SPACs 2.0

Pandemic driven craze or lasting change for private companies?

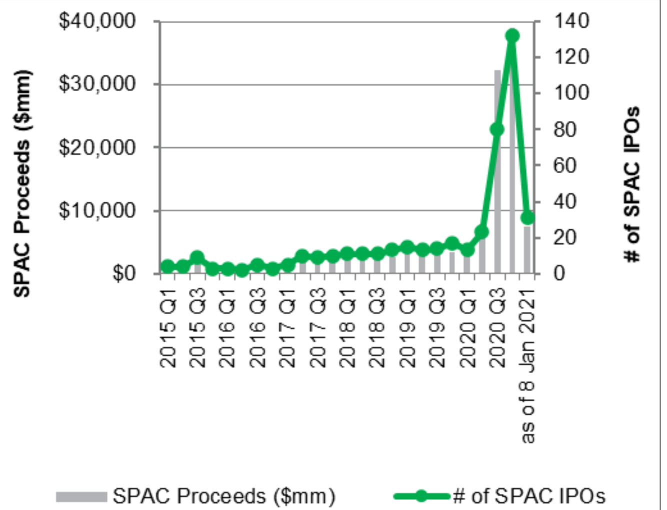
One of the areas of the financial markets that has benefited from the pandemic is special purpose acquisition companies (SPACs), a type of blank cheque company designed to take companies public without going through the traditional IPO process. Historically, SPACS have been considered a relativity niche pathway to the public markets, often seen as a mechanism to extract fees from adding structure to a reverse merger of companies that would have struggled to go public otherwise. However, the strategy received a facelift as the stature of the investment professionals and Sponsors involved legitimized the space and governance practices improved, resulting in a massive uptick in volume of Blank Cheque company IPOS.

But with great popularity comes great competition and in 2020 over 5 times as many SPACs came to market versus that of 2019, and as many as 10 times historic averages.

The Sponsors behind the renaissance of SPACs are typically well-known executives or investment managers with impressive track records. In general, Sponsors can raise capital faster than a traditional IPO, and hold a 20% stake in the SPAC equity for a nominal purchase price of $25,000.

Meanwhile, target companies can go public faster and for investors, SPACs provide a way to participate in a private equity-like investment that is normally the reserve of the Ultra High Net Worth's or professional institutional investors.

SPAC IPOs by Quarter



Source: SPAC Research

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Despite extensive coverage by the industry, many misconceptions are still widely reported, and details that add nuance to the debate are commonly omitted from discussion. With so many SPACs in the market it's hard to contest that throughout 2021 they have a sustained opportunity to change routes of private companies to IPO.

What is a SPAC and how is it different to an IPO or a Direct Listing?

- SPACs are companies that have no operations and are formed with the sole purpose of acquiring a business. SPACs first raise capital through an initial public offering and then find a private company to acquire, thereby taking it public. Once a SPAC raises its capital through an IPO, it typically has two years to complete an acquisition or its sponsors must return the capital back to investors.

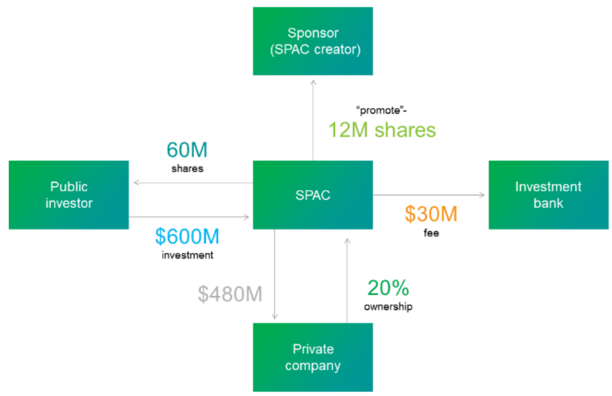
- IPO: In a traditional IPO, a block of shares is sold to institutional investors at a set price. The IPO approach gives companies a way to both go public and raise capital in the process.

