# THE SPAC ROUTE: IS IT WORTH VISITING?

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## ABSTRACT

Happiest Minds Technologies, an IT services company, recently had one of the most successful Initial Public Offer (IPO) in the last decade. They offered their shares at a price of INR 166 a piece. The IPO was heavily oversubscribed and was listed at a premium of 111 % at INR 351 per share and is now trading at 3 times its listing price[1]. While there is no formula to guarantee a successful IPO, there are certain factors which an investor looks for before putting in her application. Most notable of them are- the business model, the market size, scope for growth, reputation and record of the management and the company's financials. This IT company checked almost all the boxes and hence saw the overwhelming response.

But, what if a company had none of it. No business, no financials, no employees and was merely an incorporated company on paper making a public offer for its shares. Would an investor apply for such an IPO? Absolutely not, right? From a logical standpoint and according to every fundamental of investment, this decision would make sense. One could even go so far as to say that such IPOs would be entirely pointless and would have no takers.

But what if you were to find out that, not only does a mechanism for such IPOs exist, but in fact IPOs by such 'no business' or shell companies have recently gained massive popularity, have raised billions of dollars in investment capital and are preferred to IPOs by companies having a working business model. This is where the mechanism of the Special Purpose Acquisition Company (SPAC) comes into play.

This paper intends to deal with the concept of SPACs, their working, advantages, drawbacks, regulatory challenges and the way forward in India.


[1] *Bumper Listing: Happiest Minds debuts at Rs 351, a 111% premium over IPO price*, https://www.moneycontrol.com/news/business/ipo/bumper-listing-happiest-minds-debuts-at-rs-351-a-111-premium-over-ipo-price-5849701.html.

## What is a SPAC?

A SPAC is basically a company, which has no underlying business operations and is incorporated with the sole objective to raise investment capital through an IPO, which is ultimately used to acquire another company (target) . The target generally is an established corporation running a successful business. This structure is mutually beneficial to the founders of the SPAC as well as the stakeholders of the target. Due to the nature of its formation and purpose , it is also referred to as a ' blank cheque company.'

SPAC as a concept has been around for decades and generally was used as a last resort by small companies when all other gates to funding were closed on them. However the last decade has seen a tremendous growth in their popularity . Chamath Palihapitiya, an American venture capitalist is accredited the most, with revival of the SPAC route of raising capital. Some people have touted him as the pied piper of SPACs[2]. Soon several famous actors and sport stars like Alex Rodriguez and Shaquille O'Neal[3] were seen sponsoring SPACs as their popularity and association with the company was expected to attract a lot of investment.

In fact big established companies like Virgin Galactic, Opendoor and Nikola Motor also chose the SPAC IPO route over the traditional one to get listed[4].

SPACs' statistics further reaffirm the popularity and efficacy of this IPO route as the funds raised through SPAC IPOs in 2019 was estimated to be around USD13.6 billion, which is a substantial growth from the 2016 number of USD 3.2 billion[5]. In fact in 2020 alone, around 230 SPAC listings managed to raise about USD 80 billion in funding[6].

## How is a SPAC formed and how does it work?

- **Step 1- Formation and allocation of interest.**

[2] Charles Duhigg, *The Pied Piper of SPACs*, https://www.newyorker.com/magazine/2021/06/07/the-pied-piper-of-spacs.
[3] Matt Egan, *Celebs including A-Rod and Ciara are getting into SPACs*. What could go wrong?, https://edition.cnn.com/2021/02/23/investing/spac-arod-kaepernick-celebrities/index.html.
[4] Tom Huddleston jr., *What is a SPAC? Explaining one of Wall Street's hottest trends*, https://www.cnbc.com/2021/01/30/what-is-a-spac.html.
[5] Somer Anderson, *Special Purpose Acquisition Company (SPAC),* https://www.investopedia.com/terms/s/spac.asp.pied.
[6] Haigreve Khaitan, *The buzz around SPACs: What it means for India,* https://www.cnbctv18.com/market/the-buzz-around-spacs-what-it-means-for-india-8668661.htm.

