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Viewpoints

Special Purpose Acquisition Companies (SPACs)

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While SPACs are now making headlines on a daily basis, they have been around for years and are not a new concept. The increased attention that SPACs are receiving raises several questions, including: what are SPACs, how have they performed, and are they an appropriate opportunity for institutional investors?

What is a SPAC?

The acronym stands for Special Purpose Acquisition Company, and represents an alternative route for a company to go public. Sponsors form a SPAC to raise capital through an initial public offering ("IPO") in order to buy another unidentified private company. The SPAC initially has no commercial operations and is commonly referred to as a "shell" corporation. Once an acquisition target is identified and a transaction is negotiated, the private company merges into the SPAC (also referred to as a "reverse merger"), thus becoming public.

SPACs, also commonly known as "blank check companies," have been around for decades but have historically had a relatively poor reputation. They were perceived as a back door way for a company to go public which avoids the scrutiny of a typical IPO process for companies that may have some past blemish (e.g., fraud).

SPACs were also associated with sponsors that might not have been able to raise capital for a traditional fund. The reputation of SPACs has improved materially over the past couple of years, as more reputable brand name sponsors started raising SPACs, including well-known private equity firms, industry leaders, and even celebrities. Respected entrepreneurs and successful startups increasingly view SPACs as a viable IPO alternative.

Certain private companies have been willing to go public via SPACs as they are believed to be quicker and easier, avoiding the traditional IPO process which includes the release of financials to public scrutiny via an extensive road show, the cost of hiring underwriters, oversight from the Securities & Exchange Commission, etc. A SPAC can also provide the private company greater certainty regarding price and deal terms than a traditional IPO. The "IPO window" for new public offerings varies depending on economic conditions and investors' risk appetite. However, a SPAC is already public, allowing a private company to become public even when the traditional IPO window may be closed. Owners of the private company may also be able to sell a larger proportion of their stake in a reverse merger with a SPAC. As a result, private companies are able to become public in a shorter time frame, with more certainty on terms and valuation, and retain a larger portion of proceeds through lower costs.

There are several characteristics that SPAC sponsors find appealing, including: favorable economics, ease of fundraise, and less onerous ownership model. Sponsors gain a disproportionate share of the economics as they commonly receive 20% of a SPAC's shares at listing for a relatively minimal initial investment. The capital raising process for SPACs can often be easier than the traditional private equity roadshow for institutional investors. SPAC ownership participation at the Board level is also a less resource intensive ownership model than a traditional "hands on" approach of many private equity investors.

Critics of the SPAC process believe that the lower cost to the private company simply results from SPAC investors bearing a larger proportion of the underwriting expenses. This includes the underwriting costs and ownership dilution associated with the sponsor's 20% allocation shares and warrants.

Initial SPAC investors receive their capital back if the sponsor is unable to complete a deal within two years. Additionally, SPAC investors have to approve the acquisition in order for it to be completed. As such, some SPAC investor feel they get a "free look" at an investment opportunity.

Until very recently, there had been a trend in the private equity markets for companies to stay private for longer. This was due, in large part, to the costs and rigor associated with going public. As a result, many companies have experienced their highest growth phase while still private, and public investors have not been able to benefit from that growth. The current SPAC phenomenon has brought more companies public earlier in their lifecycle, and given public investors access to this high growth. As these companies are often earlier in their life cycles (possibly even pre-revenue), there can be increased risks to investors. A wide range of successes and failures associated with this wave of SPACs are to be expected, and it will be challenging for investors to initially assess the difference between high quality and low quality opportunities.

The amazing growth of the SPAC market: 2020-2021

The volume of SPAC IPOs has grown dramatically since 2019. In 2020, $83 billion was raised by 248 SPAC IPOs, up from $14 billion across 59 SPAC IPOs in 2019. Year-to-date in 2021, 276 SPAC IPOs have raised $90 billion in proceeds, which is on pace to achieve over $400 billion for the calendar year. The average SPAC IPO size increased from approximately $230 million in 2018/2019 to over $325 million in 2020/2021.

