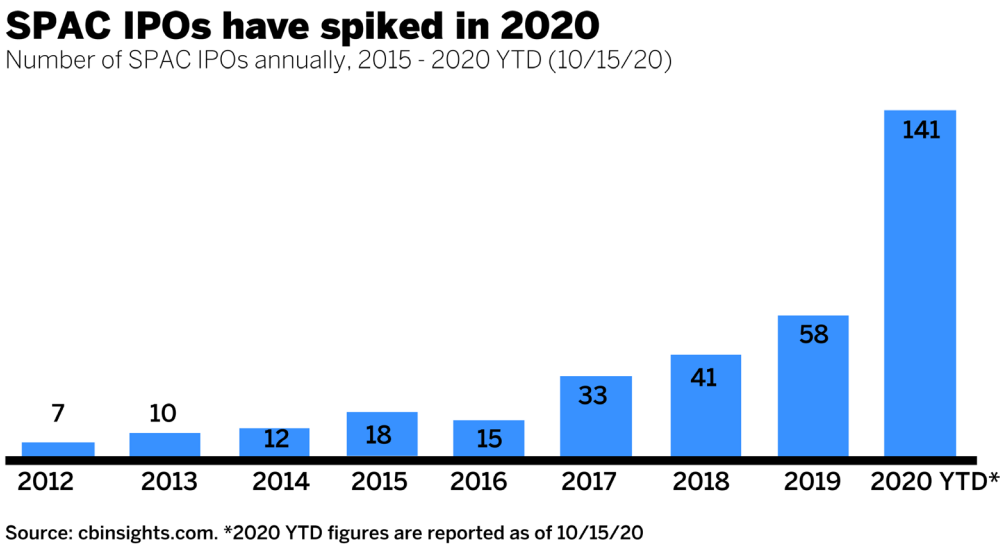
me website
PAULO@PAULODOCARMO.COM
email

WHAT IS A SPAC?

By CBInsights

This alternative to the traditional IPO is getting renewed attention. We take a look at what a SPAC IPO is and why it's changing the future of the initial public offering.

SPAC mania has taken hold of public markets.
A special purpose acquisition company (SPAC) is a "blank check" shell corporation designed to take companies public without going through the traditional IPO process.
Though SPACs have been around for decades, the financial maneuver has gained traction in recent months as more private companies eye exit opportunities and as the Covid-19 pandemic creates uncertainty in the IPO market.
In fact, the number of SPAC IPOs in 2020 has already more than doubled compared to 2019 full-year totals.

