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China Targeted M&A Re-Emerges in SPAC World

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Recently there has been an uptick in China targeted mergers and acquisitions using the formerly and again popular reverse-merger concept through special purpose acquisition companies (SPACs).

For purposes of this discussion, "China targeted" includes businesses that may be located in China or based in the United States which cater to the domestic China community. In this article, we will examine some of the legal and regulatory issues, the structural characteristics of these transactions, and the relevant factors driving this recent trend.

Background of Market for China Targeted SPACs

The use of a SPAC vehicle to complete mergers and acquisitions with China targeted companies is not new. This activity reached a high point in May 2008, when the SPAC entity Nuverra Environmental Solutions completed its $400 million public offering. Later that year, Nuverra acquired a Chinese company engaged in the bottled water business in China, China Water and Drinks, in a reverse acquisition. Soon after the closing of this transaction, M&A activity in the United States for China targeted companies decreased significantly due to several factors, including the discovery by the U.S. Securities and Exchange Commission of fraudulent activities centered on the accounting standards of Chinese companies in reverse mergers in 2008 and 2009, and the global economic crisis during and following those years.

The last two years have seen renewed interest in M&A activity for China targeted companies, particularly through the use of SPACs. In June 2018, Thunder Bridge Acquisition (TBRGU) completed

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its IPO and listed on NASDAQ, raising $225 million. Its acquisition targets will be in the financial services and financial technology industries. Also, in June 2018, New Frontier completed its listing on the NYSE, having raised $200 million to acquire a health care, technology or education business in China. In August 2018, Tottenham Acquisition I Limited, raised $46 million to acquire a target business focused on operating businesses in the technology, media, telecom, education, e-commerce, healthcare and consumer goods industries with primary operations in Asia (with an emphasis in China).

The surge in activity has continued in recent months. August 2018 saw the closing of two additional China targeted acquisition SPACs, TKK Symphony Acquisition Corporation and Longevity Acquisition Corporation, which collectively raised $260 million. Underlining the breadth and scope of China-targeted activity, TKK intends to seek an acquisition opportunity of "consumer/lifestyle assets that may have particular application for the PRC market" while Longevity Acquisition seeks to acquire a China based entity in order to "add value to these [China] businesses primarily by providing them with access to the U.S. capital markets."

Recently in August 2018, Atlantic Acquisition, a SPAC created to merge with a target company in the Chinese food industry, announced that it successfully completed its business combination with HF Group Holding Corporation, a predominantly Chinese-managed food logistics company based in the United States. The business combination had a total transaction value of approximately $300 million and the company is now known as HF Foods Group and trades under the symbol HFFG on NASDAQ. (Becker & Poliakoff and Ms. Xiu, Mr. Daughney and Ms. Klein served as counsel to HF Foods Group.)

Legal Issues Related to SPACs

A SPAC is a shell company formed for the express purpose of raising funds in an underwritten public offering under the Securities Act of 1933, and which has no business operations. The business purpose is to locate one or more suitable target businesses to acquire and merge into the SPAC. Under SEC Rule 419, SPACs are not treated as "blank check" companies because they raise and hold funds in excess of $5,000,000. This exemption allows the securities of the SPAC to publicly trade until the acquisition is complete. Additionally, treatment of SPACs is less onerous in the fully registered IPO process for NASDAQ or NYSE listed companies under state "Blue sky" laws than smaller Rule 419 offerings. Generally, however, SPAC offerings follow many of the traditional Rule 419 standards, including:

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- funds from the IPO are held in trust for the benefit of investors if an acquisition is not consummated,
- any acquisition must represent 80 percent of more of the proceeds held in trust;
- the acquisition must occur within a specified time frame (generally 18 to 24 months following the IPO); and
- stockholders of the SPAC must have the right, following full disclosure under the SEC's proxy rules, to approve or disapprove the proposed acquisition, and convert no votes into their pro rata portion of the IPO funds held in escrow—essentially to get cashed out.

Although there are many variations on the theme, to be attractive to underwriters and investors, several considerations must be addressed by the SPAC sponsors. SPACs generally need to be led by an experienced management team with specific industry sector expertise or significant M&A experience. SPACs need to qualify for either NASDAQ or NYSE listing. SPAC offerings are comprised of units of securities, with shares of common stock combined with either warrants or rights to acquire additional shares. The SPAC unit initial offering price is almost always $10.00 and following the IPO, the units become separable and the public trading market includes the units, common stock and warrants (or rights). The funds held in trust must equal and often exceed the funds raised in the IPO. These excess funds come from insider purchases completed prior to or simultaneously with the IPO. SPAC sponsors may need to agree to additional purchases of equity (usually by exercising warrants) and a post-acquisition trading lock-up of shares.

From the practitioner's viewpoint, counsel to the SPAC and any target companies will need to be familiar with and ensure compliance with the public offering process under the Securities Act of 1933; how to negotiate terms with underwriters for the IPO; the SEC's disclosure requirements for registered companies under the Securities Exchange Act of 1934; the SEC's proxy statement requirements in the mergers and acquisition context; and NYSE or NASDAQ listing requirements. Counsel will also need to focus on various voting structures or control or blocking agreements within the SPACs corporate governance documents to facilitate successful completion of the acquisition vote.

Why Are SPACs Attractive For the China M&A Market?

The surge of China-targeted SPACs is driven mostly by target side dynamics. Entrepreneurs involved with China targeted companies are typically interested in merging with a U.S. SPAC to increase visibility, obtain enhanced prestige of becoming a U.S. listed public company, and enable them to obtain liquidity out of China. On a macro level, the size and breadth of the China-targeted market, not just in China but throughout Asia and in the United States, provides large scale opportunities for continued growth.

Further, Chinese entrepreneurs who own or control operating companies are seeking to tap into the China based investor class as a base for their holdings, using the attraction of a U.S. listed post acquisition SPAC company. As China continues its economic expansion through the private sector, technological innovation, structural and economic reforms and demographic changes, the need to enter the U.S. equity markets to fund this growth will increase.

Chinese entrepreneurs are also attempting to diversify their holdings in China by expanding globally, and using the stock of a U.S. public company will assist them in making acquisitions in the United States. In contrast to the steep political hurdles for listing in China, SPAC IPOs completed in the United States are more efficient. Further, U.S. equity listings facilitate foreign exchange for RMB-funded PRC companies.

Challenges Facing Chinese SPACs

Going public in the United States is a major undertaking and not without challenges. The political sparring between China and the United States on tariffs and the U.S. government's increased scrutiny over Chinese deals may cause hiccups in the M&A market, including valuation issues.

The fallout caused by the reverse merger accounting issues from several years ago still affects investors' opinion of Chinese companies and questions are still raised on the reliability of their financials. These issues are compounded by the corporate governance challenge of board oversight and general compliance and regulatory concerns that must be addressed since the principals of many China-based entities are unfamiliar with U.S. corporate law concepts such as fiduciary duty and conflicts of interest.

Conclusion

Opportunities for Chinese companies or businesses targeting the China community to access U.S. capital markets have recently increased dramatically through a variety of business combination vehicles that avoid the uncertainty of a traditional IPO. China-target SPACs are providing a new wave of public listings and business combinations in the United States. These Chinese and U.S. combined post acquisition entities provide investment opportunities to both U.S. and Chinese investors but require legal and business oversight by experienced practitioners and corporate directors.

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