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An essential guide to SPAC listings in Hong Kong

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Content

Executive summary

Special purpose acquisition companies ("SPACs") have been used for decades as alternative investment vehicles in the United States ("US"), and recently came into vogue as seasoned investors and management teams sought to mitigate the increased market volatility risk of traditional initial public offerings ("IPOs"). 2021 was a record-breaking year for SPAC listings in the US. The proceeds raised in 2021 were nearly double the amount raised in 2020. This surge was driven by an influx of high profile investors and management teams into the SPAC market, coupled with an abundance of capital and liquidity from monetary and economic easing measures introduced by the US government and organizations to address the COVID-19 pandemic.

Given market developments in SPAC listings in the US in recent years and potential merger and acquisition ("M&A") opportunities in Asia Pacific, the Stock Exchange of Hong Kong ("HKEX") issued rules to create a listing regime for SPACs that took effect on 1 January 2022.

SPAC transactions come with unique challenges, and it is essential that entities understand the risks associated with these investment vehicles and have a comprehensive project management plan to meet the demands of shorter merger timelines.

This publication covers:

Background

a brief look at the past and present of SPACs, including the new listing regime in Hong Kong;

The rise of SPACs

an examination of the conditions and trends driving the momentum of SPACs in recent years;

The lifecycle of a Hong Kong SPAC

an overview of a possible lifecycle of a SPAC, from inception to the consummation of a merger under the new listing regime;

Managing ongoing operations

a survey of the core competencies that should be examined and elevated after a target company is acquired;

Considerations for targets

SPAC listings versus other traditional exit options; and,

The listing regime for SPACs in Hong Kong

key features

Recent market volatility, coupled with the arrival of seasoned sponsors and management teams, has created a SPAC revolution. The abundant funds held in trusts and the increased appetite for private investment in public equity ("PIPE") transactions have thrust SPACs from the fringe of capital markets into the mainstream as vehicles for potential sponsors, investors, and target operating companies.

Background

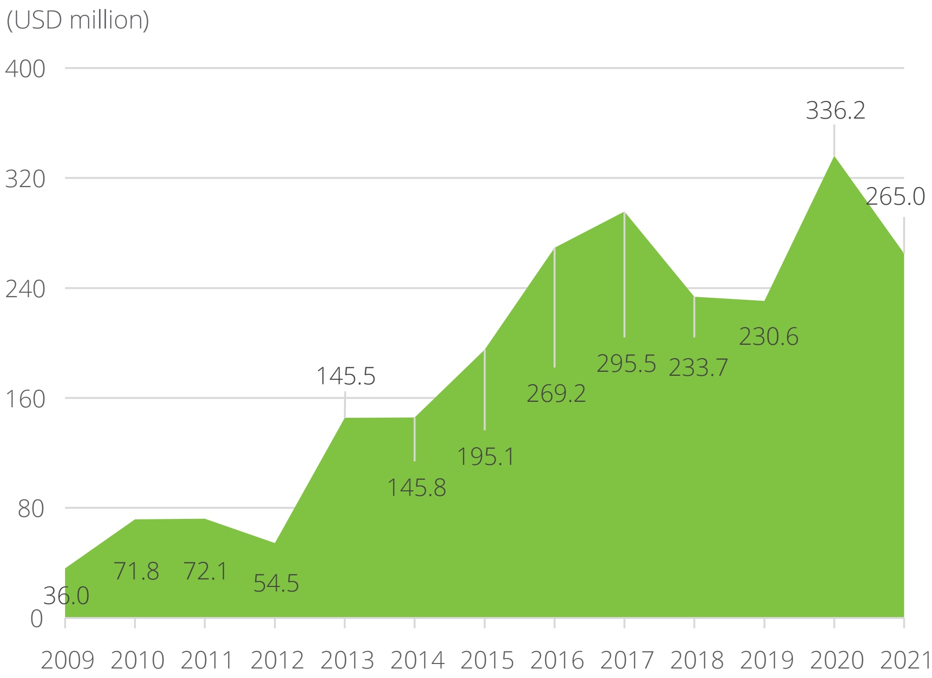
Introduction

A SPAC is a newly created company that uses a combination of IPO proceeds and additional financing (including PIPEs, which have become common in recent years) to fund the acquisition of a private operating company. The IPO proceeds are placed in an escrow account while the SPAC's management team seeks to complete the acquisition of an existing private operating company ("target"), usually in a specific industry or geography, within the period stated in the SPAC's governing documents. In Hong Kong, SPACs are given a timeline of 36 months to complete a de-SPAC transaction. If the SPAC completes an acquisition, the target takes on the SPAC's public filing status, and effectively becomes a public company. If the SPAC cannot complete an acquisition in the allotted timeframe, the cash held in its escrow account is returned to investors unless the SPAC extends its deadline via a proxy process.

