Highlight

May 2021

SPAC warrant valuations

SPAC is HOT in 2021

A special purpose acquisition company (SPAC), often called a "blank-check" company, is a corporation with limited operation and no history for the purpose of raising capital through an initial public offering (IPO) in order to acquire one or more businesses after the IPO. SPAC has obviously become a hot topic in recent years, but it is not a new idea. The first listing of a SPAC occurred in 1993. Being one of the alternative ways of listing with a lower barrier for almost 3 decades, SPAC began the boom in late 2019 in US market. European and Asian market (including Hong Kong according to the news) try to catch up by exploring the feasibility of listing SPAC in its exchange.

SPAC at a glance

A SPAC generally offers units, each may be comprised of one share of common stock and a fraction of a warrant to purchase common stock in the future. Only the unit is tradable at the time of the IPO, but its component - common stock, warrant (which is publicly listed), or the whole unit could typically be traded following the IPO. The purpose of the warrant is to provide the investors with additional compensation for investing in SPAC.

In most cases, "public shares" and "public warrants" refer to the component of the units sold to the public, while "founder shares" and "founder warrants" refer to the shares and warrants sold to the sponsor.

Typically, the purchase price of a unit is $10, while the strike price for the warrants is $11.5. The warrants normally become exercisable on the later of (i) 30 days after the De-SPAC transaction and (ii) the anniversary of the SPAC IPO. The founder warrants and public warrants are generally identical apart from the redemption features mostly found in public warrants.

Chart 1 shows the capital raised through SPAC has climbed significantly, raising more than $83 billion in 2020 in US. The number of SPAC IPOs has surged from 13 in 2016 to 248 in 2020 in the US market (Chart 2). The number of SPAC IPOs and capital raised via SPAC IPOs in Q1 2021 even overtook the whole year of 2020.

Chart 1 Proceeds of SPAC IPOs in the US from 2016 to 2021 April (in USD billion)

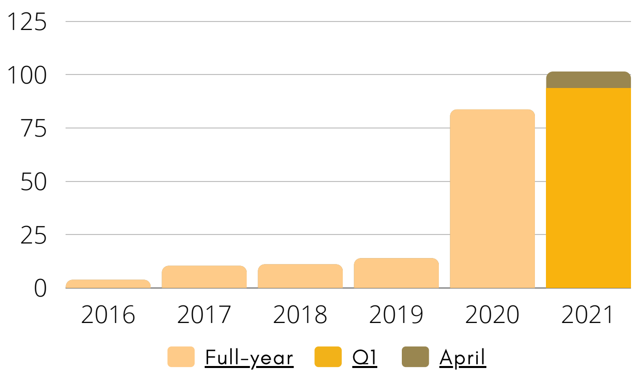
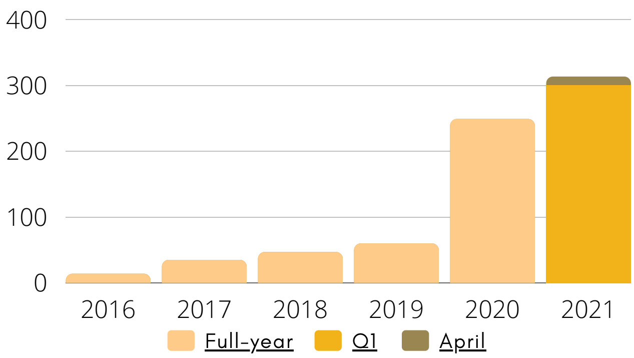


Chart 2 Number of SPAC IPOs in the US from 2016 to 2021 April



Source: S&P Capital IQ, SPAC Insider

The SEC's scrutiny of SPAC

On 12 April 2021, the U.S. Securities and Exchange Commission (the "SEC") issued a statement (the "Statement") discussing the accounting implications of certain terms that are common in warrants issued by SPACs. It highlights potential accounting implication to many SPAC warrant agreements and specifies the requirement for SPACs to classify the warrants as an equity or a liability.

Prior to the Statement, most SPACs have accounted for private and public warrants as equity. The Statement has expressed their views that warrant containing certain provisions is more appropriate to be recognized as a liability and measured at fair value quarterly, with changes in fair value recorded in the statement of profit or loss. If the impact of the change in accounting treatment is material, a restatement of previously issued financial statements may be required. Since the beginning of the year 2021, more than 170 SPACs have announced that they have to restate their financial statements.

What makes SPAC warrants special?

Warrants are usually exercisable at a price of $11.50 per share. Public warrants usually have a redeemable feature that allows the SPAC to redeem the warrant at a price of $0.01 per warrant when the warrant trades at an average price of $18 for any 20 trading days within 30 trading days, the warrant holders then have a 30-day period to decide whether to (i) exercise the warrants, (ii) sell the warrants in the market or (iii) let the SPAC buy back the warrant at $0.01 per warrant.

If SPACs are unable to consummate a de-SPAC transaction within a predetermined period, the SPACs will cease all operations with all warrants expiring without liquidation distributions.

Key takeaways from SPAC warrant valuations

Callable features
The warrants may contain features conditioned only on the stock price. For example, the company may call the warrant, effectively forcing exercise if the stock price exceeds a certain level. These components should be factored in using binomial models.

Redeemable features
The warrant may contain a redeemable feature of which the SPAC is eligible to redeem the warrants within the 30-day redemption period in case that the share price exceeds a certain level (an average price of $18 in most cases). This feature, which is common in public warrants, shall be factored in by modifying a traditional option pricing model.

Pre-SPAC or post-SPAC volatility?
Volatility is a key assumption in almost all option pricing models. However, the volatility is normally low until one or more de-SPAC transaction is undertaken. Those SPACs with de-SPAC transactions completed recently or an intention to merge with a company in a specific segment could be taken as one of the benchmarks for the volatility to be adopted in the option pricing model.

Probability and timing of the de-SPAC transaction to happen
Unlike the public shares that could be redeemed if no de-SPAC transaction is consummated by the predetermined period, the warrants would likely expire without value in that case. A scenario-based analysis with the consideration of the probability and the timing for the de-SPAC transaction to happen could be adopted in the valuation of the warrants.

How to take into account the extraordinary features?
Warrants might contain a number of unique provisions depending on the potential outcomes of the SPACs. If those complex features are likely to happen, you may require a complex valuation model to cater the possible outcomes, for example, Monte Carlo simulation or other valuation tools.

Sanity test
A warrant is typically sold together with common share as a unit. As such, the price of a unit should be the same as the total purchase price of the warrant and share. During the course of the valuation of warrants, iterative modeling may be required as the warrant price is determined based on the share price, while the unit price is publicly available on the exchange market.

Market value as fair value?
In most cases, public warrants become marketable shortly after the IPO. Technically, one might not ignore its market price when determining its fair value if sufficient market liquidity is observed. Other valuation approaches have to be adopted as well if the warrants are thinly traded or without a meaningful quoted price.

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