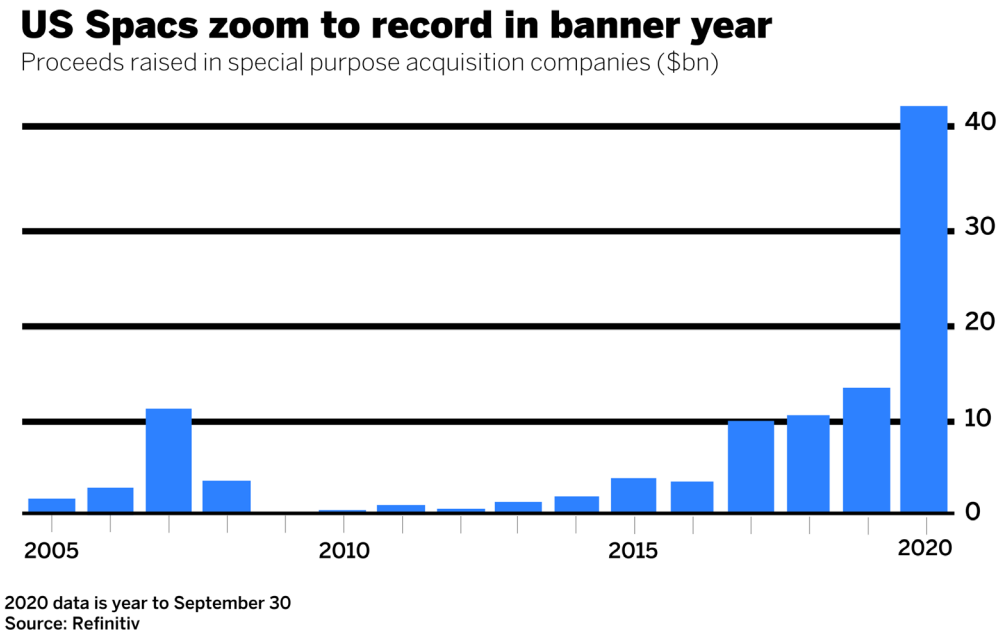


Right now, SPACs are an attractive offering. The target company is able to go public quickly without much of the volatility associated with a traditional IPO, and investors get access to high-reward investments with limited risk.
Sponsors — the people or companies that launch the SPAC and find the company to acquire — stand to make millions regardless of how the acquisition works out. Nearly anyone can start a SPAC, which is enticing a cross-section of big names including entrepreneur and VC Peter Thiel and baseball exec Billy Beane to get involved.
Hedge fund manager Bill Ackman raised a $4B SPAC in July 2020 — the largest to date — while Social Capital CEO Chamath Palihapitiya has launched 6 SPACs since 2019, and has reportedly reserved 26 public company tickers for SPAC public offerings — from IPOA to IPOZ. (The first 3 of these were used to acquire and debut space company Virgin Galactic, real estate startup OpenDoor, and Medicare Advantage platform Clover Health, respectively.)
In this report, we examine how SPACs work, why they're gaining popularity now, and who the potential winners and losers are when it comes to this type of public market debut. We also look at what it means for the future of the IPO.

WHAT IS A SPAC?

A special purpose acquisition company (SPAC) is a public shell company that acquires a private company and takes it public. Also called a "blank check" company, SPACs go public before their acquisition target is identified.

The SPAC IPO has been around in its current form since the 1990s, but the surge in popularity is more recent. Already in 2020, SPAC proceeds have tripled the previous record set in 2019.

