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High redemption rates see SPACs relying on alternative financing

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When a special purpose acquisition company (SPAC) completes an IPO, the proceeds are held in a trust account until the SPAC identifies a target company to merge with, typically within a one- to two-year window after listing. Because the SPAC itself has no business operations and the target company isn't known at the time of the IPO, investors have the opportunity to redeem their shares prior to the business combination for a pro-rata share of the funds in the trust account. These redemption rights help incentivize investors by providing a "money-back guarantee" of sorts, allowing them to redeem their shares at the original IPO price — typically a nominal $10 per share.

In December 2021 alone, several SPACs faced high (and sometimes unexpected) redemption rates which were mitigated by alternative methods of financing.

However, if a large percentage of shareholders choose to exercise their redemption rights — which has been the case for several SPACs as of late — this can drastically reduce the cash proceeds that the combined company will have available for its future operations. If the redemption rate is exceptionally high, the SPAC may be in danger of failing to meet its minimum cash condition (i.e., the minimum amount needed to proceed with the deal).

For 2021, SPAC redemptions were on the rise. According to SPAC Research/SPAC Alpha (https://bit.ly/3zvMeeV), from January to July, the average monthly SPAC redemption rate ranged from 7%-43%. From July to November, however, this range jumped to 43%-67%, with the average SPAC seeing approximately a 60% redemption rate during these four months.

Investors may redeem their shares for a variety of reasons. If shares are trading below their listing price ahead of the business combination (i.e., below $10 per share), investors can recoup their losses by redeeming their shares at the original price. Alternatively, investors who purchase SPAC stock that is already trading below its listing price can turn around and redeem these shares at the higher original value.

In some cases, investors may redeem their shares if they are not in favor of the business combination. When SPACs merge with companies (especially start-ups) in highly speculative industries — such as commercial space flight or electric vehicles — investors may balk at the additional risk this presents. Even if a shareholder votes in favor of a business combination, they may still choose to redeem their shares prior to the de-SPAC transaction if they have misgivings regarding the target company's viability.

Additionally, heightened scrutiny from regulatory bodies such as the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) within the last few months has made SPAC deals inherently riskier. The recent initiation of federal probes into several high-profile SPACs has likely cooled the heels of many retail investors.

The primary backstop to ensure a SPAC meets its minimum cash threshold is additional financing. This can take the form of public investment in private equity (PIPE), forward purchase agreements, or debt financing.

Despite this, SPACs can attempt to guard against the possibility of high redemption rates in several ways. To begin with, SPAC sponsors, directors, and officers typically waive their redemption rights with regard to their founders' shares and any public shares they may have purchased. SPACs can also set a limit on the percentage of total outstanding shares any single shareholder (or shareholders acting as a group) can redeem. This limit is set forth in what's known as a "bulldog provision" and usually falls between 10% and 20% of the total outstanding Class A Stock.

The primary backstop to ensure a SPAC meets its minimum cash threshold, however, is additional financing. This can take the form of public investment in private equity (PIPE), forward purchase agreements, or debt financing. PIPEs — which often run concurrently with de-SPAC transactions — consist of an agreement with one or more large institutional investors (e.g., hedge funds, mutual funds, banks, etc.) who agree to purchase a certain number of shares in the SPAC, sometimes at a discounted rate. Because institutional investors are accredited and typically more sophisticated than retail investors, they provide a more reliable and efficient source of capital. It is also not uncommon for entities affiliated with the SPAC sponsors to participate in these types of PIPE deals.

A forward purchase agreement is similar but materializes at the time of the IPO. The agreement is a commitment by affiliates of the sponsor to purchase shares in the future if additional capital is needed to fund the business combination. SPACs also have the option to utilize convertible debt financing to raise capital by issuing notes that will mature and convert into company shares at a later date.

In December 2021 alone, several SPACs faced high (and sometimes unexpected) redemption rates which were mitigated by alternative methods of financing. Two recent cases are those of Virgin Orbit and Buzzfeed.

Virgin Orbit (VORB) — 82.3% of SPAC's shares redeemed.

	Expected	Actual	Difference
PIPE	$100M	$160M	+$60M
SPAC Trust	$383M	$68M	-$315M
Total	**$483M**	**$228M**	**-$255M**

Data source: SPAC Research and The Wall Street Journal (https://on.wsj.com/31vBtwv)

On Dec. 29, 2021, Virgin Orbit (a company specializing in small satellite launch) closed its transaction with NextGen Acquisition Corp. II. Virgin Orbit had originally expected to raise $483 million in total gross proceeds, including a $100 million PIPE led by Boeing, AE Industrial Partners, and others. However, an 82.3% redemption rate ahead of the transaction drained $315 million from the SPAC's trust account, leading the company to raise less than half of the originally anticipated total.

While the SPAC's trust dropped to an underwhelming $68 million, the PIPE was subsequently boosted to $160 million, with the Virgin Group and Mubadala Investment Company agreeing to purchase shares in order to finance the deal.

Buzzfeed (BZFD) — 94.4% of SPAC's shares redeemed.

	Expected	Actual	Difference
Convertible Note	$150M	$150M	$0M
SPAC Trust	$288M	$16M	-$272M
Total	**$438M**	**$166M**	**-$272M**

Data source: SPAC Research and Space News (https://bit.ly/3pZXoFC)

Another SPAC redemption case that garnered significant publicity was popular online content and media platform Buzzfeed and its business combination with 890 5th Avenue Partners. Before the transaction closed on Dec. 4, 2021, 94.4% of the SPAC's shares were redeemed, an unexpectedly high percentage. As a result, Buzzfeed only managed to raise a meager $16 million out of an expected $288 million. However, Buzzfeed had also arranged a concurrent $150 million convertible debt financing round led by Redwood Capital Management to provide a cushion of capital.

According to SEC filings (https://bit.ly/3t4o9uA), the convertible notes mature in 2026 and will be convertible into approximately 12 million shares of 890 5th Avenue Partners Class A Common Stock. While the interest rate was originally set at 7% per annum, the term sheet stipulated that this would jump to 8.5% in the event the SPAC's trust fell below $144 million, which was indeed the case.

If the trend of high shareholder redemption continues into 2022, SPACs will likely have to continue relying on alternative methods of financing as a safety net for their business combinations. This has the potential to foster an even more competitive PIPE market, which could force SPAC sponsors to get more creative with supplemental financing methods. While high redemption rates don't necessarily reflect how a company's shares will perform post-transaction, they are perhaps a good barometer of the level of risk retail investors are willing to assume as the SPAC market continues to fluctuate.

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