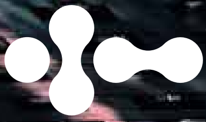

SG Analytics
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SPACs

Sunshine or a Flash of Lightning

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1

Why this whitepaper?

> **It took me 20 years to become an overnight success**
>
> ~ Eddie Cantor ~

What is the one thing that Walt Disney, Airbnb, and Apple have in common? All of them are incredible success stories of companies that have fought odds over several years and made a mark for themselves. Walt Disney was fired by a local newspaper for 'not being too creative'. His first animation studio went bankrupt before he finally decided to move to Hollywood and start the Disney Studio. When Airbnb started in 2008, the idea was dismissed by hundreds of investors and the company resorted to basic jobs such as creating custom cereal boxes, just to make ends meet. Apple was operating in loss for a long time and approaching bankruptcy, but a massive rebranding campaign helped it become the first company to ever reach $1 trillion in market capitalization. In no way were these companies 'overnight successes'.

A similar phenomenon was witnessed in the last couple of years in the capital markets. A once forgotten method of public listing made its way into the limelight and posted two record years back-to-back, and the momentum continues. It would be only fair to say that 2020 was the year of Special Purpose Acquisition Companies or SPACs.

Much like the inflation, FDI, or any other financial concept, one cannot exactly trace the genesis and resurgence of SPACs to one single point. However, broadly speaking, SPACs initially appeared on the scene in the 1990s but had a patchy run until 2018. And that got us thinking: why did SPACs become so popular suddenly? What is it that investors find so attractive about this vehicle?

Hence, we decided to explore SPACs in detail through this whitepaper, where we delve into their structure, advantages, risks, comparisons with other investment routes, and our view on whether these are really a long-term success story.

2

What is a SPAC?

The mechanics

A special purpose acquisition company (SPAC) is a 'blank check' company formed for the sole purpose of raising money through an initial public offering (IPO), and eventually using the funds to acquire another company. A SPAC does not have any operations at the time it is founded. It is generally formed by a group of investors called sponsors, with a strong background in a particular industry or business sector. These include a team of institutional investors and also Wall Street professionals from the world of private equity (PE) or hedge funds.

A SPAC raises funds from the public, which sits in an interest-earning trust account for a prescribed period of time (usually 2 years). During this time, the SPAC must find a suitable target, failing which they must return the money to investors along with the interest earned.

SPACs sometimes have specific mandates regarding the type of acquisitions they pursue. Their criteria can be something as specific as sector focus to something much broader. SPACs have existed broadly in the technology, healthcare, logistics, media, retail, and telecommunications industries. But today, we are witnessing PE firms in the process of raising multi-billion dollar funds via the SPAC route with focus on renewables and ESG-focused businesses, amid sustainability investments gaining traction and President Biden focusing on boosting clean tech.

Similar entities in various forms such as a 'blank check company' or 'public shells' have existed since decades. However, the shells of the 1980s employed 'pump and dump' schemes in an effort to earn abnormal returns, which made it prone to manipulation and swindles. The laws have transformed for the better since, leading to the emergence of a new type of entity and coining of the term 'SPAC' in the 1990s. The SPACs from 1990s are broadly similar to the SPACs as we see today, though it has been the subject of continuous reforms to safeguard investors' interest.

Here is an infographic that summarizes the mechanics of a SPAC:

Source: CBInsights

It is worth noting that the initial funds SPACs raise usually cover only about **25–35%** of the purchase price. The sponsors may ask existing institutional investors (such as large funds or PE firms) or new investors for additional money through a Private Investment in Public Equity (PIPE) transaction.

A SPAC will then identify the relevant target, acquire it, and in the process take it public through the mechanism of a reverse merger. This is known as de-SPACing (or a De-SPAC transaction).

One example would be the DraftKings IPO back in early 2020. DraftKings merged into Diamond Eagle Acquisition Corp, a SPAC vehicle with more than **$400 million** in cash at the time of acquisition. The acquisition was further supported by additional cash infusion from PIPE investors. Pro-forma ownership at close included 74% of the seller in the form of rollover equity, **12% PIPE investors**, and **14% SPAC shareholders**.