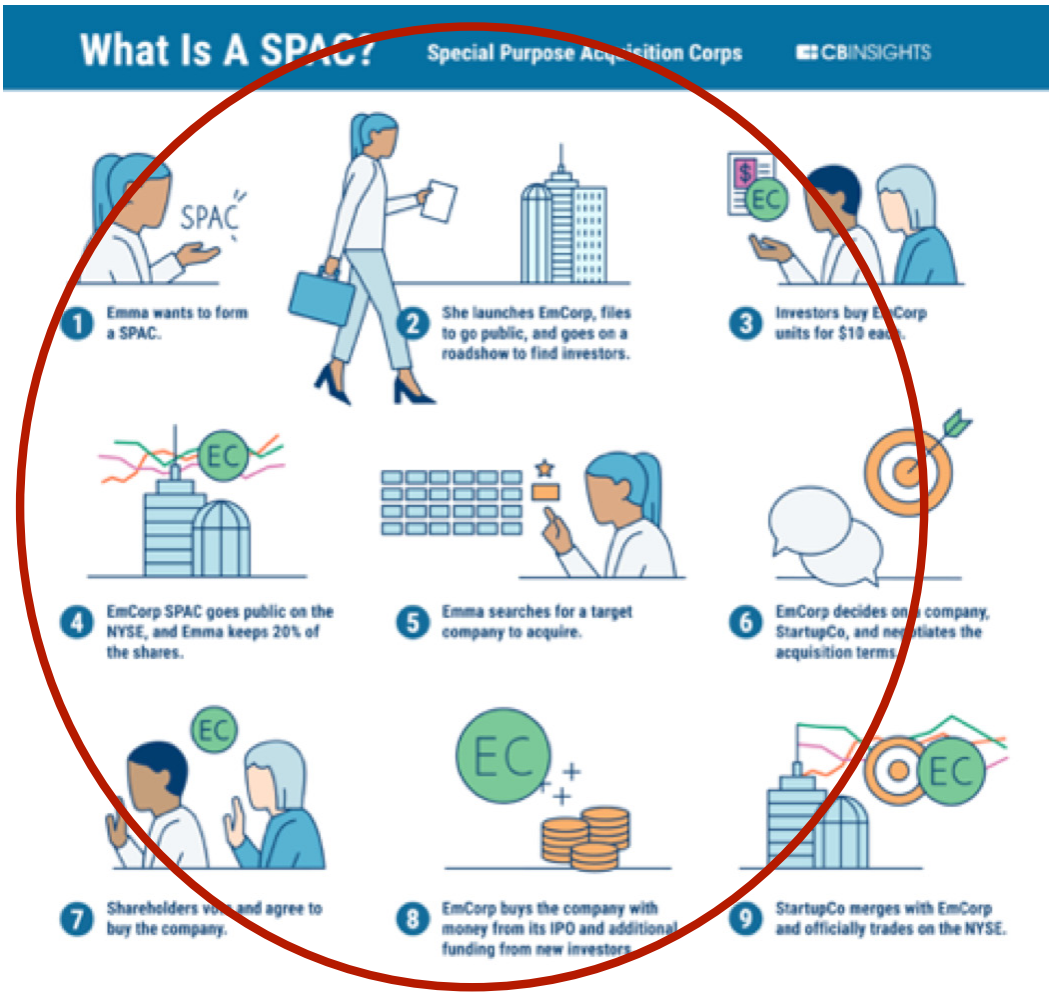


Source: Refinitiv via Financial Times

In the 1990s, the SPAC had a reputation for taking small, immature companies public for a large fee, leading to high levels of company failure and lacklustre stock performance at the expense of investors.

Regulations enacted in the 2000s helped to bring SPACs back into the spotlight, but the financial manoeuvre lost traction following some high-profile failures in 2008.

Here's how a SPAC works:



GOING PUBLIC

The sponsor — typically a person or team with significant business experience — decides to launch a SPAC.

They create a holding company, then complete the normal filings associated with going public — but because the company doesn't do anything (i.e. it has no operational business), the filing process is fast and easy.

The sponsor then goes on a roadshow, similar to traditional IPOs, to try to find interested investors. The difference here is that they are selling themselves, their team, and their experience, rather than a specific company.

Once the sponsor has attracted enough interest, they sell units in the company. Units are typically $10 each, and represent one share of the company and a warrant to buy more shares in the future. The money raised from the IPO is put into a blind trust, and is untouchable until the shareholders approve the acquisition transaction.

The SPAC goes public and trades on an exchange like any other publicly traded company. This is where retail investors get involved — they can purchase shares on the open market, but the future acquisition is still unknown. Instead, these investors are buying on the strength of the sponsor or the promise of a strong future acquisition.

The sponsor also receives 20% of the shares of the SPAC as a fee, called a "promote" or "founders shares."

ACQUIRING A COMPANY

Once the SPAC is public, the sponsors can begin the hunt for a target company to acquire.

There are no restrictions on the type of company a SPAC can acquire, though many will highlight a target industry before IPO. Typically, the sponsors have 2 years to find and announce an acquisition, or else the SPAC will dissolve and shareholders will get their money back.

When the sponsors find a company, they then negotiate the terms of the acquisition with the target company, like purchase price or company valuation.

Following a deal, the "de-SPAC" process begins.

DE-SPAC

After deciding on the terms of the acquisition, the sponsors must propose the acquisition target to shareholders. The initial shareholders have the opportunity to vote on the acquisition, which gives them some recourse if a sponsor chooses a company they do not like. Even if the acquisition is approved, shareholders can then redeem their shares for their money back.

Once the company is approved and all redemptions have been completed, the sponsor can move forward with acquiring the target company.