The founding members of a SPAC are called *'sponsors'* and they are generally an individual, a group or an institution with an expertise in the field of management.

The sponsors have to contribute some nominal capital in the company which amounts to 20 percent interest in the SPAC, and is commonly referred to as '*founder shares*'. The remaining 80 percent interest in the company is offered to the general public as *'units'* through an IPO. A unit is generally priced at USD 10[7] and consists of a share and a derivative called warrant ( an instrument that gives investors an option to purchase additional shares at a lower price) and after the merger, both shares and warrants are publicly traded.

- **Step 2- Finding a target**

Once a SPAC is formed, the next step is to raise funds through an IPO. All the proceeds raised by the company are placed in a trust account and a time frame of 18 to 24 months is given to the company to identify a suitable target to acquire or merge with . A successful merger with a SPAC is often referred to as ' de-SPACing'. SPACs generally look for targets within a particular sector, generally one in which the sponsors have an expertise. For instance, if a company has an automobile manufacture magnate as one of its sponsors, then they would try to seek out other automobile companies to merge with. SPACs can also raise additional capital by issuing financial instruments or by a private investment in public equity(PIPE) deal, in case additional funds are required to complete the merger.

- **Step 3- The Merger**

The approval of the SPAC's shareholders is a condition precedent to the finalisation of the merger. Further the company will also prepare a 'proxy statement' (and a joint registration if needed) which will contain all relevant information vis a vis the merger like financial statements of the target, management's discussion and analysis and various items that need the shareholders approval.

The investors also have an option to vote against the merger and redeem their shares, if they are unhappy with the choice of target and don't wish to be part of the merged company.

If the SPAC makes it through all the regulatory hurdles and gets the requisite approval, the merger is completed and the target becomes a publicly traded company.

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[7] *Why SPACs Are Booming*, https://knowledge.wharton.upenn.edu/article/why-spacs-are-booming/.

However if the merger is unsuccessful, the company is forced into liquidation and the proceeds of IPO are returned to the public investors.

**The IPO route choice: SPAC over traditional?**

With the rapidly growing investor interest in SPACs, the traditional IPO route is witnessing fewer visitors. This decline can be attributed to blue chip private equity firms, banks and other financial institutions becoming sponsors in various SPACs. The presence of such reputed institutions further attracts investments from a lot of private companies who are willing to be associated with them .The latest wave of SPACs involve Pershing Square Capital Management, Goldman Sachs and TPG Capital, among other major investment groups[8]. Some notable benefits that the SPAC route offers over the traditional one are:

- **Easy access to capital[9].**

Low net worth companies or new entrants in the market are constantly in need of capital to fund their expansion operations like acquisitions, marketing etc. and though IPOs are a very effective medium to raise capital, they usually work well for high net worth companies.

So investment in a SPAC provides these companies with much needed capital without them running the risk of losing any or substantial equity.

Funds raised by investment in SPACs have seen a 64% increase from the numbers reported in the year 2007 and they now stand at an amount well over USD 30 billion[10].

- **Eliminates risks associated with market volatility**

There is no fixed formula to guarantee a successful IPO. Big successful businesses have seen their stock price open at a discounted price due to market volatility or bad market sentiment on a particular day or session. There have also been instances where companies, with a view to

[8] Renaissance capital, *TPG's ESG SPAC TPG Pace Beneficial Finance files for a $350 million IPO,* https://www.nasdaq.com/articles/tpgs-esg-spac-tpg-pace-beneficial-finance-files-for-a-%24350-million-ipo-2020-09-04.
[9] Mike Bellin, 'Why are companies joining the SPAC boom?', https://www.pwc.com/us/en/services/deals/blog/spac-boom.html.
[10] 2020 Annual Capital Market Watch', https://www.pwc.com/us/en/services/deals/library/us-capital-markets-watch.html.

avoid under subscription of shares, have listed their shares at a value much lower than what it was actually worth, thus leaving a lot of money on the table.