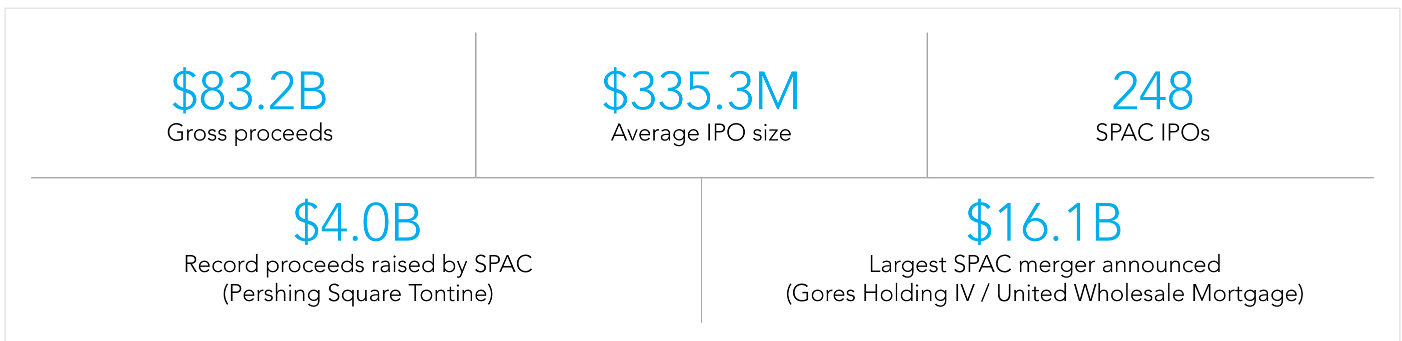
A SPAC would typically hire an investment bank to help with the IPO and the subsequent de-SPAC merger. Underwriters typically get a fee of 2% of the money raised in the initial listing, and then another 3.5% when the company completes the deal with its target. While those fees can be lower than traditional IPOs, investment banks can also earn fees by advising a company on its sale to a SPAC or the SPAC raising more money for its acquisition.

