Demystifying SPACs

Is the time ripe for Indian companies to list on overseas bourses?

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L. Badri Narayanan, Sarang Dublish and Aman Singhal

Goldman Sachs backed Renew Power - one of India's largest renewable energy companies, finally announced overseas listing through SPAC after long drawn discussions on raising funds through asset sale or listing through an IPO in India.

Investors are increasingly interested in raising funds through SPACs post Renew's announcement of its landmark deal with RMG Acquisitions Corporation II.

Understanding SPACs

Special purpose acquisition companies (**"SPAC"**) are companies that have no business operations of their own, and are incorporated solely to raise capital through an initial public offer (**"IPO"**). Its investors include renowned private equity funds, hedge funds and other institutional investors. These companies have become quite popular among corporates for fund-raising. A SPAC offers securities for cash, and places all offer proceeds into a trust or escrow account for acquisition of potential targets in the future.

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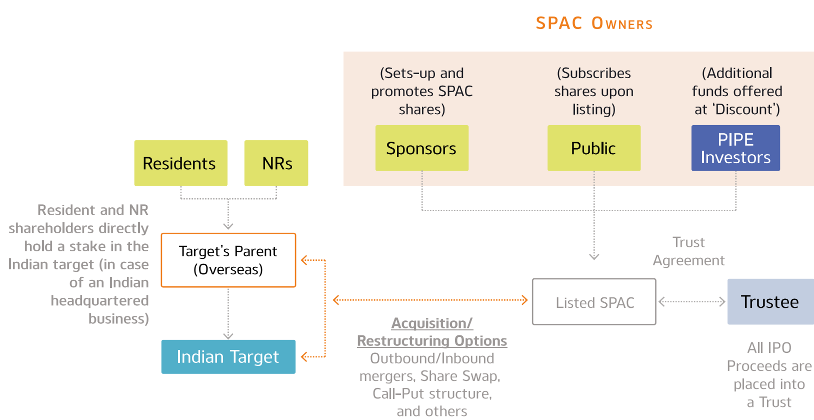

The usual lifecycle of a SPAC runs for two years, to identify and acquire a potential target but sometimes may extend to three years.

SPACs are not new. They evolved during the 1990s in the USA and were seen especially in industries such as media, retail, technology, healthcare and telecommunication, attracting interest from institutional investors.

Investors in SPACs are reputed financial sponsors, PE funds and VC funds, who have a huge capital base to invest in specific sectors. Generally, SPACs are formed to acquire a particular target but can also acquire multiple targets, if feasible.

A SPAC structure is formed by an experienced management team or sponsor(s) with nominal invested capital. Public shareholders hold the remaining interest through units offered to them in an IPO of the SPAC's shares. In case the SPAC needs additional funds to close the potential acquisition deal, sponsors may ask existing institutional investors, or new investors such as larger funds, or private equity firms, or VCs, to invest additional money in the SPAC. This is usually referred to as Private Investment in Public Equity (**"PIPE"**).

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De-SPAC (Closing of SPAC)

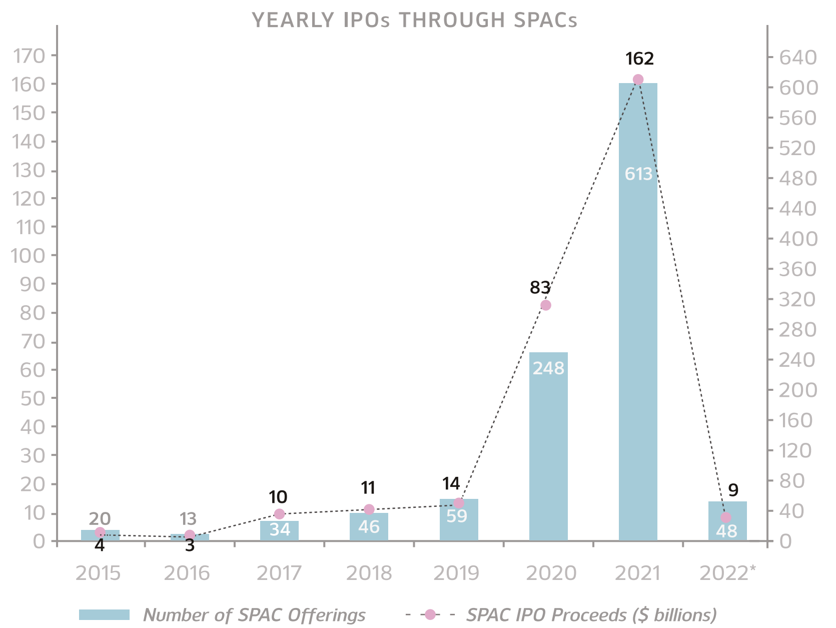
De-SPAC is a crucial stage, which begins once the target company has been identified. It is the stage after execution of the agreement and before the actual combining of the SPAC with the target operating company. These combinations are usually facilitated through mergers, reverse mergers, share-swaps, acquisitions or a combination of these with the SPAC.

