Should Canadian private companies merge with a special purpose acquisition company?

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Going public in Canada is usually accomplished in one of two ways - through a traditional IPO or, for smaller companies, through the capital pool company (CPC) route. These days, however, a third option is gaining momentum: the special purpose acquisition company (SPAC).

SPACs (also known as blank check or blind pool companies) are formed with the express purpose to raise money through an IPO and then use that money, in combination with its stock, to merge with a privately-held operating company - effectively taking that private company public.

Wildly popular south of the border, an estimated 200 SPACs went public in the United States in 2020, raising roughly $64 billion.[1] Canada's SPAC market looks lacklustre in comparison, with 25 SPACs going public in 2020, predominantly in the mining and cannabis sectors.[2]

Yet, despite this relatively modest showing, SPACs could offer some unique benefits to Canadian operating companies looking to access the public markets. First off, because SPAC transactions do not require a road show or market canvas to find investors, it is typically faster to go public through a SPAC than through a traditional IPO. SPACs still need to prepare an information circular setting forth prospectus-level disclosures about the resulting company formed from the merger and file a non-offering prospectus with securities regulators. That said, there is somewhat less scrutiny with a SPAC transaction than with a traditional IPO. Canadian operating companies are also attracted to the large pools of capital parked in SPACs.

After a SPAC goes public, it has only 36 months to merge with an operating company - which is pushing up demand for growth-oriented operating companies interested in accessing substantial capital in a short timeframe. For companies that fall into that category, it makes sense to consider a merger with a SPAC as an alternative to an IPO, a sale to a strategic buyer or a sale to a private equity buyer.

A word of caution

All that said, SPACs do come with a range of complexities that make them less suitable for some companies. Before jumping in to the SPAC world, there are a number of issues that should be considered:

- **Dilution.** The starting point of any negotiation with a SPAC will involve determining the value that will be ascribed to the operating company. Setting a value can be challenging in the absence of the market canvas that is required for a traditional IPO, which involves receiving pricing inputs from a number of possible investors. In setting this value, it is important to understand the extent of dilution that the operating company's founders or shareholders will be expected to bear. For instance, if the deal is structured as a share-for-share exchange, the operating company's shareholders may lose a larger ownership percentage than anticipated. Similarly, warrants issued by the SPAC as part of the IPO could also add to the dilution. A deal that looks good on paper may not deliver the desired end result if the economics of the transaction are not carefully considered right from the start.

- **Governance.** In merging with a SPAC, completion of the qualifying transaction is only the first step. To lay a foundation for ongoing success, it is critical to adopt an effective governance structure. For operating companies, this means addressing a host of questions up front, including who will act as management, who will form the board and whether any class of shareholders will have greater voting rights. Ideally, the SPAC's sponsorship team should bring expertise to the table that the operating company lacks. This makes it critical to assess the quality of sponsors ahead of time.

- **Ongoing capital needs.** Implicit in the structuring of a SPAC deal is the assumption that the SPAC has sufficient capital to allow the operating company to execute its business plan. While this may seem obvious, it cannot be overlooked. Availability of additional capital when required down the road cannot be assumed, as it will depend on the prevailing market's receptiveness to the company's subsequent offerings to raise further capital. Therefore, effective capital management and planning are critical in order to ensure that the company subsequently taps the capital markets from a positon of strength rather than desperation or weakness.

- **Deals**
  - **Canadian SPAC deals.** Merging with a SPAC involves one or a combination of corporate steps, which may include a sale of shares, asset sale, amalgamation or a court-approved plan of arrangement. Additionally, the following matters will need to be considered in pursuing a transaction with a SPAC:
    - restrictions on share transfers under the shareholders' agreement and the company's articles;
    - structuring the transaction in a tax-efficient manner;
    - the required disclosure of the company's business in the deal-related disclosure documents;
    - disclosure of financial matters, including the company's audited financial statements;
    - consents and waivers that may be required in connection with a change of control;

    - purchasing D&O insurance policies; and
    - establishing equity compensation plans for directors and employees.
  - **Doing a deal with a U.S. SPAC.** A Canadian operating company considering going public through a merger with a U.S. SPAC will have additional considerations, including:
    - structuring the transaction in a tax-efficient manner, keeping in mind cross-border tax issues;
    - ensuring that shares received by Canadian shareholders may be resold without restriction on the U.S. stock exchange, where the resulting issuer will be listed;
    - understanding the risks and opportunities for listing on a U.S. stock exchange; and
    - understanding the heavier financial accounting and reporting requirements under U.S. regulations.

Do your homework

By giving operating companies a way to go public without worrying about the vagaries of the IPO market, SPAC transactions will likely continue to grow in popularity in Canada. This is especially true if institutional investors decide to leverage SPACs as a way to support the nation's innovative and growing companies and as an alternative to participating in larger financing rounds.

Despite their mounting popularity, SPACs may not be right for every company. Legal complexities and operational intricacies may mean that an alternative form of financing is best for you.

[1] CNBC, Jan. 30, 2021. "What is a SPAC? Explaining one of Wall Street's hottest trends," by Tom Huddleston Jr.

[2] BNN Bloomberg, Feb. 3, 2021. "As big-name SPACs heat up in U.S., Canada's workhorse deals wane," by Kevin Orland and Michael Bellusci.

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