3

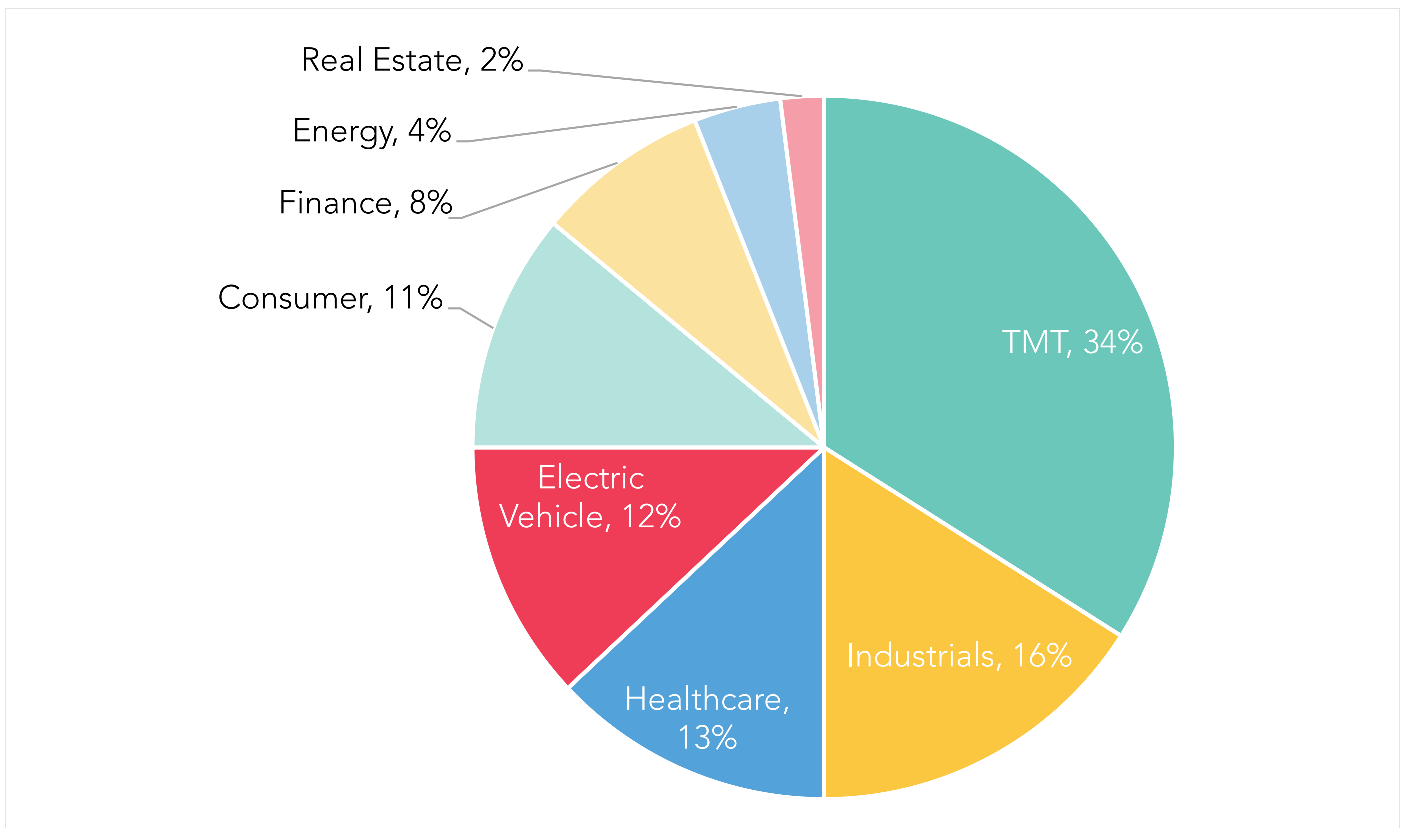
The rise of SPACs in 2020

2019 was already a record year for SPACs. In 2019, SPAC IPOs raised $13.6 billion in gross proceeds, driving more capital than in any prior year. However, the rise of SPACs in 2020 was meteoric to say the least and was powered by a multitude of factors: (i) COVID-19 necessitating companies to seek alternate ways of raising capital, (ii) the recent success of some SPACs, (iii) public display of attraction by high-profile and well-known companies, (iv) changing investor attitudes, and (v) better regulations to protect investors.

2020 SPAC Milestones



In the two years between Jan 2019 and Jan 2021, the Technology, Industrial, and Healthcare segments have accounted for >60% of total companies brought public via the SPAC route.