The process of a SPAC acquiring the target is called De-SPACing. Some SPACs however, might need a PIPE to complete the De-SPAC transaction.

Recent Global Trends in SPAC Listing

In recent years, newspaper headlines are flooded with capital starved companies raising funds through public listing. As compared to direct listings, which were more in focus until 2019, raising funds by unconventional methods such as through investment vehicles like SPACs has become more common recently.

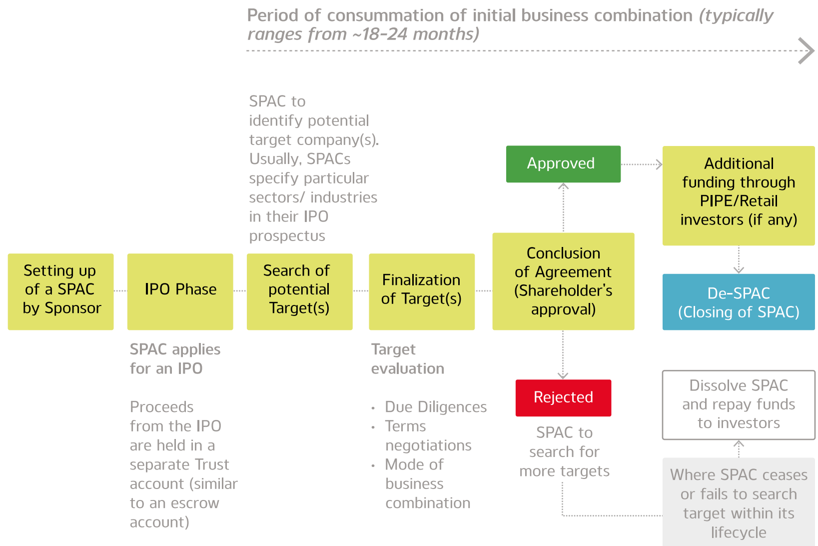
> In 2020, the total capital raised by SPACs amounted to USD 83 Bn, while USD 97 Bn has already been raised by SPACs in the first quarter of 2021. Globally, there are more than 430 SPACs that are currently looking for prospective targets (source: www.spacresearch.com and https://spacinsider.com).



*As on 2 March 2022

Source: SPAC insider (https://spacinsider.com/stats/)

The SPAC Cycle



Direct listing through SPAC

In a traditional IPO, a company undergoes a cumbersome and time-consuming process, including the justification of the business proposition to regulators as well as the public. SPACs have a simpler business model which takes relatively lesser time for the exchange commission to approve the listing process.

Why choose SPACs over traditional IPOs?

In a traditional IPO, the target company intends to raise public funds through listing. On the other hand, while listing through a SPAC, the transaction involves acquiring a target company by an already listed SPAC with no business operations of its own – commonly referred to as a 'reverse IPO route'.

What is the ideal mode of going public?

This decision depends upon various factors such as valuation, timeline for listing, raising funds and the presence of investors, along with applicable capital gains tax implications on De-SPACing and the final exit. Private companies should consider such factors in their decision-making process.

Valuation in a SPAC is agreed through negotiations between the SPAC and target's shareholders, unlike determination of price and valuation through pricing guidelines in the case of an IPO.

Further, participation of renowned sponsors, PIPE and industry experts increases the SPAC's credibility, and provides better value realization for existing shareholders.

SPAC – The India Story

Although SPAC structures are not new to India, they are yet to emerge as a promising option to raise public funding from offshore markets. India has seen a few SPAC acquisitions such as:

- Acquisition of 30% stake of Videocon D2H Limited by Silver Eagle Acquisition, a SPAC wherein Videocon D2H's American Depository shares were listed on the NASDAQ.

  Note: Presently, Videocon D2H Limited amalgamated with Dish TV India Limited.