- Direct listing: In contrast, a company doing a direct listing starts trading without new shares being sold, and therefore without new capital being raised. A direct listing gives founders, vested employee shareholders, and prior investors a path to liquidity. The approach has become increasingly popular in recent years because it gives companies that want to trade their stock on a public exchange a way to get there without the extra money and hassle of a traditional IPO.

Direct listings became novel following the successful processes ran by Spotify and Slack and hence became a potential public market exit strategy for the portfolio companies of VC and Growth Investors. Then came the pandemic, which plagued markets with economic uncertainty, especially public markets. The sustained volatility and the distinct price declines in the first few months of 2020 made IPOs and direct listings impractical options for the majority of private companies, allowing SPACs an opportunity to step into the void. SPACs, unlike direct listings, allow private companies to raise new capital as part of the process, which is a key consideration for many startups given the ongoing economic uncertainty. In 2020, these private companies needed to raise cash, and often quickly! However, NYSE's recent approval to add primary shares into the opening auction of a direct listing levels the playing field of each public market pathway in this respect. Unlike SPACs, direct listings and IPOs involve selling shares via an auction process, which can be somewhere between a frustrating and practically impossible challenge in volatile market conditions. The latter process creating a material risk for the underwriters.

Since a SPAC is essentially just a large box of money, the listing of a SPAC requires a much lower level of diligence than a similarly sized IPO of an operating company since there are no financial statements or history to analyze. In terms of sponsor fundraising, the process has parallels with raising a closed-end fund, allowing for a shorter and more controllable timeline during the fundraise. The early life of most SPACs is relatively uneventful as they usually trade at small discounts or premium to the NAV. The reverse merger, when the target operating company is announced, represents the first big test for SPACs and the first big decision for investors.

Hypothetical SPAC funding



Capital raised in the IPO is placed in a trust account and can only be invested in the ultra-safe assets such as U.S. T-bills. These funds cannot be used to finance the operations of the blank-check company as it seeks an acquisition target. Whilst in trust the capital accrues interest and is only used to acquire a company or to distribute to redeeming shareholders. To provide the necessary working capital, the SPAC sponsor subscribes to private placement warrants, which will allow the sponsor to buy shares after it completes a business combination. This investment in private placement warrants represents capital at risk for the sponsor. If the deal is not completed in time, the millions of dollars spent on the private placement warrants are potentially lost. The private placement warrant financing provides working capital to the SPAC, so the IPO proceeds in trust remain untouched until the deal vote, business combination or company liquidation.

Who is the Sponsor and why are they taking should a large stake of the equity?

The sponsors of the SPAC also reap other benefits in leading the SPAC, such as positions on the board that will help guide the strategy of the acquired company and the option to organize a PIPE deal concurrently with the acquisition.

Sponsors receive high participation in the acquired business for essentially sourcing the deal; that said, there are signs, such as the reduction or elimination of the promote or warrant allocations, that the structuring component of the fees will become less of a fee grab and instead more of a company-friendly vehicle with potential to create value.

Bill Ackman CEO of Pershing Square, who on July 22, 2020 raised the largest SPAC in history at $4 billion in the IPO of Pershing Square Tontine Holdings Ltd, has publicly talked of the compensation structure of the standard SPAC creating a "misalignment of incentives", stating "The massively dilutive nature of the founder shares often makes it difficult to complete a deal on attractive terms for the SPACs shareholders".

In addition to the $4 billion raised in the IPO, Pershing Square has committed to acquire an additional $1 to $3 billion of units pursuant to a forward purchase agreement, resulting in $5-7 billion at the SPAC's disposal for its initial business combination

A shift in the makeup of SPAC sponsors toward institutional and reputable market participants has also begun to further legitimize the future of SPACs, as the tangible value-add of the sponsor is increasingly obvious and aligned to the type of operation being acquired.