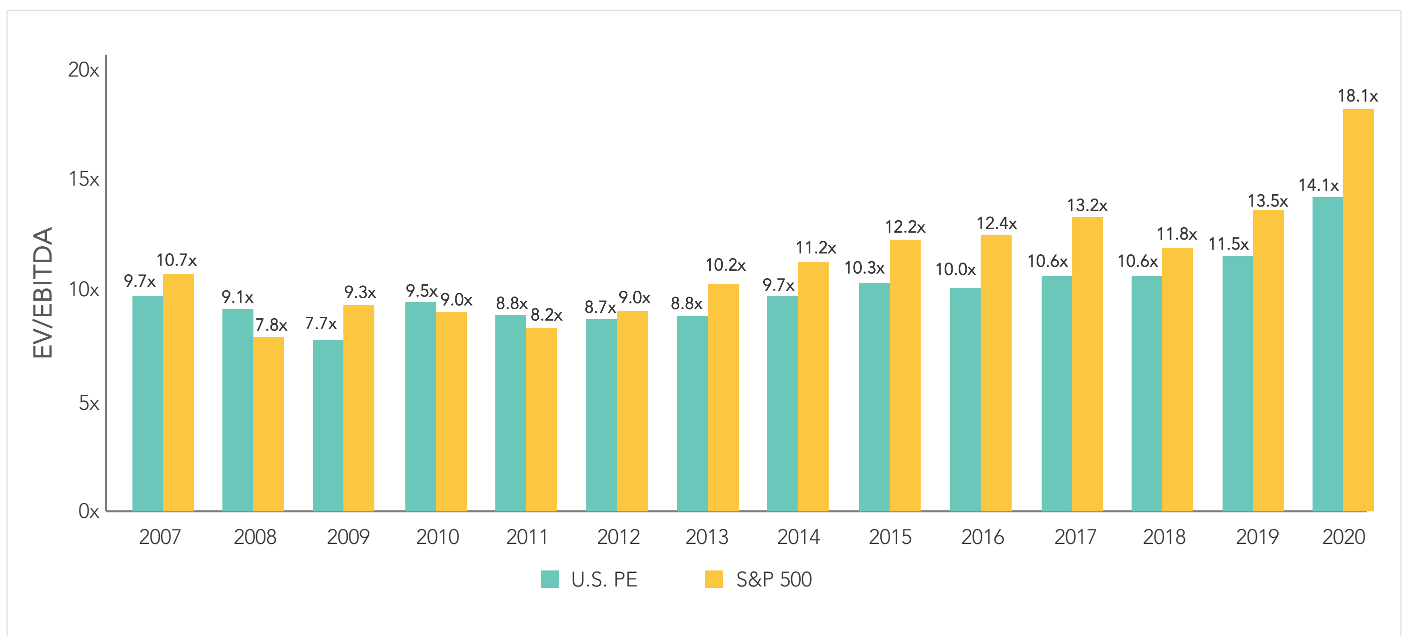
Source: JP Morgan Research

It is worth pointing out how many SPACs are targeting EV (Electric Vehicle) start-ups. This makes sense as EV players are capital-intensive companies that need money to grow. Raising capital via a SPAC rather than traditional VCs probably presents better terms as companies do not have to dilute a major chunk of their equity, which they generally do if they get cash infusion from a VC firm. Major names that adopted this route include electric truck maker 'Nikola Motors', electric bus maker 'Proterra', electric truck startups 'Xos' and 'Lucid Motors', charging station 'EVgo', and EV company 'Canoo'. Given this success, we might further see more money being invested in this vertical through the SPAC route. President Biden's pledge of a $174 billion spend to boost the electric vehicle (EV) market just makes it easier.

Record amount of dry powder stock at PEs is a major factor that has worked in favor of SPACs, and capital that was hitherto sitting on the sidelines found its way into the markets. The dry powder was estimated to be near $3 trillion globally around March 2021, around one-third of which is reserved for SPACs and Buyouts – still a strong number for this year.

More companies are now looking to realize additional liquidity through listing publicly and to capitalize on the current favorable public market conditions. Private market valuations have trended downward, while public company valuations have continued to surge amid the pandemic-driven recession, reaching an all-time high and widening the public-private valuation gap. To ride that trend, many private companies are now using SPACs as their vehicle of choice for the last financing round and IPO, all-in-one.

Private Equity Valuations Discount to the Public Market



Source: Partners Group, Pitchbook

The uncertainty induced in the markets by the COVID-19 pandemic has only accelerated the pace for acceptance of SPACs. Private companies seem to be less sure about being able to raise large rounds in the near future, but still need access to capital. Given the volatility of public markets, the traditional IPO is less enticing, as companies have less control over how much money they can actually raise. The traditional IPO also takes years to complete, and the pressure to go public is pushing some companies to explore quicker alternatives. Sponsors and investors are therefore taking this opportunity to provide companies with this alternative. The SPAC process offers a simpler path to the public market than the usual IPO roadshow, which is most important now when travel and in-person meetings are difficult.