- Yatra Online Inc., parent company of Yatra India (Yatra.com) was merged with Terrapin 3 Acquisition Corp (TRTL), a NASDAQ listed SPAC in 2016.

With a revival of business opportunities in emerging economies, the focus of Indian entities towards SPAC has re-emerged, post the following SPAC acquisitions.

- Acquisition of Reviva Pharmaceuticals Inc. by Tenzing Acquisition Corp., a SPAC incorporated in British Virgin Islands (re-domiciled to USA) through its subsidiary Tenzing Merger Subsidiary Inc. by way of merger.

- Acquisition of Renew Power Private Limited by RMG Acquisition Corporation II, a SPAC listed on NASDAQ, wherein the existing shareholders of Renew accepted 70% effective ownership upon merger into SPAC.

Listing of Top Unicorns through SPACs

Recently 'Think Elevation Capital Growth Opportunities' a SPAC backed by Elevation Capital (formerly known as SAIF Partners) and seed-investment company Think Investment, filed for an IPO to obtain listing of their securities on Nasdaq.

This SPAC is specifically formed with a business strategy to identify and acquire Indian technology-based companies.

The SPAC is chaired by some of the most reputed business leaders of the Indian tech industry such as Vijay Shekhar Sharma (PayTM), Harsh Jain (Dream 11), Kabir Misra (former Managing Partner, SoftBank) and Neeraj Arora (former Global Business Head, Whatsapp).

SPAC – Regulatory framework in India

For unlisted companies in India (including start-ups), SPACs provide an additional opportunity to raise capital from overseas markets, as well as provide an exit to existing investors. However, given the current scenario, there are certain challenges from a regulatory standpoint in India that remain unresolved, and need to be addressed.

FEMA and RBI Implications

A typical De-SPAC transaction involves merger of the target entity with the SPAC. Such merger is considered as an outbound merger in compliance with Section 234 of the Companies Act, 2013 and Foreign Exchange Management (Cross Border Merger) Regulations, 2018 (**"Merger Regulations"**). An outbound merger requires sanction from the National Company Law Tribunal (**"NCLT"**), and approval from the Reserve Bank of India (**"RBI"**). Such an outbound merger is deemed approved by the RBI if the transaction is compliant with the conditions prescribed in Merger Regulations. Although such conditions may be fulfilled, RBI approval may still be needed where the fair market value of the shares/ units of the SPAC acquired by resident individuals (being shareholders of the target entity) pursuant to the outbound merger exceeds the ceiling limit of USD 2,50,000 under the Liberalized Remittance Scheme (**"LRS"**) prescribed by the RBI as per extant foreign exchange regulations.

This issue will not arise in an externalized structure where the Indian target is held by a foreign parent company.

Prior approval of the RBI may be required by resident shareholders upon swap of shares of Indian targets against shares in SPACs, to ensure adherence to compliance requirements under FEMA Overseas Direct Investments Regulations (**"ODI Regulations"**) and LRS.

RBI approval may be required where pursuant to De-SPAC (either through share swap or merger), shares are issued to investor(s)/ beneficial shareholder(s) situated in restricted jurisdictions (i.e. a country which shares land border with India) covered in Foreign Exchange Management Act, 1999 (**"FEMA"**) notification under Press Note 3 of 2020.

POINT TO NOTE

FEMA provisions with respect to pricing guidelines, applicable sectoral caps and prescribed conditions applicable for foreign investment in India should also be considered in a SPAC transaction.

RBI usually puts a question mark on cross-border transactions that result in Indian residents owning shares of an overseas company, which in turn, has a stake in another Indian company. Therefore, swap of shares in SPAC structure may trigger 'round tripping' issues for Indian resident shareholders from a RBI perspective.

NCLT Implication

The optics of obtaining a prior approval from the NCLT should be evaluated, given that the objective of outbound merger is to obtain overseas listing, and a SPAC is essentially a company without operations. Therefore, it is imperative to have a robust commercial rationale for undertaking an outbound merger or an SPAC transaction.

SPAC – Indian Tax perspective

Apart from various challenges and grey areas of a SPAC structure, there are certain tax incidents that SPAC structures will attract.

Tax on merger of an Indian target with a SPAC

Tax neutrality on amalgamation is limited to capital gains tax, which may arise in case of an inbound merger, that is, a foreign company merging into an Indian company subject to prescribed conditions. However, in a scenario where an Indian target is merged into an overseas SPAC, capital gains tax liability will arise, both in the hands of Indian target company and its shareholders.