The high demand from investors has allowed many SPACs to upsize the amount raised in their IPOs; both serial SPAC sponsors and new entrants alike have taken it as an opportunity to raise capital while the strategy remains hot. From the sponsor's point of view, raising a SPAC is just another fundraise with a slightly different LP base. However, with many retail investors entering the IPOs, SPAC sponsors should consider valuations thoroughly (despite the economic alignment being in their favor via the promote) given potential repercussions.

The Promote has also caught the attention of Jay Clayton, the chairman of the SEC. He has expressed concern regarding the impact on ordinary investors, stating "We want to make sure that investors understand those things and then at the time of the transaction… that they're getting the same rigorous disclosure that you get in connection with bringing an IPO to market"1.

Potential returns come at an undefined point in the future when the business combination is announced, with an added kicker in the form of warrants.

In practice, the SPAC vehicle resembles a growth equity fund for a single portfolio company with a truncated time horizon. The confidence SPAC investors have in the sponsor is therefore crucial. There are typically redemption rights built into the SPAC for the investors, which lets them receive their money back once the acquisition is announced if the target or price of the deal does not meet their requirements. If investors do choose to redeem, they have effectively locked up some of their allocation for anywhere from a few months to two years just to secure the risk-free rate. However, given the potential exposure to high potential companies and high returns, many see this as an acceptable trade off. After buying into the SPAC IPO, the investment is essentially committed capital, similar to an allocation to a PE fund that is waiting to be called but resides within the institutional investor's public equity strategy. Even if the stock ends up trading higher, there will always be a drag on the time-weighted returns given the delay from the SPAC IPO to the reverse merger.

Since the SPAC transaction functions more like a tradition acquisition, the private company has to deal with only one party rather than a host of investors on a road show, which will typically smoothen the deal pricing and shorten the process. A company can transition from identification to completion in around four to six months as opposed to the year or more it takes for an IPO. The reverse merger path also allows for more creative deal structuring as the private company can sell more of the business, raise more capital than they may have in an IPO, attach earn-outs, reduce insider lockups, and more, giving the private company more flexibility to tailor a transition to the public market around its idiosyncratic needs. This high level of customization and thoughtfulness versus a traditional IPO can be a huge advantage to private companies that have a complicated business or would be a more difficult sell to traditional public market investors.

US Vs Europe

While the flurry of listings continue in the US, the European markets have not seen a similar level of activity. In addition to the disparity of large early stage businesses in the two regions, there are structural impediments that have resulted in a drought of listings on European exchanges.

For example, in the UK, shareholders don’t get a vote on the acquisition and they don’t have the ability to redeem their shares if they do not want to invest in a specific target which makes fundraising more difficult as it is seen as riskier and less investor-friendly.

In addition, when the acquisition takes place, the company’s shares are suspended until a deal prospectus is published, which locks in investors who might want to sell for a longer period than desired.

According to the Financial Times, the London Stock Exchange is exploring how to attract blank cheque companies2. “We are in continuous dialogue with stakeholders and regulators about keeping the London market attractive and competitive for issuers and investors,” the LSE said.

As capital formation transforms both for investors and issuers, we expect that new and creative approaches will continue to emerge to create efficiencies, reduce friction costs for all parties and facilitate more rapid access to capital. The SPAC phenomena is an important trend to consider as companies seek capital in the most efficient ways. Importantly, the SPAC process is one that we might expect will be prevalent to the extent that quality companies are available to avail themselves of this process.

Valuation considerations

From a valuation perspective, there are two stages within the lifecycle of the SPAC, each requiring a different approach.

Pre-Announcement

During the early life of the SPAC, prior to the announcement of the target operating company, there is generally little fundamental information available to determine a price outside recent transaction. However, it is good to understand where the SPAC stands in the deal-making process. For example, has a preliminary conversation occurred? Is there an LOI in place? Has the transaction been structured, i.e., dilution of promote, earn-out criteria, post-closing capitalization of the combined company, etc.? It is also important to remember that if a deal is not reached, investors can redeem their shares at the $10 offering price plus interest accrued.