A few other key drivers for the mounting investor interest in the SPAC market are as follows:

- Much stronger 'announcement pops' (returns on the day of announcement of a potential acquisition) than in previous years - the average announcement pop for SPACs that completed acquisitions in 2020 was 13.6%, compared to ~2.5% in prior years.
- Significant improvement in the quality of sponsors - most SPAC sponsors today are either C-Suite operating executives from big companies, well-established investors, or headline names that bring real investment capabilities.
- Top-notch marketing - high-profile, well-regarded companies and investors got involved in SPACs and that visibility edged others to try it themselves.

All the attention has also resulted in a steep rise in completed SPAC acquisition multiples. The weighted average EV/Trust Account of completed SPAC acquisitions rose significantly from 4.0x in 2019 to 6.4x in 2020..

4

What really differentiates a SPAC IPO from a regular IPO?

In a traditional IPO, a company announces that it wants to go public. This is followed by the company disclosing details about its business operations. After this, investors put money into the company in exchange of shares.

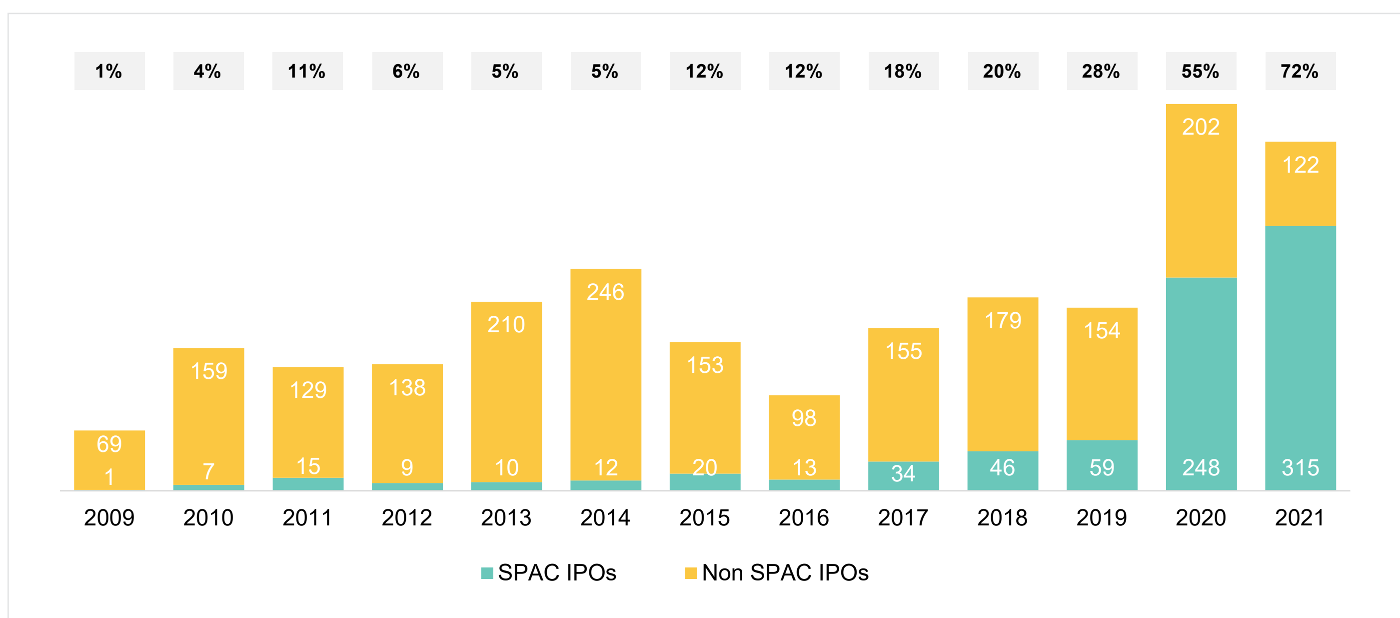
A SPAC flips that process around. Investors pool their money first with no idea about the company or the business they are investing in. The SPAC goes public as a shell company. The required disclosures are simpler than a regular IPO and is usually in boilerplate language, because money is invested in an entity with no business operations to describe, assess, report, or forecast.