However, the initial SPAC raise usually only covers about 25-35% of the purchase price. Here, the sponsors can ask existing institutional investors (like large funds or private equity firms) or new outside investors for additional money using a Private Investment in Public Equity (PIPE) transaction.

Following the final capital raise, the SPAC can now take the target company public.

Even though the SPAC is already public and has filed with and been approved by the SEC, the target company also needs to gain approval from regulators. In other words, the target company does not necessarily face fewer regulatory requirements when going public via a SPAC merger instead of a traditional IPO — it's just a shorter timeline.

Once approved, the ticker changes to reflect the name of the acquired company and it starts trading as a typical public company. For example, Social Capital's IPOA SPAC acquired Virgin Galactic in 2019. On the day of the acquisition, the ticker IPOA stopped trading and was replaced with SPCE.

WHY NOW?

There are a few reasons why SPACs have recently experienced a boom in popularity.

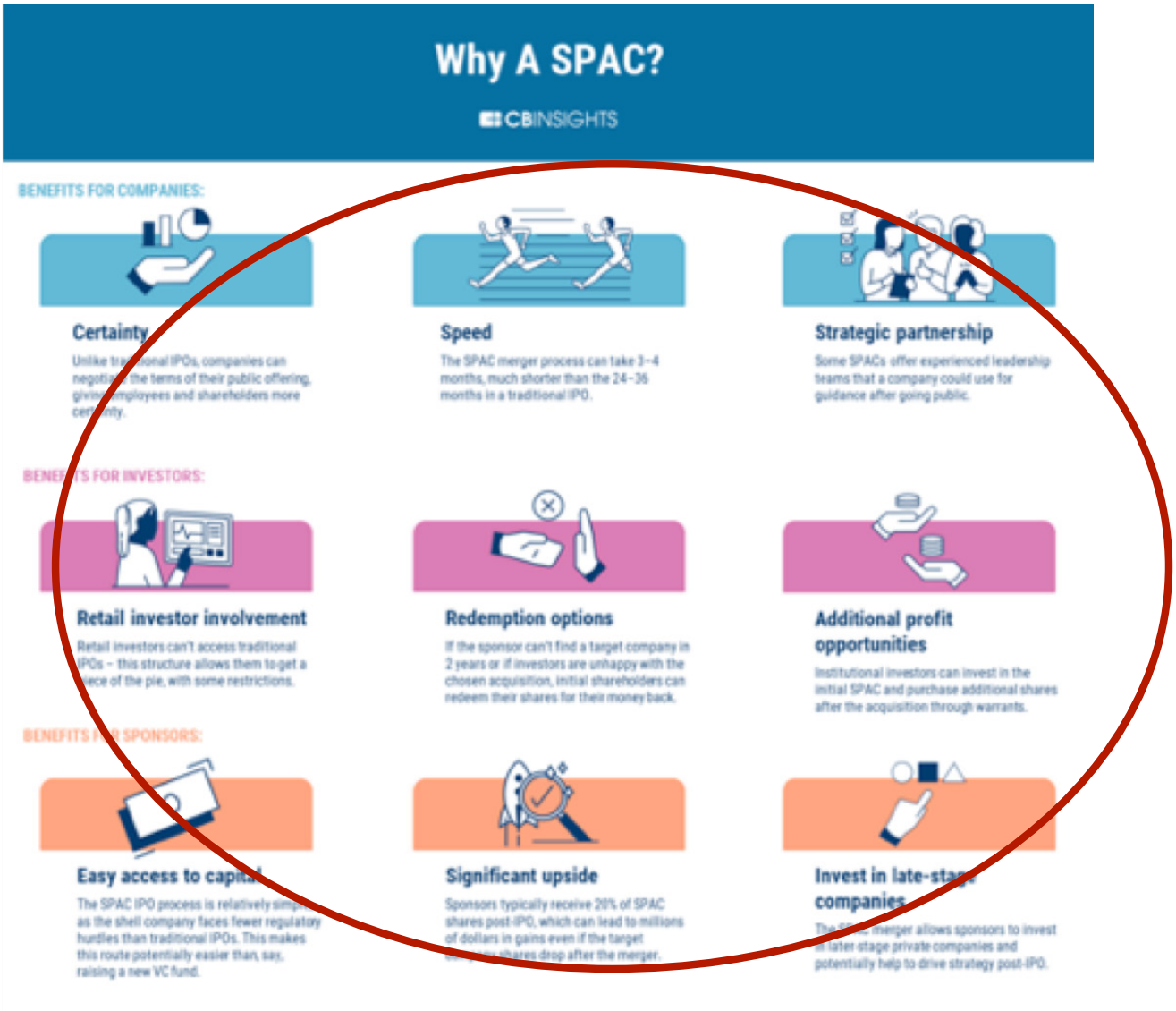
For one, private companies have been staying private for longer. Many VC-backed companies have had ample access to capital, as large venture firms like SoftBank dole out $100M+ rounds to late-stage private companies, deferring the need to go public.