SPACs help investors eliminate this risk associated with market volatility to a great extent as the investors and the sponsors are allowed to negotiate the terms of merger agreement and fix the price at which their shares will be listed.

- **Experienced management and freedom to set deal terms**

Good management is the backbone of any successful business. It is like the engine of an automobile. No matter how much you invest on the body and interiors of a car, unless you don't have a good engine, poor performance will be the end result. Similarly no matter how brilliant an idea or a product a company has, in the long run it would not survive without competent professionals running it.

This is another reason that makes SPACs so attractive and gives them an edge over an IPO, because the sponsors generally consist of successful management teams or industry leaders, whose presence almost guarantees success, raises fundraising standards and strengthens the investors confidence. For instance, a SPAC IPO by US based Accelerate Acquisition Corp. , in March 2021, was able to raise USD 400 million and the success of this IPO was accredited to its sponsors, which houses big names such as Accelerate's CEO Robert Nardelli, former chief of both Chrysler and Home Depot and Jeffrey Kaplan, a veteran dealmaker and the former head of M&A at Merrill Lynch[11].

However it would be prudent for an investor to make sure that his business model and his vision are aligned with the sponsor's long term business goals . For example a company involved with AI should look for a SPAC sponsor who works and has a good reputation in the tech space.

All these things form part of the determinants considered by the investors at the time of closing of a deal, and generally make them stick with the company.

[11] Jeff Reeves, *The SPAC List: 10 Dealmakers to Watch*, https://www.kiplinger.com/investing/stocks/ipos/602601/spacs-list-dealmakers-to-watch.

Further at the time of negotiation, the investors have a lot of wiggle room to set the terms of the merger to their advantage. This may involve naming their choice of directors or setting up terms to bring in additional funding.

- **Inexpensive and shortened time frame.**

Getting listed on a stock exchange by merging with a SPAC involves considerably less time when compared to the traditional IPO route as all that needs to be done is a merger between the two companies. The process is also comparatively inexpensive.

**However, that is not to say that this route is without risks.** To capitalise on the boom and make themselves a lucrative option for merger, sponsors have been seen rushing in to have a SPAC IPO without having any goal or particular sector in mind. This has led to a significant number of SPACs being targetless, while the 24 month time frame closes on them. In fact of the 248 SPAC listings that happened in 2020 in the US, 138 of them still haven't found a target[12]. Further this excess supply of SPACs has tilted the scales in favour of prospective targets, which may lead to such targets structuring the merger or the acquisition in such a way that may affect the returns of the retail investors post the de-SPAC process.

**Regulatory framework and challenges to companies in India[13]**

The very concept behind the existence of SPAC is that, the company, pre merger, is not supposed to have any business operations. This is why it is often referred to as a blank cheque or a shell company. This is perhaps the most integral aspect of its appeal, that the target company gets to keep its operations as is, and via a merger, are able to get listed on the stock exchange in a speedy and inexpensive manner.

However this aspect of a SPAC presents a major hurdle in its incorporation, working and compliance with India's regulatory framework.

Companies Act 2013, which is the governing legislation for incorporation and working of companies, does not define what a 'shell' company is, nor does it justify its legality despite it being suggested parliamentary committee report in 2018 to do the same in order "to avoid legal

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[12] Pranav Mukul, *Explained: What are SPACs and why are they under the scanner?,https://indianexpress.com/article/explained/what-are-spacs-and-why-are-they-under-the-scanner-7242646/.*

[13] 'Implementation of SPACs in India – Key Regulatory challenges M & A CRITIQUE JUN, 201', https://mnacritique.mergersindia.com/regulatory-challenges-special-purpose-acquisition-company-india/.

ambiguity and pre- empt avoidable legislation ". However the Securities and Exchange Board of India (SEBI), in it's advisory capacity to the government, did define the term ' shell company' which was largely based on the definition under the U.S SEC regulations[14].