Post Deal Announcement

Once a target company is identified and a merger is announced, market participants have enough information to consider the transaction on a more fundamental basis. As such, the public share price of the SPAC will incorporate market views on the business combination, structure, and likelihood of consummation. Consequently, during this stage the valuation approach generally becomes similar to other PIPE (Private Investment in Public Equity) securities, where a discount for lack of marketability (DLOM) is considered.

In determining an appropriate DLOM, the first question to think about is what is the expected time to exit? In the case of a SPAC PIPE, the exit timeline is generally based on the expected merger close date combined with the time required to complete the registration process. It is common to consider multiple exit scenarios within the valuation, weighting the likely outcomes.

Another aspect to take into consideration is volatility. How do I appropriately measure future volatility? There are several items to consider here, including the use of implied versus historical volatility, volatility time horizons, and whether it is more appropriate to use the volatility of the underlying security or a basket of comparables.

Arbitrage strategies

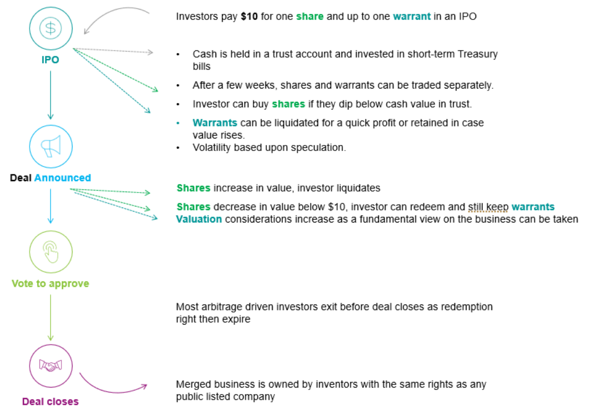
There are three ways in which an enterprising investor can earn arbitrage returns from a special purpose acquisition company:

1. Acquire the SPAC units, at a discount to NAV if possible, and earn a yield above treasuries. Split the units into common stock and warrants when

available. When a deal is announced observe the market reaction to the proposed reverse merger and compare the SPAC common share price versus the underlying net asset value. At the time of the shareholder vote, if the SPAC price is above its NAV, then sell. If the SPAC price is below its NAV, then redeem. Vote for the deal and hold onto the warrants for additional upside optionality.

2. Acquire the SPAC shares, at a discount to NAV if possible, before a reverse merger deal is announced. Earn the treasury yield, which consists of accrued interest on the company's T-bills plus the return gained from the eventual closing of the NAV discount. If a positive deal is announced that takes the SPAC's share price above its NAV, then sell and crystalize the upside optionality. If the deal stinks and the shares do not trade above NAV, redeem the SPAC shares upon shareholder vote or liquidation and close the position. If you only own the common shares, no warrants come into play.

Structure of a SPAC investment

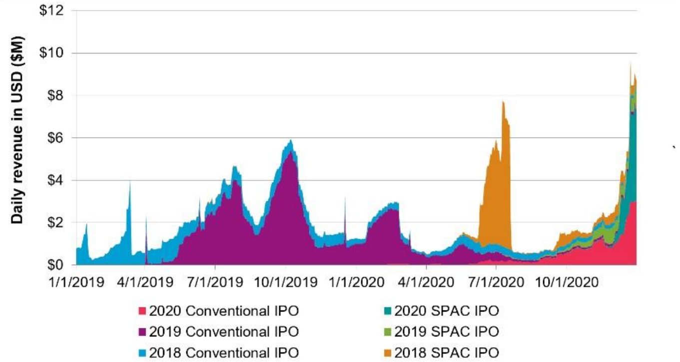


3. Acquire SPAC shares at a discount to NAV as they head into liquidation. This is an IRR trade, in which an investor earns the underlying treasury yield plus the NAV pull to par up to the SPAC's liquidation. If a SPAC doesn't announce a deal before its deadline, or if too many investors redeem in the case of an unattractive business combination, the SPAC will liquidate and distribute the issue price per share plus accrued interest.