Listing through a SPAC does offer a myriad of advantages over the regular route. It is undoubtedly much faster, with a quicker time-to-market. The books of accounts and the registration statement for a blank check company can be prepared in a short span and are also subject to lesser evaluation and comments by the SEC. Lesser time also means lesser uncertainty. Listing through a SPAC is a more streamlined process with less paperwork.

SPAC offers a better opportunity for retail investors to be early investors in a growing company, contrary to a typical IPO where the proceeds are allocated to large institutional investors. Many SPACs are priced at $10 per share, well within the reach of retail investors. The price stays low for a while, which makes these shares quite inexpensive.

SPACs are also cheaper, with a lower underwriting fee. In a traditional IPO, underwriters are paid around 7% of the gross proceeds, whereas in a SPAC process, underwriters are paid 2% at the successful closing of the SPAC IPO and another 3.5% on closing the de-SPAC transaction. Moreover, no roadshows mean no marketing costs for the company.

SPAC IPOs As a % of Total IPOs



Source: SpacAnalytics (Updated as of May 13, 2020)

However, a regular IPO does have some benefits over SPAC. The traditional process of going public has been in vogue since ages and is hence more trustworthy. Moreover, IPOs do provide a better mechanism to 'time the market' based on current situation and market readiness. A SPAC, on the other hand, must complete the investment process within 24 months or investors could recall their investment.

In a traditional IPO, sponsors, directors, and officers sign a lock-up agreement for 180 days from the pricing of the IPO. For a SPAC IPO, the lock-up runs until one year from the closing of the de-SPAC transaction, but is subject to early termination if common shares trade above a fixed price (usually $12.00 per share) for 20 out of 30 trading days starting 150 days after closing the de-SPAC transaction.

	SPAC	IPO
Time of Process	8-10 weeks for IPO followed by 3-4 months to effect the merger	24-36 months, and the timing of going public is dependent on market conditions
Financial Disclosure	Minimal and not Mandatory	Mandatory and detailed
Risk	Lower	High
Cost	Cheaper, no heavy underwriting costs	Expensive, marketing and compliance costs
Marketing	Minimal with no need of roadshows	Extensive, testing the waters and pre-trading roadshows
Deal Consideration	Value of deal consideration is generally known at the beginning of the business combination	Value of deal consideration is generally known at the end

In addition to helping companies list on the exchange, a SPAC also offers a strategic partnership opportunity. Strategic SPACs use sponsor experience and knowledge as a selling point for potential companies. For example, an AI company may find a SPAC offering more appealing if the sponsor comprises a team of AI investors, operators or people who have worked in the industry before. The fact that the sponsor takes a board seat and works with the company's management team on the post-IPO strategy sweetens the deal. In this way, the strategic SPAC is quite similar to a venture capital firm: the company benefits not only from the investment itself, but also from the extensive hand-holding by the investor.

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Are SPACs like private equities?

On the face of it, one can indeed draw multiple parallels between how a SPAC and a Private Equity (PE) work.

Much like a PE, a SPAC is also looking for investors. Once that is done, both the entities search for the best company to make most of their investment. Like a PE, a SPAC also lets the existing management remain in charge, though a PE has greater flexibility in reversing the roles, if required. Akin to a PE fund, the success of a SPAC is driven by sponsors with experience and track record in identifying, acquiring, and operating a company within an industry and an established network of anchor investors. One slight difference: a SPAC ends up taking the company public or dissolving, whereas a PE might also choose to sell to a strategic acquirer or another financial sponsor, apart from considering a public listing.

It is due to these similarities that more and more PE firms are now sponsoring their own SPACs. PE firms such as Apollo Global Management, TPG Capital, and others have raised billions of dollars in the last 1.5 years sponsoring SPACs. SPACs allow PEs access to the broader public market. In a way, the influx of PE participants has added a further degree of credibility to SPACs, spurring their growth as an investment platform. A recent study by the law firm Sidley reported that 69% of PE firms expect to be involved in SPAC-related transactions in the coming years.