Additionally, according to the 'objects' clause of the Act, an applicant looking to form a company is required to state its business objective. For instance, if it is a company which intends to operate in the FMCG segment, it must mention, inter alia, whether its objective is to be involved merely in production or in distribution as well. This is a problem because SPACs by its very nature have no business and the sole purpose behind their creation is to find a target and merge with it. Due to the rigidity this clause causes, a proposal was introduced to remove the objects clause altogether by The Companies (Amendment) Ordinance 2017, but it was never approved.

The old act of 1956 had a workaround for this in the form of 'other objects' clause, which gave a company a bit of flexibility to define its objectives, if they didn't fit in the traditional scheme of things. But this clause was done away with by the 2013 Act.

Another issue that SPACs could face lies in **section 248 of the Companies Act**, where a company's name may be struck off from the register of companies by the registrar if the company fails to commence its operations within one year from the date of its incorporation. This is particularly challenging for a SPAC because the time frame provided to them to find a target for a merger is 18 to 24 months. So it is highly unlikely that they will have any business operations within the first year. Further, SPACs cannot be asked to reduce their time frame as this is the least time that is required to research and find a suitable target which would help maximise shareholders' wealth.

As soon after their formation, SPACs go for an IPO, another problem they could face is, the requirements from an issuer set out by **section 26 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (amended Aug 2017)**[15]

They state that the issuer must have -

- "Net tangible asset of at least INR 3 crore in each of the preceding three years

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[14] https://content.next.westlaw.com/2-382-3819?__lrTS=20210323033310594&transitionType=Default&contextData=(sc.Default)&firstPage=true.
[15] https://www.sebi.gov.in/acts/icdrreg09.pdf.

- Minimum average consolidated pre-tax operating profit of INR 15 crore during any three of the last five years.
- Net worth of at least INR 1 crore in each of the last three years".

To begin with, by its very design, a SPAC will not have any tangible assets in the initial years because their sole asset is cash in hand raised from sponsors and the IPO, and further due to lack of operations there would be no operational profit as well.

Also all these conditions mention a minimum period of 3 years, whereas according to the SPAC model, to avoid liquidation, the entire merger process has to be completed within 2 years at the most which can only happen after the SPAC has been listed, so it is impossible for it to meet the SEBI's time frame requirements.

A SPAC would also find itself ineligible for listing according to the listing rules of the National Stock Exchange (NSE) which requires the companies to have positive operational cash accruals (EBITDA) for 2 years immediately preceding the application.

In addition to the above hurdles, the **SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (amended Mar 2017)[16] and Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations[17]2018** (FEMR) also have significant impact on the incorporation and working of a SPAC as they make the process time consuming and restrict the amount of control that can be exercised by the target or the acquirer. It also has a significant impact on cross border mergers.

**Where does India Stand?**

So from the discussion above, it is clear that in the face of existing regulatory challenges, a SPAC IPO is not possible in India right now. But Indian companies can still reap the benefit of this boom by merging with or being acquired by SPACs overseas and getting listed on a foreign stock exchange. Some recent examples of Indian companies that got themselves listed

[16]https://www.sebi.gov.in/legal/regulations/apr-2017/sebi-substantial-acquisition-of-shares-and-takeovers-regulations-2011-last-amended-on-march-6-2017-_34693.html.
[17] https://www.rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=11248.

on the NASDAQ through the SPAC route include Videocon d2h[18] and Yatra online inc[19].

While such international merger or acquisition may give them access to significant overseas capital and sophisticated investors among other advantages, the Indian company still needs to pay attention to compliance requirements under domestic laws such as the Foreign Exchange Management Act (FEMA) ,Companies Act 2013 and RBI approvals in case of acquisition and divestment of shares. . There could also be certain taxation issues post the cross border merger like the target being treated as a branch of the foreign company which apart from increasing the tax liability would also make the model less feasible[20].

