SPAC Warrant Valuation: Insights and Considerations

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The SEC's *Statement on Accounting and Reporting Considerations for Warrants by Special Purpose Acquisition Companies (SPACs)* issued April 12, 2021 (the SEC Statement) has resulted in a SPAC issuance decline, at least temporarily. The SEC Statement highlighted that many SPACs were improperly classifying their warrants as equity. ASC 815 specifically describes the features of a financial instrument that would qualify it to be classified as equity or liability. To this end, warrants issued in SPAC transactions typically have features requiring them to be disclosed as liabilities.

In response to the SEC Statement, many SPACs are currently analyzing the terms and conditions of their warrants to determine if they should be recorded in their financial statements as equity or a liability. Depending on the conclusion (i.e., if the delta between recording the warrants as a liability instead of equity is material to the company's financial position), the SPAC should restate its financial statements.

SPAC Defined

SPAC sponsors organize a corporation which goes public via an IPO (initial public offering) to raise capital from investors. The SPAC's goal is to acquire an operating business. The sponsors and investors who acquire shares in the SPAC also typically receive warrants in the corporation. The sponsors' warrants are private warrants and the outside shareholders receive public warrants. However, the terms and conditions of these two classes of warrants are often different.

SPAC Warrants

Both public and private warrants are typically issued at the same time, and in conjunction with, the underlying SPAC shares. SPAC shares are usually priced at $10, and the public warrants usually carry a "strike price" of $11.50 or higher. The strike price is the price at which the holder can purchase a share of common stock in the SPAC.

In contrast, "private warrants" are typically offered to the SPAC sponsors or founders prior to the SPAC going public, often referred to as the "promote." Private warrants can have a purchase price or even a strike price significantly below the original issue price of the SPAC shares. Most SPAC warrants are subject to a "lock up" period (e.g., one year after the original issuance of the SPAC shares, or in the alternative after completion of a merger or acquisition).

In some SPACs, the private-placement warrants may feature a cash and cashless exercise (e.g., the exchange of SPAC common stock) or no redemption terms. In many SPACs, when the private-placement warrants are held by the SPAC sponsors, the price at which the warrants can be redeemed fluctuates based upon the terms of the particular warrant and market conditions.

The SEC's View on SPACs

The SEC has deemed that such terms and conditions mean that the private placement warrants may be deemed a liability and not equity. As such, the SEC view is that reporting a warrant as equity could be potentially misleading to investors.

Further, in accordance with U.S. GAAP (generally accepted accounting principles), liabilities must be reported at fair value (ASC 820 fair value accounting). In the event the fair value analysis results in a value that materially differs from the value at which the warrants were recorded (as equity), the SPAC may have to restate its financial statements.

Valuation Models Used for SPACs

Commonly used valuation models include the adjusted Black-Scholes and Monte Carlo Simulation. The inputs to both methodologies will include duration to exercise, volatility, common stock share price, the warrant strike price and the risk-free rate of return.

In general, the public warrants must be valued with a Monte Carlo Simulation. That is because the warrants cannot be exercised unless the stock price trades at or above $18 for 20 days in a 30-day period. Black-Scholes does not capture the path-dependent nature of the feature, and therefore a Monte Carlo analysis must be used. Private warrants that are not subject to path-dependent features can be valued using an adjusted Black-Scholes model.

Sound Actions for SPAC Warrant Valuations

Best practices include:

- Review the terms and conditions of the public and private warrants
- Conclude whether the warrants should be treated as a liability or equity
- Consult your professional advisors, for example lawyers and auditors
- Value the warrants under ASC 820 to ascertain whether they qualify to be treated as a liability
- Determine whether the difference in the warrants' fair value compared to the reported amount is material to the SPAC's financial statements
- Determine whether the SPAC should restate its financial statements

The Takeaway

The SEC's April 12, 2021 Statement addresses if SPAC warrants should be reported as a liability or equity. If the warrants do not qualify as equity, the SPAC must fair value its warrants and determine whether the difference in the fair value and the reported value is material to the SPAC's financial statements and/or whether the SPAC's financial statements could otherwise be misleading to investors. A material difference could require restatement of the SPAC's financial statements.

Contact Us

PKF O'Connor Davies can assist with IPO readiness and SPAC warrant valuation, as well as provide related audit, tax and advisory services.

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