Necessary changes need to be incorporated in to tax legislations in India to maintain tax neutrality in the hands of Indian targets for outbound mergers.

Additionally, Indian tax authorities may consider providing specific provisions to defer the capital gains tax liability for Indian shareholders until ultimate exit from the SPAC.

Tax on swap of Indian Target's shares against shares of a SPAC ('Share Swap structure'/ 'Indian Target subsidiarisation')

In this scenario, the SPAC and Indian shareholders will enter into a bilateral share-swap agreement wherein the SPAC will issue its shares to the shareholders of the Indian target, against the shares of the Indian target.

- At the time of share swap: In a share swap scenario, capital gains tax implications will arise for Indian shareholders on the swap of shares (considered as a taxable event) of the Indian Target to the SPAC. However, no capital gains tax implications may arise where the cost of shares of the Indian target is equivalent to the fair market value (as per tax) of the SPAC shares.

- On exit from the SPAC: Upon subsequent exit by non-resident shareholders (including PIPE and sponsors) from the SPAC, indirect transfer provisions under Indian tax legislations may arise, assuming that the SPAC derives its value substantially from assets located in India (i.e., the Indian target). Therefore, SPAC shares may be deemed to be a capital asset located in India, and any gains derived from such transfer shall be taxable in India.

Tax implications will remain similar in case of an externalized Indian target company structure.

Tax on merger of Indian Target's Parent Company into the SPAC (for an externalized structure)

This scenario involves merger of two foreign companies, that is, the SPAC and the target's foreign holding company. Upon merger, shares of the Indian target will be held by the SPAC, and shall be considered as transfer under Indian tax laws. However, the Income-tax Act, 1961 specifically provides for an exemption from levy of capital gains tax, if (a) at least 25% shareholders continue to remain the shareholders of the SPAC; and (b) no capital gains tax on such amalgamation arises in the jurisdiction where the foreign holding company is incorporated.

The feasibility of amalgamation of two foreign companies will have to be evaluated based on the requirements of applicable laws of the jurisdictions involved.

POINT TO NOTE

Re-domiciling of the target's foreign holding company, or the SPAC, to a favourable jurisdiction may be considered. *A similar structure was adopted by Tenzing Acquisition Corp to acquire Reviva Pharmaceuticals.*

Applicable tax and regulatory implications at the time of re-domiciliation should also be considered. For instance, in the USA, there is a levy of entry tax on retained earnings of the foreign company on re-domiciliation. On the other hand, Singapore does not permit cross border amalgamations.

Therefore, re-domiciling the target's foreign holding company or the SPAC to a tax efficient and a regulatory compliant jurisdiction becomes pivotal.

Recent SPAC deals involving Reviva Pharmaceuticals and Renew Power have revived the interest for SPACs in India, and multiple unicorns such as BYJU'S, Grofers, Flipkart and Zoomcar are also exploring the option of overseas listing through SPACs.

SEBI must bring in suitable regulations providing appropriate flexibility to SPACs to operate in India with an exhaustive reporting and disclosure requirements, along with requirements of due-diligence, audits and other control frameworks.

RECENT DEVELOPMENT IN THE MIDDLE EAST

The United Arab Emirates' Securities and Commodities Authority has recently approved a regulatory framework for SPAC, allowing sponsors abroad to list their SPACs on the Abu Dhabi Securities Exchange.

Conclusion

Indian start-ups have an important role to play in the economic growth of the country, and SPAC transactions offer a much-required alternative to the start-up community to raise funds, as well as provide an exit to their investors through overseas listing.

There are various SPAC-IPO structures commonly adopted by various funds and investors. These structures range from a typical merger or share-swap deal, to a complex structure such as a reverse triangular merger.

For overseas listing by Indian companies, the capital market regulator in India, that is, the Securities and Exchange Board of India (**"SEBI"**) is currently working to introduce a policy for direct listing of shares of an Indian company overseas in certain permissible jurisdictions. This will help provide an environment conducive to raise public funds overseas. However, discussions on policy are at a nascent stage, and implementation of such policy is likely to take a while.

Furthermore, to encourage SPAC listing in India, SEBI has formed an advisory committee in March this year to evaluate the feasibility of introducing SPAC structures in India. The counterpart for India's Fintech hub, GIFT City of Gujarat, the International Financial Services Centres Authority has also proposed an apposite framework for raising capital, and listing of SPACs on recognized stock exchanges in International Financial Services Centres.

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