During the volatile market conditions in 2020, for a period of time many SPACs traded at a discount to net asset value as hedge funds, who are one of the cornerstones of the market, were forced to sell SPAC holdings in order to meet client redemptions. Hence, investors could buy SPACs at a discount to their NAVs and earn high single digit annualized returns, not taking into account any upside in the equity.

Connected to the theme of arbitrage strategies one must also consider the revenue boon to equity finance desks SPACs have helped drive of recent quarters.

Daily US equity finance revenues from recent IPO classes



Source: IHS Markit Securities Finance © 2021 IHS Markit

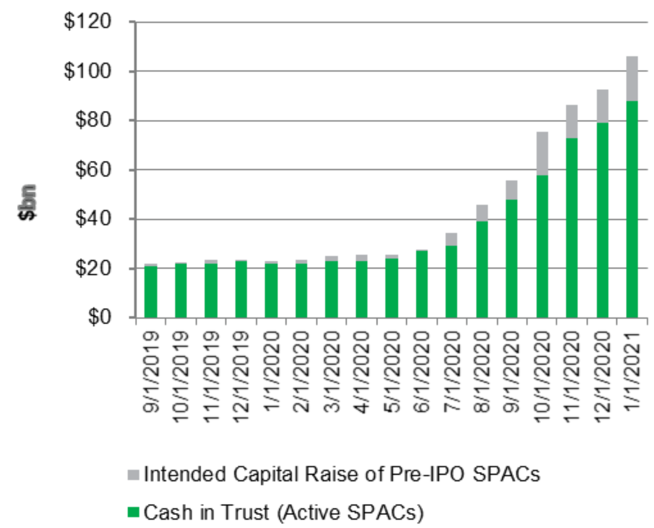
"The December 2020 SPAC revenue was just over 3x the November revenue tally, however it's still only the 2nd most revenue generating month of 2020. In July Nikola Motors generated $106m in revenue, 95% of the recent SPAC IPO total, In December the most revenue generating recent SPAC was Quantumscape, which generated 61% of the SPAC total." Sam Pierson – Director IHS Markit Securities Finance

In conclusion it's clear that SPACs are currently having a profound impact on the capital formation environment and offer an innovative way for private companies to go public. Its success as a structure will be largely determined by the quality of the businesses Sponsors can attract as well as its ability to compete with traditional IPO markets in more ordinary market conditions where the challenges of 2020 do not weigh as a heavy burden on the century-old process. But as the growth of the level of SPAC dry powder (or Cash in Trust) shows, this story still has some way to run.

"We expect that new and creative approaches will continue to emerge to create efficiencies, reduce friction costs for all parties and facilitate more rapid access to capital or IPO. The SPAC phenomena is an important trend to consider as companies seek capital in the most efficient ways. Importantly, the SPAC process is one that we might expect will be prevalent to the extent that quality companies are open to this process and route to market."

[1] CNBC business news channel
[2] Financial Times; https://www.ft.com/content/af75ce79-2bcd-46c4-92f4-8886513e53

SPAC Cash in Trust Summary



Source: SPAC Research © 2021 IHS Markit

As new entrants flood the market and competition increases, iteration on terms and structures make them more founder-friendly.

The process to bring companies public is certainly broken, nor do SPACs provide a silver bullet for all types of private companies and their specific needs. However, it will likely work best for capital-intensive businesses and those with complicated, innovative, or long-term stories. This will often be companies at the forefront of new economies.

Written by;

Leon Sinclair, Global Head of Private Equity and Private Debt Services

Laura Erwin, Head of North American Delivery, Private Equity and Private Debt Services.