Past and present

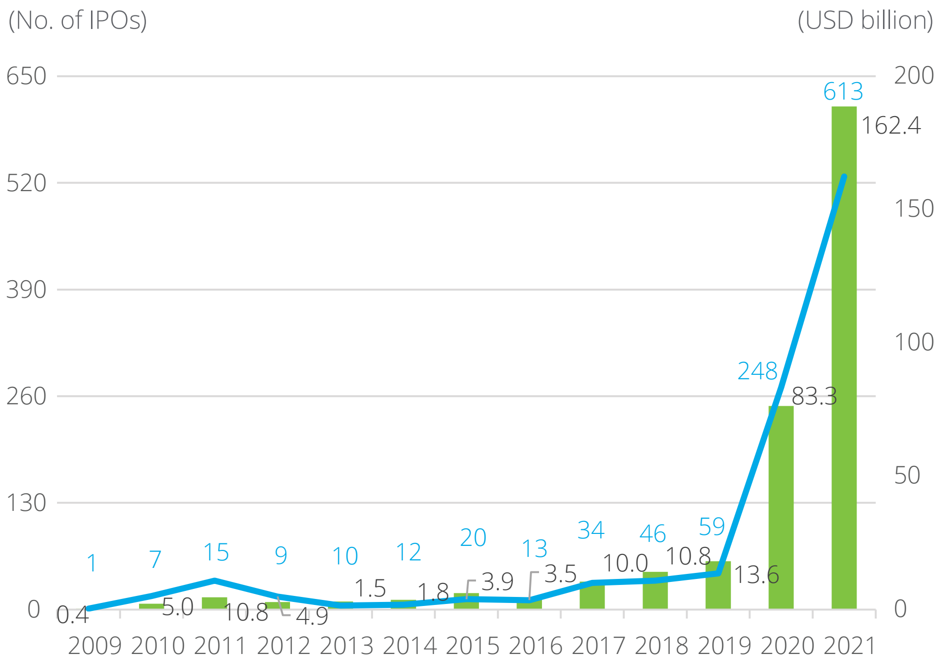
Entities with characteristics similar to those of SPACs have existed for decades in various iterations as "blank check companies" or "public shells." The term "SPAC" was coined in the US in the 1990s, when sponsors focused on the technology, media, and healthcare industries. Since then, the popularity of SPAC offerings has ebbed and flowed, depending on economic conditions, trends in capital markets, and the general health of the IPO market. In the mid-2010s, SPACs gained popularity in the US oil and gas industry as depressed commodity prices drove investors towards experienced management teams that were increasingly likely to find existing operating companies or mineral rights to purchase at a discount. Since 2013, the number of SPAC IPOs in the US has increased steadily, and 2021 was a banner year for SPAC listing volume in the US.

Average size of SPAC listings in the US since 2009



Source: SPACInsider, 6 January 2022.

SPAC listings in the US since 2009



Source: SPACInsider, 6 January 2022.

Due to this proliferation of SPAC listings in recent years, Hong Kong's Securities and Futures Commission ("SFC") and HKEX were asked to explore a suitable listing regime to enhance the competitiveness of Hong Kong as an international financial center while safeguarding the interests of investors.

In September 2021, HKEX published a consultation paper seeking public feedback on proposals to create a listing regime for SPACs in Hong Kong. The consultation conclusions were published on 17 December 2021 and shaped the listing regime for SPACs that took effect on 1 January 2022. They presented detailed market feedback and conclusions alongside several appendices, including a guidance letter.

The amendments to the Rules Governing the Listing of Securities on HKEX set out in the consultation conclusions and guidance letter also came into effect on 1 January 2022.

The rise of SPACs and the lifecycle of a Hong Kong SPAC

The rise of SPACs

The increasing use of SPACs as an alternative to traditional IPOs is the result of a confluence of factors.