This is not to say that the possibility of a SPAC IPO in India seems bleak, in fact paying heed to growing demand and popularity of this IPO route, The Securities Exchange Board of India (SEBI), has created and expert group to draft new set of regulations and propose amendments to the existing framework to make SPAC listings on domestic stock exchanges in India a possibility[21]. Recently, it has announced that it plans to do so soon, but has cautioned that certain departures from SPAC procedures around the world should be expected. Some of the proposed changes by the regulator and other financial advisors are -

- a minimum threshold size for the IPO,
- qualifications for sponsors so that only experienced and sophisticated individuals get involved,
- mandatory investment time for sponsors post the de-SPAC process, (12-18 months)
- Increasing maximum time allotted for completion of SPAC process from 24 months to 36 months.
- Mandatory due diligence ,audit, financial reporting requirements.
- Approval of merger by a minimum percentage of members of SPAC.

[18] Bhawan Gupta, Videocon d2h inks $375M deal with US blank cheque co; on track for NASDAQ listing, https://www.vccircle.com/videocon-d2h-inks-375m-deal-us-blank-cheque-co-track-nasdaq/.
[19] *'Yatra.com to list on NASDAQ via reverse merger with US-based blank cheque firm*', https://www.vccircle.com/yatra-merge-nasdaq-listed-terrapin-3-acquisition/.
[20] Kalpesh Maroo and Shruti BV, *SPACs: Bidding goodbye to traditional Initial Public Offers, but will it work for Indian firms?,* https://www.financialexpress.com/market/spacs-bidding-goodbye-to-traditional-initial-public-offers-but-will-it-work-for-indian-firms/2260893/.
[21] *Markets regulator Sebi plans to come out with framework for SPACs*', https://www.business-standard.com/article/markets/markets-regulator-sebi-plans-to-come-out-with-framework-for-spacs-121062401506_1.html.

**SPAC and The IFSCA Regulations.**

In 2015, at the GIFT Multi Services Special Economic Zone (SEZ) the Government of India operationalized the country's fist International Financial Services Center (IFSC). To further strengthen the legislative framework around it , the IFSC Act 2019 was enacted under which a unified regulator was appointed i.e. the IFSC Authority.

IFSCs are financial centers that can be established in SEZs only, for the purpose of providing International financial services. The most peculiar feature about such centers is that they are considered to a foreign territory for the purpose of any trade operation. This presents a unique opportunity for businesses, looking to set up or incorporate overseas to set up in India, take benefit of the expertise of several Indian professionals, yet still be treated as an overseas or off shore entity.

As a part of the IFSC's regulatory regime, the IFSC Authority (Issuance and Listing of securities) Regulations 2021 ("IFSC Listing Regulations") which were notified in July 2021, has created a detailed framework for issuing and listing of securities at such centers. Among other things these regulations also permit the setting up and listing of SPACs, thereby bypassing the regulatory challenges to setting up a SPAC in India to a certain extent. This also presents a great opportunity for domestic and international sponsors alike to acquire unlisted companies overseas and in India. Further the merger between an Indian target and a SPAC listed in IFSC would be relatively less time consuming as opposed to a cross border merger with a foreign SPAC.

**Conclusion**

The SPAC mechanism without a doubt is a great invention and has the capacity to act as a catalyst to a financial revolution in the area of raising capital. While it has numerous advantages over the traditional IPO route, it is not without its drawbacks and every interested party, especially retail investors should do their due diligence before investing in a SPAC and should avoid the lure of celebrity sponsors.

Also, the mechanism being relatively new, the regulatory authorities haven't really been able to cover every aspect of it, which has led to certain legal irregularities coming up from time to time. But with the pace at which its demand and popularity are growing, it is only a matter of time before we have a comprehensive mechanism governing the same. Apprehensions regarding the SPAC route being a bubble that will soon burst seem to find frequent mentions

but if history is anything to go by, similar apprehensions existed about Private Equity, over 8000 companies of which exist today.

So far as the Indian scenario is concerned, the need of the hour is to bring about systematic changes in its regulatory framework vis a vis SPACs and to move past the perception of shell companies being merely money laundering machines. A global study of rules and regulation governing SPACs should be conducted and either a new legislation dealing with formation , merger and regulation of SPACs should be enacted or corresponding chapters or provisions should be inserted in all relevant laws. SEBI forming an expert level committee to look into this matter is a bright ray of hope for the Indian financial market.