Now, the Covid-19 pandemic has injected uncertainty into the market.

Private companies are reportedly less sure that they'll be able to raise large rounds in the near future, but still need access to capital. Some are looking to public markets for liquidity. In fact, the general IPO market proceeds in the first 3 quarters of 2020 have already surpassed full-year totals for the past 5 years, even when excluding SPACs, according to the Financial Times.

However, given the volatility of public markets, the traditional IPO is less enticing, as companies have less control over how much money they are able to raise. The traditional IPO also takes years to complete, and the pressure to go public is pushing some companies to explore faster alternatives.

Sponsors and investors are therefore taking this opportunity to provide companies with that alternative — for a significant fee.



WHY NOW FOR PRIVATE COMPANIES

There are a few reasons why private companies would choose to go public via SPAC instead of a traditional IPO.

Healthcare D2C startup Hims recently announced that it would go public via a SPAC sponsored by Oaktree Capital Management. It is going public at a $1.6B valuation, and is raising $280M in the transaction.

In the decision to go public, Hims considered both a typical IPO and a SPAC. When discussing the process with Axios, Hims CEO Andrew Dudum said,

"We had always expected and prepped for a traditional IPO, but there are a lot of favorable dynamics in the new group of SPACs. There's greater speed and certainty of a deal, which helps the team stay focused, and we get to partner with an amazing investor like Howard Marks."

Some companies prefer the SPAC process to the traditional IPO process because of stability, speed, and strategic partnerships, despite the increased costs associated with sponsor fees.

STABILITY

In a typical IPO, the company's share price is not certain. It is determined by investor appetite and market forces as much as by the company's underlying business valuation. A company is unsure of how much it will make until the day before its IPO, even though it takes months to go through the IPO process.

Further, the traditional IPO price is determined by the IPO bankers, who make their best guess at what the company is worth in the eyes of investors. However, this is never perfect, meaning that the IPO can be mispriced. If a company's bankers priced its IPO at $10/share, but then it immediately pops to $15, this means that the company may have been able to sell its shares at a higher price, missing out on more money.

A SPAC transaction is appealing because it avoids price uncertainty altogether. The company management team is able to negotiate an exact purchase price, ensuring that the company doesn't leave any money on the table, though it pays a price for this certainty — the valuation received may be lower than a company could receive through a traditional IPO, and the sponsor fees add additional costs.

SPEED

The traditional IPO can take years from start to finish. The SPAC merger process is much faster for the target company, taking as little as 3 to 4 months, according to PwC. This is attractive for companies looking to raise money and go public quickly.

However, the time crunch does mean the company has to prepare to be a public company much quicker, despite needing to complete all the same filing requirements as a traditional IPO. This includes financial reporting, SEC oversight, tax preparation, technology upgrades, cybersecurity measures, and more.

STRATEGIC PARTNERSHIP

Though not every SPAC plans on being a strategic partner to the company it takes public, the strategic SPAC is becoming a more typical pitch for the hotter tech companies that are looking to go public fast.