First, the unspent committed capital, or "dry powder," held by private equity together with abundant liquidity arising from the pandemic-related monetary easing measures of different countries in 2021 bolstered the supply of capital sitting on the sidelines. Second, although the price of a traditional IPO is affected by market volatility and broader investor sentiment, which can fluctuate leading up to the time of pricing, SPAC mergers provide more certainty because of their upfront pricing and valuation, typically determined through negotiations that occur months before a transaction closes. The recent rise in market volatility, which is largely attributable to the pandemic, has also prompted some companies to forego a traditional IPO for the upfront price discovery and potentially shorter timeline offered by a SPAC transaction. Furthermore, SPAC mergers give promoters the opportunity to raise additional capital through PIPEs to finance a large portion of the target's acquisition price and provide post-merger operating cash.

As the use of SPACs has increased, several well-known investors and hedge fund managers have entered the space, and some high-profile SPAC acquisitions have given repute to the structure as an investment vehicle. In many cases, these sophisticated promoters have remained involved with the target company after a merger is consummated to provide ongoing support. The influx of seasoned managers with proven track records, coupled with better alignment of promoter incentives with investor returns, has increased investor confidence in SPACs, enabling them to raise large amounts of capital with which to target bigger, more mature companies. In addition, the SPAC market has benefitted from the entrance of investors who have looked at post-IPO SPACs as a means of finding suitable returns in a volatile market.

The lifecycle of a Hong Kong SPAC

A SPAC's life begins with its establishment, followed by its IPO (or listing), search for a target, a shareholder vote on a merger decision, and finally the close of an acquisition (or the return of the SPAC's proceeds to investors). This is unlike a traditional IPO because the target company (which becomes a public company post-acquisition) is not involved in the formation of the SPAC or the IPO. In Hong Kong, the terms of the units offered in a SPAC IPO and the agreements the SPAC has with its promoter and management team ultimately influence the value that investors in the target company extract from a merger.

The SPAC lifecycle is outlined below.

Formation → IPO → Target search → Shareholder vote and de-SPAC → Close of acquisition

Formation

When a SPAC is launched, the promoter, and often its management team, pays a nominal amount for an equity stake in the SPAC, which is often referred to as "promoter shares". The promoter shares the initial investors receive generally represent not more than 20% before the completion of a de-SPAC transaction. These shares are intended to compensate the initial investors for identifying a promising target and consummating a merger. During this stage, the promoter typically lends money to the SPAC to fund ongoing expenses, while the SPAC selects legal counsel and underwriters and establishes its terms of governance.

IPO

After its formation, a SPAC begins its public offering, with the promoter submitting a listing application to HKEX.

The SPAC then raises capital by issuing units (each consisting of a common share and a warrant), and the proceeds are held in a ring-fenced escrow account until a target is acquired. In Hong Kong, a SPAC must distribute shares and warrants to at least 75 professional investors, of which 20 must be institutions. Once an IPO is completed, the units are separated into common shares and tradable warrants, with the latter designed to provide additional compensation for the initial investment and usually exercisable shortly after a merger is consummated.

Target search

The search for a suitable acquisition target is similar to the process in a typical M&A transaction, with the promoter vetting potential targets through accelerated financial, legal, and tax due diligence. In Hong Kong, a successor company must meet all new listing requirements of the Main Board, including engaging an IPO sponsor to conduct due diligence and meeting minimum market capitalization requirements and financial eligibility tests.

The timeline to close a SPAC acquisition depends on multiple factors. Because dissenting SPAC shareholders have the right to redeem shares, the amount of cash available to pay the target shareholders and fund post-close operations can be uncertain. Therefore, SPACs and targets often negotiate "minimum cash" as a closing condition. For this reason, SPAC acquisitions often involve a simultaneous PIPE investment upon consummation of a merger.

Key terms

Promoter ("sponsor" in the US): founding investors that lead the SPAC process.

Successor company: A private company targeted for acquisition that ultimately becomes a public company after the merger is consummated.

De-SPAC: This process begins after a letter of intent is executed and ends when shareholders approve the transaction and the merger into the SPAC is consummated.

PIPE: A means of raising additional capital after a target is identified to finance a substantial portion of the acquisition price.