PEs are also drawn to SPACs on account of the relatively low investment with possible chances of a significant upside in a shorter horizon. Sponsors would typically contribute a relatively smaller token amount (2–3% of gross proceeds) at the time of investment. This results in a larger stake, typically 20% of the equity ('the promote') of outstanding shares at the time of the de-SPAC transactions. The sponsors are also eligible for warrants that allow them to purchase additional shares at a certain premium (15%) to the $10 IPO price. Even if the share price sinks post-merger, the promote offers a large cushion against losses. If the price goes up, the warrants sweeten the deal. For example, Chamath Palihapitiya's Social Capital, which acquired Richard Branson's Virgin Galactic and triggered the SPAC wave, invested $10 million in risk capital. This turned into an almost $200 million stake in Virgin Galactic. Bradley Tusk, CEO and co-founder of Tusk Ventures, said that the risk capital on his $300 million gaming-focused SPAC, which he started as a project not associated with his VC firm, was a meagre $8 million in comparison.

A PE can also sell its investment to a SPAC that provides the target companies the opportunity to get listed. This gives PE firms a great way to exit and yet derive maximum returns out of the IPO. An IPO has typically been the best way to exit a company, given the high returns. PE firms that have sold portfolio companies to SPACs include Cerberus Capital Management, Platinum Equity, the Blackstone Group, J.F. Lehman & Company, Clearlake Capital Group, Roark Capital Group, L Catterton, Irving Place Capital, Corsair Capital, Peninsula Pacific Strategic Partners, and Energy Capital Partners, among others.

Even VC firms, who initially sat out the SPAC craze, now want a piece of the cake. Most recently, more than a dozen venture firms have jumped into the SPACs game, including Foundry Group, General Catalyst, Fifth Wall, Lerer Hippeau, and Khosla Ventures (which formed four separate vehicles).

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What are the risks involved with SPACs?

SPAC transactions come with their own set of unique challenges. For instance, SPAC sponsors pay a nominal amount for a stake as large as 20% in the SPAC entity, which results in a loss of precious equity for the target company. However, newer SPACs have alleviated such concerns by reducing the amount of the 'promote' that sponsors retain in the public company.

Because of the 'promote' feature, sponsors earn a lot of money even if the merger fails. Because of this, they do have an ulterior incentive to complete a SPAC at the earliest. They might end up acquiring a mediocre company just to get their payday. However, recent norms have made it possible for an investor, who doesn't approve of the company that a SPAC sponsor chooses to merge with, to get his or her money plus interest back.

Also, because the SPAC doesn't have any operations at the time of an IPO, the investors are, in reality, betting on the sponsors, which adds a new layer of risks for them. 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 is proven after the merger that the sponsor did not do proper due diligence or chose a company in bad faith.

However, a lot of risks have been mitigated in the recent past. Regulations around SPACs underwent a series of changes over time in an effort to become more investor-friendly. Sponsors quickly adjusted the terms to become more aligned with investors instead of getting rich quickly at their expense.

For example, the acquisition timeframe came down from 30 months to 18–24 months, whereas the % of proceeds held in the trust surged to 100% from the 96–100% range earlier. Also, over the last few years, SPACs have employed structuring techniques to avoid the hedge fund arbitrage play (where a hedge fund would vote down the proposed merger to get its capital back but keep the warrants in the event the merger succeeds). Also, as the SPAC investor class has grown, underwriters now have a far wider universe of investors and are not restricted to only hedge funds.

From the investors' point of view, the SPAC structure does provide a safeguard for their money. As mentioned before, the SPAC places money in an interest-bearing trust fund and if the SPAC fails to find a suitable target within the mandated time, it returns the money along with the accumulated interest back to the investors.

SPAC sponsors, directors, and officers are also considering proactive steps to mitigate potential litigation risk by closely reviewing the SEC's guidance, avoiding any conflict of interest, employing cautionary language in disclosures, etc.