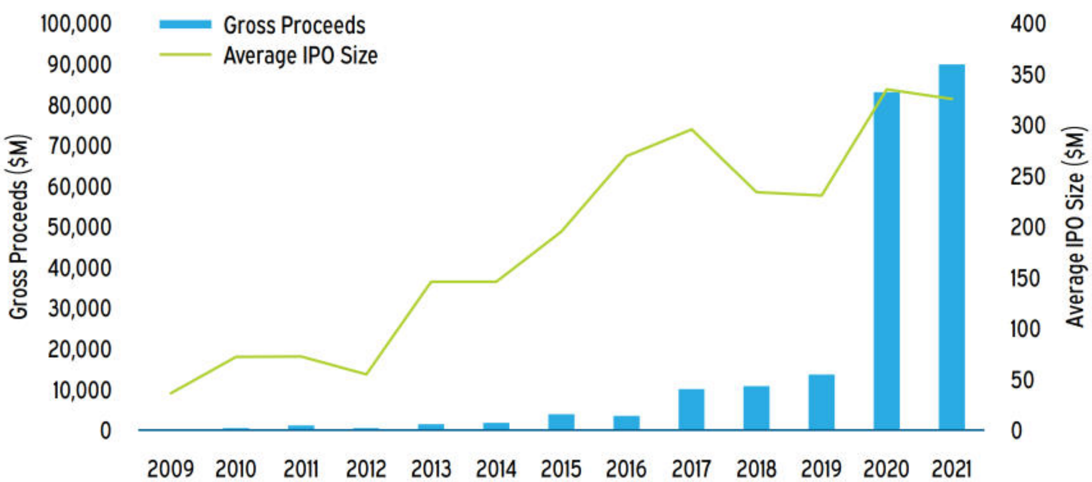

FIGURE 1

SPAC IPO Transactions: By Year

Source: SPACInsider, as of March 19, 2021

The number of SPACs has increased dramatically along with the growing proceeds. The chart below displays the current status of SPACs, grouped by the year of IPO. Highlighted below are the number of SPACs that have filed for an IPO (218) combined with the number that are already public and searching for a transaction (275), which already materially exceeds the number of SPACs raised in 2020 (254). Of the 2020 SPACs, 140 are currently searching for deals while 84 have announced deals, and 24 have completed them. Since 2009, the percentage of SPACs in any particular IPO year that never completed a deal and ultimately liquidated ranged from 0% to 57%, with an average of 16%.

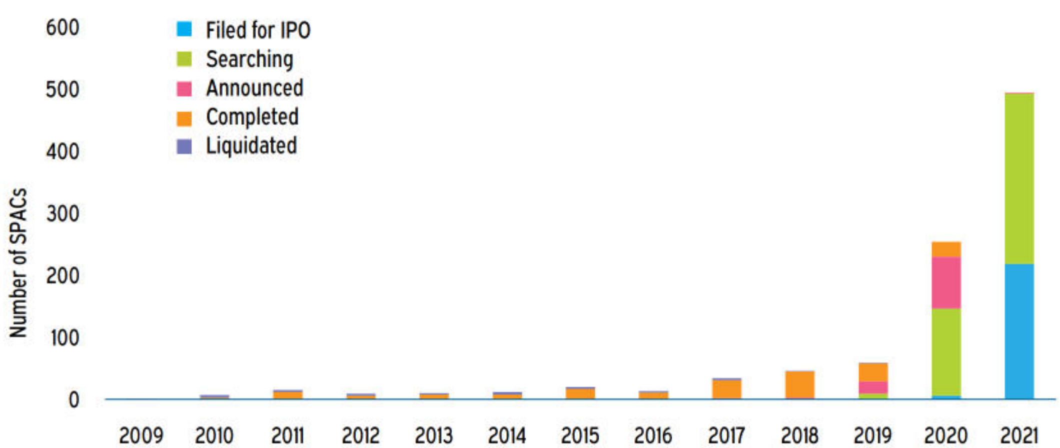

FIGURE 2

SPAC Status: By Year of IPO

Source: SPACInsider, as of March 19, 2021

Until 2020, proceeds generated by "traditional IPOs" vastly outpaced SPACs. Year-to-date in 2021, SPACs are significantly outpacing the activity of IPO exits of private equity backed transactions. This activity does not reflect the 218 SPACs that have filed for IPO so far in 2021.