Lock-up period: A period after an IPO in which certain shareholders cannot sell the shares they hold. The lock-up period for a SPAC IPO is typically longer than for a traditional listing.

In Hong Kong, the acquisition of the target must be completed within 36 months of a SPAC IPO, with a possible extension of up to six months. The target must also have a market value of at least 80% of the funds raised by the SPAC from its IPO.

Shareholder vote and de-SPAC

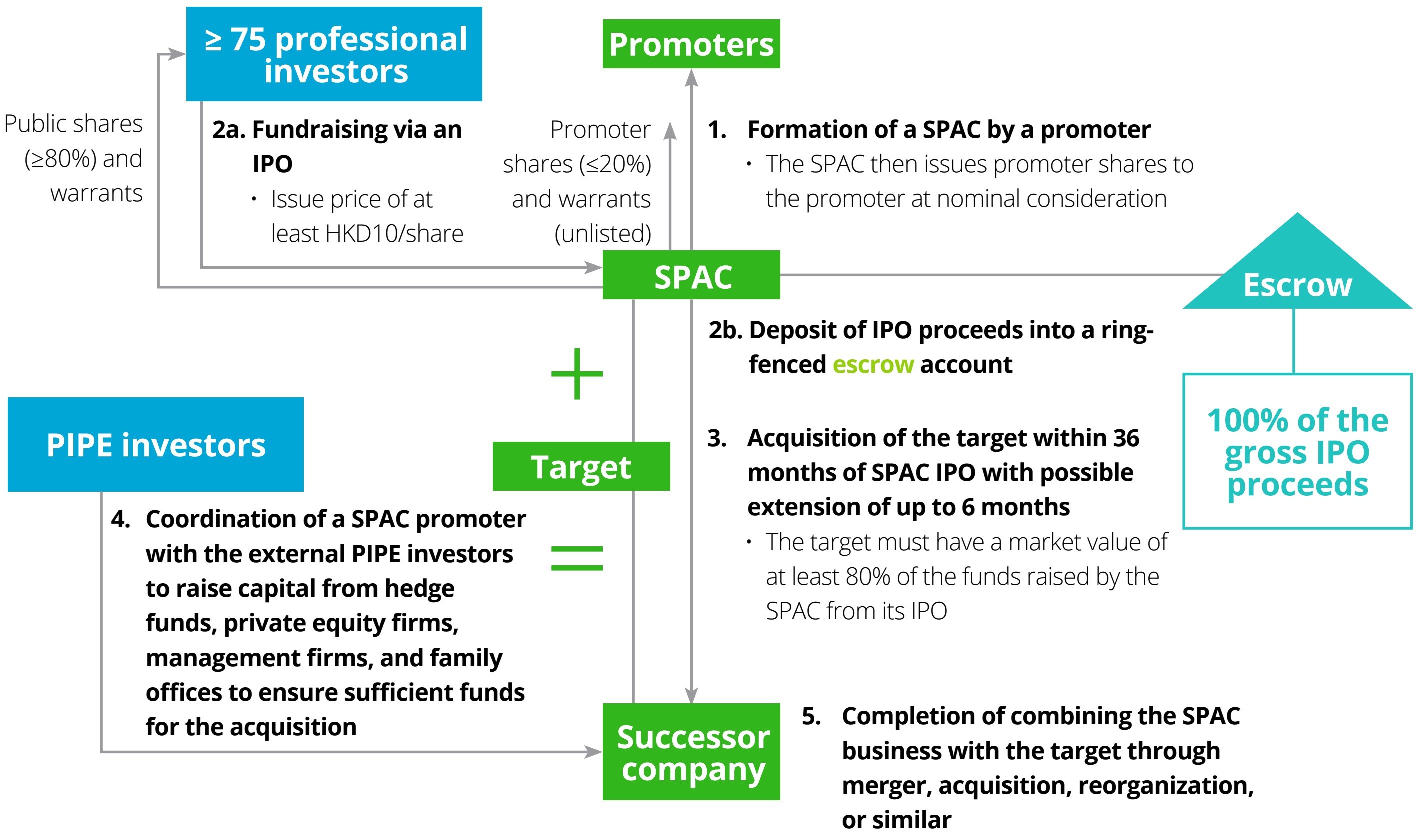
A de-SPAC transaction must be approved by the SPAC shareholders at a general meeting. At founding, the promoter and other initial shareholders typically commit to vote their interest (generally representing not more than 20%) in favor of a transaction, which decreases the number of additional common shares that need to vote for the merger. As such, SPAC promoters and their close associates who are regarded by the HKEX as having a material interest must be abstained from voting on this resolution.