Strategic SPACs use sponsor experience and knowledge as a selling point for potential companies. For example, an electric vehicle company may find a SPAC offering more appealing if the sponsor comprises a team of EV investors or operators, especially if the sponsor plans to take a board seat and work with the company's management team on post-IPO strategy.

In this way, the strategic SPAC serves a similar purpose as venture capital does to private investment: the company benefits not only from the investment itself, but also from the investor.

WHY NOW FOR INVESTORS

This has proven to be an enticing new strategy for many investors, including institutional and retail investors, as well as the sponsors behind the SPAC.

SPAC SPONSORS

SPACs are very attractive opportunities for sponsors, who stand to make significant amounts of money in most cases.

One challenge for sponsors is to convince people and funds to invest hundreds of millions, at times billions, of dollars in their SPAC. For this reason, many SPAC sponsors are well-known in their field or have a team of experienced businesspeople.

Hedge fund manager Bill Ackman raised $4B for a SPAC in July 2020 — the largest SPAC to date. However, Ackman has opposed the current SPAC structure, which gives sponsors huge upside opportunities and severely limits their downside.

As it currently stands, SPAC sponsors pay about $25,000 to receive 20% of the SPAC shares, assuming a deal is completed. For example, if a SPAC raised $500M initially, the sponsor pays $25K and gets $100M in shares once the merger occurs. This is a huge profit margin and is not severely impacted if the acquired company performs poorly — even if the new company's stock drops by 50%, the sponsor still makes nearly $50M. To try to remove these incentives, Ackman forfeited the 20% founders shares. He also claimed that his hedge fund, Pershing Capital, would invest $1B+ of its own capital to complete the merger. The IPO was very successful, with about 3X more interest in the offering than was available. However, sponsor-friendly rules are still the norm, so the SPAC process remains incredibly attractive for well-known individuals and firms as a way to make significant amounts of money with relatively little risk.

INSTITUTIONAL INVESTORS

Institutional investors, like pensions, hedge funds, mutual funds, or investment advisors, have long invested in SPACs and other less traditional funding vehicles. This structure is attractive for these investors mainly because of the limited risk they face when investing: when investors get in before the IPO, they receive warrants, which allows them to buy more shares after the target company is announced for only slightly more than the initial purchase price. They are also able to redeem their shares if they are unhappy with the acquisition decision, and get their money back if a company isn't purchased within 2 years.

For example, if a hedge fund buys 1,000 shares in a SPAC at $10 each, it also receives 1,000 warrants to buy more shares for $11.50 a piece. When the target company is announced, the fund can redeem its shares for all of its money back, limiting its potential losses if it thinks the company will not do well. However, if the fund likes the announced target company and the stock jumps to $15, it can buy 1,000 more shares for $11.50 each — making a potential profit.