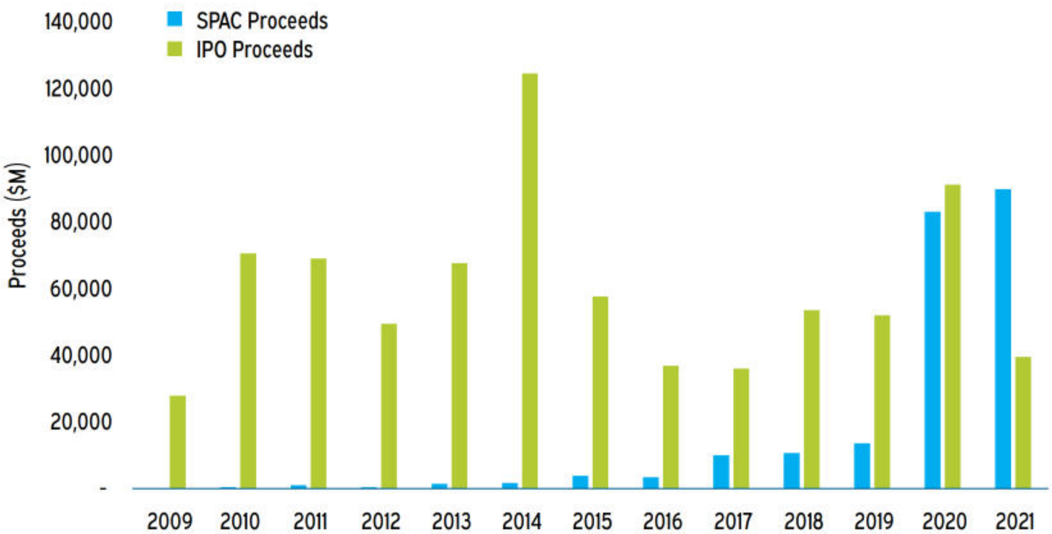

FIGURE 3

Proceeds: SPAC vs "Traditional IPO"

Source: SPACInsider, ThomsonONE (Private Equity Backed IPOs, as of March 19, 2021

The gross proceeds raised in 2019 through YTD 2021 represent over $185 billion of capital, with over 70% of the SPACs still looking to complete a deal. This capital may increase competition for deals, as the universe of potential SPAC deals is a subset of the broader private equity market. However, this value pales in comparison to the approximately $1.6 trillion of dry powder in the private equity market seeking deals (per Preqin).

How have SPACs performed?

There are examples of strong performance for individual SPACs, but the overall results historically have been mixed at best. Academics Johannes Kolb and Tereza Tykvova, examined the performance of SPAC acquisitions from 2003 to 2015 and found that SPACs underperformed the market and comparable IPOs. During this period, lower-quality firms (i.e., smaller, more leveraged, with less growth prospects) were more likely to go public via SPAC than traditional IPO. As a result, longer-term underperformance is believed to be impacted by the SPAC universe being populated with slower growth opportunities. Researchers Michael Klausner and Michael Ohlrogge from Stanford and New York University law schools, respectively, examined 47 SPACs that merged between January 2019 and June 2020. They found that SPACs tended, on average to lose a third of their value post-merger. They concluded that much of this value lost was due to the dilution of the sponsor's 20% allocation of shares, the underwriting fees, and the implicit cost/dilution of the warrant issuance. While the current universe of SPACs may be more robust and populated with higher growth opportunities, the dilution and costs must still be overcome and a longer time period will be necessary to appropriately evaluate performance results.

Are SPACs an appropriate opportunity?

Given the focus on private companies, SPACs have been perceived as competition to private equity transactions, but they are primarily an exit opportunity rather than direct competition for deals. SPAC capital is targeting a specific opportunity set that is expected to increase the number of high growth companies going public and shorten the time before going public. Hence, SPACs are not expected to have a material impact on broader private equity investment strategies at this time, but this is worth continued monitoring.

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For most investors, SPACs are more similar to a post-IPO investment strategy that may be part of a microcap manager's portfolio rather than directly competitive to private equity investment strategies. The most relevant comparison to private equity investing would appear to be late-stage venture capital or pre-IPO strategies, where there is competition for high growth deals that are deemed to be close to going public. However, there appears to be more value-add efforts in the private equity approach to position a company to be public. The SPAC's value add will generally be at the Board level post IPO.

A wide dispersion of outcomes is expected between high quality and low quality opportunities, and differentiating between the two will be difficult. While this is also true of private equity investing, particularly in venture capital, access to company-specific information and the ability to perform in-depth due diligence is more limited for public SPAC investors. Therefore, continued monitoring of the SPAC opportunity set is warranted.

Summary

SPACs have gained significant popularity in a very short period of time. The improved reputation of sponsors and the approach, combined with investors' desire to access high growth opportunities, appears to be driving activity. Private companies that desire to go public will be faced with a trade-off of approaches among traditional IPOs, SPACs, or even direct listing.

Despite the significant increase of capital raised by SPACs, it is still relatively small compared to the amount of capital in the private equity markets. The lines have been blurred as certain private equity firms are raising SPACs, but the targeted strategies are not (so far) anticipated to be in direct competition with a firm's traditional "flagship" strategy in any material way. As more private equity firms raise SPACs, investors in private equity funds will need to monitor potential conflicts of interest.

Currently, the majority of benefits appear to favor the SPAC sponsors and acquisition targets, while SPAC investors appear to be bearing a disproportionate amount of the costs and risk. Sponsors benefit from receiving the (generally) 20% allocation of the SPAC shares, and acquisition targets benefit by going public more quickly, with less fees and greater certainty of terms. In contrast, SPAC investors bear a significant portion of the underwriting fees and operating costs for the opportunity to potentially benefit in the high growth phase of a previously private company. The structuring and economics of SPACs are expected to be "self-correcting" and evolve to better alignment for investors over time, particularly with experience of losses. Continued monitoring and assessment of SPACs is warranted as the market continues to grow and evolve.

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