A successor company must appoint at least one IPO sponsor to assist with its listing application. The requirements for any forward-looking statements in the listing document for a de-SPAC transaction are the same as those for an IPO, including the requirement that the reporting accountant and IPO sponsor report these statements.

Close of acquisition

If an affirmative vote is obtained from the proxy, the acquisition can close by merging the target into the SPAC, and the target company becomes a publicly traded entity. The promoter shares and warrants will be locked up for 12 months upon completion of this de-SPAC transaction.

The key stages in the lifecycle of a SPAC in Hong Kong are as follows:



Managing ongoing operations

Closing the acquisition is merely the beginning of the new, public phase of the operating company. On the date of closing, the formerly private operating company must meet public company reporting obligations. At this stage, it is imperative that the company makes a concerted effort to elevate its personnel, processes, and technology to support the demanding reporting schedule of a public company.

An assessment of capabilities should at least include:

- **Budgeting, forecasting, and investor relations** — Financial planning and analysis and investor relations should be emphasized to enable the entity to ensure that accurate and transparent forecasts are communicated to investors and analysts.
- **Financial reporting** — Finance and accounting professionals should have strong skills in preparing reports in Hong Kong Financial Reporting Standards or International Financial Reporting Standards, and be disciplined in meeting half-yearly and annual close reporting deadlines.
- **Internal controls over financial reporting** — Finance and accounting personnel should be well versed in effective disclosure processes and controls, particularly for financial reporting.
- **Tax planning and strategy** — Tax planning and strategy is a key element of cash management and budgeting.
- **Governance** — The board of directors and related committees must meet HKEX governance codes, which require an audit committee, nomination committee, risk committee (if any), and corporate governance functions.
- **Information technology** — A well-structured enterprise resource planning suite is needed to sustain the business objectives above. The board and chief information officer should tighten their focus on cybersecurity and protecting sensitive information.
- **Other key processes** — Treasury, executive compensation, environment, social and governance, internal audit, legal and compliance, and human resources should be assessed.

Considerations for targets: SPACs versus other traditional exit options

Are we ready and willing to operate as a public company?
When SPAC promoters approach private companies, often out of the blue, the deal can look so attractive that the successor companies scramble to meet strict deadlines in complying with a public company's immediate and ongoing requirements. An IPO, however, generally provides more time—sometimes years—for a company to get ready to operate, upgrade financial reporting, and develop governance structures and functions.

Are we willing to negotiate to improve SPAC merger economics?
Post-merger shareholders typically assume significant dilution due to a SPAC's inherent structure. In many cases, promoters provide just 2% of an IPO's value yet receive 20% of the SPAC's total equity. However, nearly every aspect of SPAC merger transactions is negotiable, and successor companies should be prepared to negotiate everything from the opening stock price and sponsor ownership stakes, to board composition, and beyond. As more successor companies become engaged in these negotiations, the quality and economics of deals are steadily improving in favor of post-merger investors.

Do SPACs portend even higher valuation multiples?
SPACs in Hong Kong and the US must close transactions at least within three years (in Hong Kong, this can be extended by up to six months if shareholders approve), or return their IPO proceeds to shareholders. In the US, pressure to close a deal as this two-year anniversary approaches has led some SPAC sponsors to overpay. This, and the record SPAC issuance in the US, with a huge amount of private equity dry powder and excess corporate liquidity, creates a real risk of demand for targets exceeding supply and pushing up valuations.