RETAIL INVESTORS

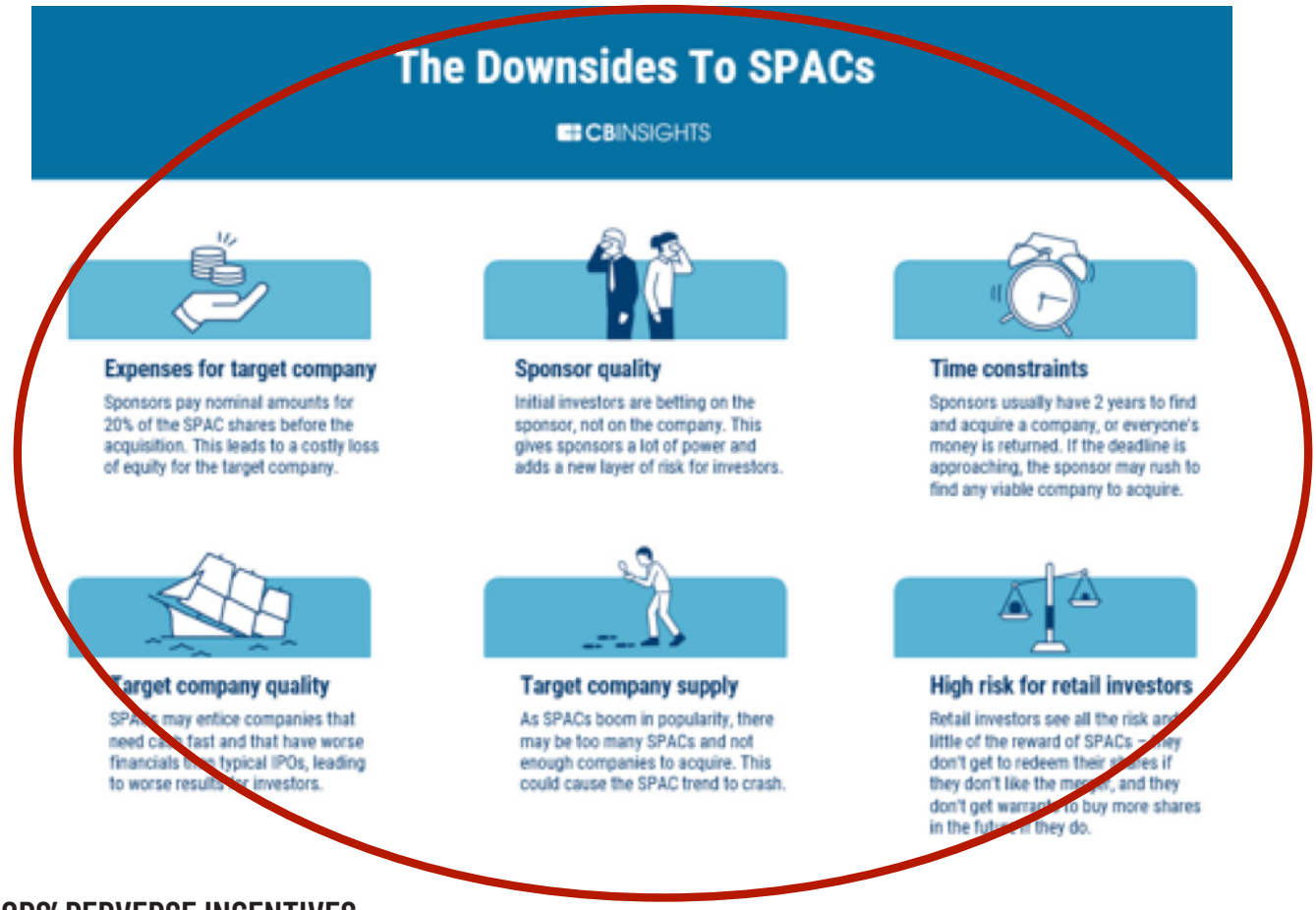
Retail investors — individuals making investments through traditional or online brokerages like Robinhood — are not allowed to invest in a traditional IPO, and therefore have to buy on the open market on the day of trading. This means that retail investors are largely left out of the upside available from an IPO.

These investors have a unique, albeit mixed, opportunity with SPACs. The structure allows retail investors to get involved in a SPAC after it has gone public but before it has announced the merger, which allows them to enjoy the "pop" once the business to acquire is announced.

However, these investors are favoring the sponsor, not the company to go public, which adds risk. They also are not able to get the rights (enjoyed by institutional investors) that make this structure so attractive: they do not get the warrants that allow shareholders to buy more shares in the future, and they do not have the right to redeem their shares for their money back if they are unhappy with the announced merger. In other words, if institutional investors get a lot of the reward with limited risk, retail investors get a lot of risk with limited upside.

CHALLENGES & CONCERNS

Despite the positives, there are also challenges and concerns regarding the structure of the SPAC method.
From sponsor risk to low-quality companies to supply & demand concerns, SPACs are far from perfect.



