of SPAC securities needs to consider other possible complexities. Some SPAC securities can be subject to "vesting" provisions, where shares will not be freely tradeable unless the public stock price maintains certain levels for a particular period of time. As another example, if the SPAC is nearing the end of its life, it may be under pressure to complete its business combination and may agree to issue PIPEs to investors who demand structural features and protections that go beyond the

typical PIPE shares. Sometimes, these negotiations extend to structuring a convertible instrument that provides significant downside protection to PIPE investors. These and other complexities may require additional significant modeling and simulations to capture the relevant rights and privileges.

How do you estimate the various discounts or probabilities that you just mentioned (e.g., the discount for lack of marketability or the probability of renegotiating the incentive)?

Discounts for lack of marketability are often estimated via put option pricing models (but generally, not Black-Scholes). Expected volatility and time to maturity are two key inputs in estimating a put option premium. Generally, the longer the stock is restricted, the bigger the discount. Higher expected volatility typically implies bigger discounts. Observed historical volatilities for a SPAC may not indicate expected volatility for SPAC securities, and thus, more thorough analyses may be required to estimate appropriate volatilities.

The probability of the SPAC not closing a deal is estimated with historical data as a starting point. On average, about 80% of recent vintage public SPACs eventually closed a deal. However, there are a number of qualitative factors that may impact the probability of a successful SPAC transaction, including the strength and track record of the sponsor, whether a deal has actually been announced, the remaining search time left for the SPAC, and (to some extent) the stock price movement. If the SPAC share price has traded up significantly, it could indicate that the market thinks there is a high chance of the deal closing.

Estimating the probability of renegotiating the incentive begins with an analysis of closed SPACs and whether their sponsors had agreed to give up or restructure sponsor shares. Key questions to be analyzed include:

(1) What is the probability that the sponsor will give up any economics?

(2) If the sponsor does give up economics, how much was ultimately given up or restructured?

The SPAC market is undergoing significant growth and acceptance, and the observed probabilities are changing. Valuations of private SPAC securities should consider the latest data and trends.

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- Financial reporting, technical accounting, and IPO readiness associated with the initial registration statement, S-4/proxy statement, and post-close accounting and reporting as a public company.
- Warrant valuations.
- Target selection and buyside financial, tax, and accounting diligence (including target public company readiness assessment).
- Fairness opinions where related parties are involved.
- Tax structuring.

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