Key features of the SPAC listing regime in Hong Kong

<table>
<tr><th>Item</th><th>Requirements</th></tr>
<tr><td>Minimum funds to be raised</td><td>HKD1 billion</td></tr>
<tr><td>Minimum public float</td><td>Successor company must ensure:
i. its shares are held by at least 100 shareholders;
ii. not more than 50% of its securities in public hands are beneficially owned by the 3 largest public shareholders; and
iii. at least 25% of its issued shares are held by the public</td></tr>
<tr><td>Minimum issue price</td><td>HKD10 per share</td></tr>
<tr><td>Investor suitability</td><td>Only professional investors can subscribe for and trade SPAC shares.</td></tr>
<tr><td>Open market requirement</td><td>SPAC shares and warrants must be distributed to at least 75 professional investors, of which 20 must be institutions
At least 75% of a SPAC's securities (shares or warrants) must be distributed to institutional professional investors</td></tr>
<tr><td>Trading arrangements</td><td>SPAC shares and warrants can trade separately from the initial offering date to a de-SPAC transaction</td></tr>
<tr><td>Timeframe for a de-SPAC announcement</td><td>24 months (with an extension of up to 6 months if shareholders approve)</td></tr>
<tr><td>Timeframe for a de-SPAC transaction</td><td>36 months (with an extension of up to 6 months if shareholders approve)</td></tr>
<tr><td>Approval for de-SPAC</td><td>Requires a majority of SPAC’s shareholders at a general meeting, where SPAC promoters and their close associates must abstain</td></tr>
<tr><td>Value of a de-SPAC target</td><td>At least 80% of the funds raised by the SPAC from its initial offering</td></tr>
<tr><td>Independent third party investment</td><td>The following amounts from independent PIPE investors must be raised, staggered to cater for de-SPAC targets of different sizes:
<table>
<tr><th>Negotiated De-SPAC value (A) (HKD billion)</th><th>Minimum independent PIPE investment as a percentage of (A)</th></tr>
<tr><td><2</td><td>25%</td></tr>
<tr><td>2-5</td><td>15%</td></tr>
<tr><td>5-7</td><td>10%</td></tr>
<tr><td>=> 7</td><td>7.5%</td></tr>
<tr><td>>10</td><td>Waiver to be considered on a case-by-case basis</td></tr>
</table>
At least 50% of the independent PIPE investment must come from at least 3 institutional investors with assets under management of no less than HKD8 billion</td></tr>
</table>

Item	Requirements
Escrow account	100% of gross proceeds of the offering
SPAC promoters	Suitability and eligibility requirements must be meet, including the requirement for each SPAC to have at least 1 SPAC promoter that is a firm which holds: a. a Type 6 (advising on corporate finance) and/or a Type 9 (asset management) license issued by the SFC; and b. at least 10% of the promoter shares (Waivers will be considered on a case-by-case basis)
Material change in SPAC promoters	Material change in: a. the SPAC promoter who, alone or together with its associates, controls or is entitled to control 50% or more of the promoter shares, or, where no single SPAC promoter controls 50% or more of the promoter shares, the single largest SPAC promoter; or b. the SPAC promoter holding the requisite SFC license Any material change must be approved by a special resolution of shareholders (excluding the SPAC promoter and close associates) within 1 month from the date of the material change, and by HKEX
SPAC directors	At least 2 Type 6 or Type 9 SFC-licensed individuals (including one director representing the licensed SPAC promoter) must be included on the SPAC's Board
Lock-up period for promoter	12 months from date of completion of the de-SPAC transaction
Redemption rights	SPAC shareholders can redeem their shares irrespective of how they vote on the matters below:- 1. a material change in the SPAC promoter managing a SPAC or the eligibility and/or suitability of a SPAC promoter; 2. a de-SPAC transaction; or 3. a proposal to extend the de-SPAC announcement or transaction deadlines
IPO sponsor	Must be a corporation or authorized financial institution, licensed or registered under the SFC Ordinance for Type 6 regulated activities, i.e. advising on corporate finance

How Deloitte can assist

Deloitte has a dedicated team of experts with experience in advising companies throughout the SPAC lifecycle. We can advise and assist on:

- Seller assistance, vendor due diligence, or both
- Implementation of new accounting standards
- Preparation of interim financial statements
- Preparation of pro forma financial statements
- Responding to HKEX comments
- Drafting management discussions and analysis and providing advice on non-generally accepted accounting principles measures
- Evaluating the significance of business acquisitions and the resulting reporting requirements
- Assessing and building an internal control environment for public companies
- Designing automated solutions for financial reporting processes and controls
- Tax planning and compliance
- Information technology system assessment and implementation
- Preparation for, and management of, additional audit procedures to conform to standards of the Financial Reporting Council and the SFC
- Corporate governance structuring and reporting
- End-to-end project management

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