SPONSORS' PERVERSE INCENTIVES

For decades, the SPAC has had a negative reputation as a way for sponsors to get rich quickly at the expense of other investors.
Though SEC regulations and improved sponsor quality have helped to improve the SPAC reputation, there are still risks and downsides associated with the sponsor, including:

- Expenses for the target company. Sponsors pay nominal amounts for a 20% ownership of the SPAC shares, which can lead to a 1-5% stake in the acquired company after the business merger. This means that sponsors are poised to make significant income if they merge — regardless of the outcome of the merger — which may disincentivize appropriate due diligence on target companies. It also costs the target company a large portion of equity, which could make this deal more expensive than a traditional IPO.
- Sponsor quality. Investors in the initial IPO are investing in the sponsors, not in a specific company — giving sponsors a lot of power while adding a new layer of risk for investors. Institutional investors are able to redeem their shares and get their money back at the time of the acquisition announcement, but there is little a retail investor can do if it's proven after the merger that the sponsor didn't do proper due diligence or chose in bad faith.
- Time constraints. The sponsor typically has 24 months to find and acquire a company, or else the SPAC is liquidated and everyone's money is returned. If that deadline is approaching, the sponsor may rush to acquire any willing company, potentially harming investors.

However, as the quality of sponsors has improved over the years, it has helped add some credibility to the structure and push the SPAC into the spotlight.

QUALITY OF TARGET COMPANIES

For a struggling company, a SPAC may provide a temporary lifeline that's faster to access than the public markets.
One study showed that, between 2003 and 2013, 58% of companies that merged with SPACs failed — a higher rate than traditional IPOs.
Even if companies don't fail outright, some negative press may have outsize impact on the SPAC reputation for companies considering this process in the future.
For example, electric truck company Nikola went public via SPAC in March 2020, despite not earning any revenue in 2019 and lacking a clearly viable truck model. It saw its market cap jump to $29B — higher than Ford's — before its CEO resigned and the SEC opened an investigation into the company for fraud.
Stories like this could taint the reputation of SPACs in the future, potentially pushing other companies away from the structure.

SUPPLY OF TARGET COMPANIES

Another concern is that the number of SPACs may outpace the number of companies willing to go public. Legally, the sponsor is not allowed to express interest or discuss a merger with any potential target companies, which means that, while sponsors may have potential companies in mind, they take their SPACs public without knowing the demand for a future SPAC merger.

The 2-year time limit for acquisition also plays into this concern. If demand for companies to acquire is greater than the companies ready or willing to go public, the SPAC bubble could burst as sponsors lower their quality standards for target companies or as the SPAC expires.

"Is there too much SPAC money chasing too few opportunities? ... I don't think we know that yet." — Jeff Sagansky, media executive and SPAC sponsor

HIGH RISK FOR RETAIL INVESTORS

Retail investors get all of the risk — and limited rewards — associated with SPACs.

If retail investors buy into the SPAC but are unhappy with the announced target company, there is little recourse besides selling their shares. And unlike institutional investors, which get warrants to buy more shares after the target company is announced as an incentive for purchasing shares in a SPAC, retail investors do not enjoy that benefit, limiting their potential upside.

LOOKING AHEAD

The future of the IPO is not in jeopardy.

Many high-profile companies that are looking to go public in the coming years are rejecting the SPAC option, opting instead to go public the traditional way. For example, Airbnb was reportedly approached by Bill Ackman's $4B SPAC, but the company ultimately decided against this route, instead filing a traditional IPO for December 2020.

It is still more expensive to go public via SPAC, and once the current market volatility dies down, there will be far less incentive to pay that higher price to reduce the uncertainty of a traditional IPO.

As for the SPAC merger, it's likely here to stay, though probably not in its current form.

Today, sponsors are the big winners of the SPAC boom. However, as SPACs get more popular, sponsors also have more competition for deals, which could force sponsors to be more company-friendly to entice potential acquisition targets.

Bill Ackman's $4B SPAC may be the first step toward less sponsor-focused deal structures — and it may not be the last.