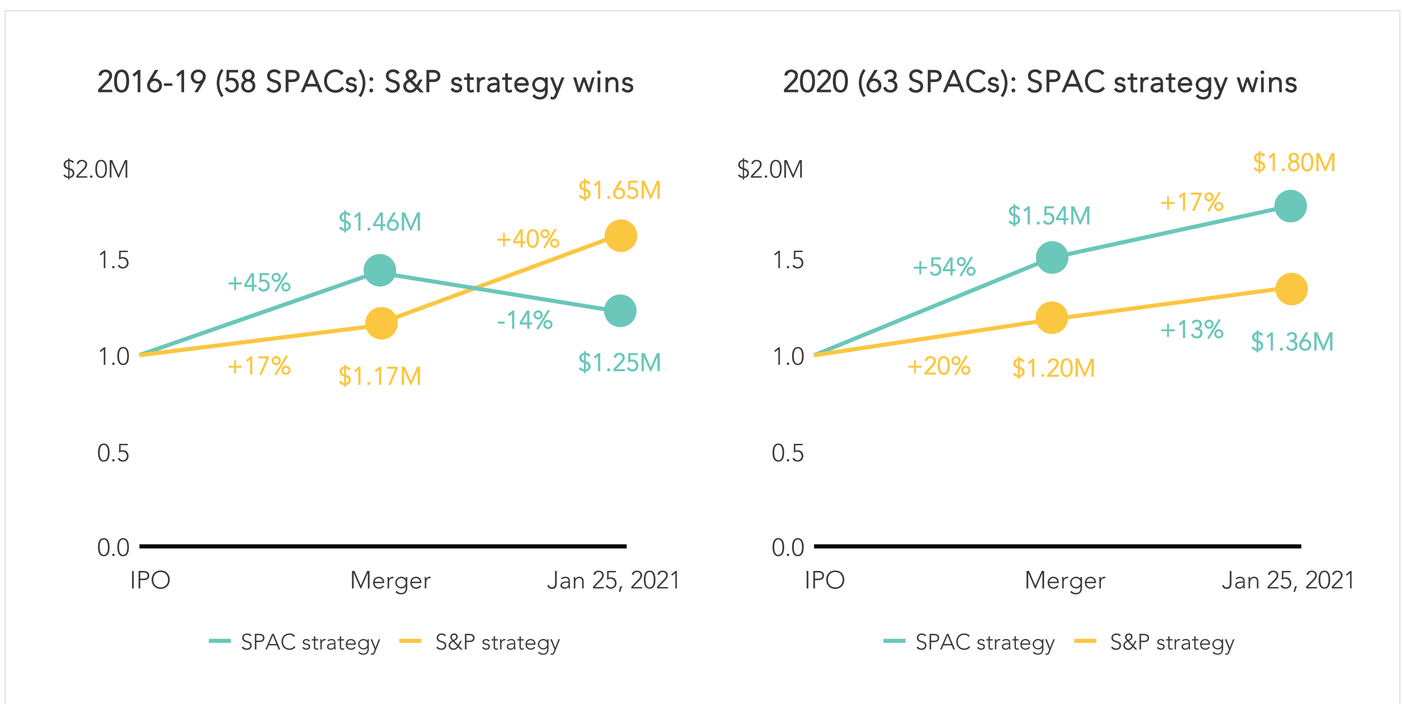
That said, like all other endeavors, stakeholders should carefully consider the risks, complexities, and challenges related to SPAC mergers, including whether the target company has a clear plan in place to become a public company.

7

How have the SPACs performed?

According to a research by Bain, aided by data from SPAC Insider, SPAC shares perform significantly better pre-merger than post-merger. If you split a $1 million investment evenly between them, you would have an aggregate $1.46 million or a 46% gain by the merger dates. Equally timed investments in the S&P 500 Index would have yielded a much lower $1.17 million. Post-merger, however, the story takes a sharp turn. By January 25, 2021, SPAC performance had fallen off 14%, leaving you with $1.25 million, while the S&P 500 Index soared 40%, boosting your investment to $1.65 million. That said, the year 2020 brought some respite for SPAC investors, with the post-merger returns exceeding the S&P 500 Index by 400 basis points.

SPAC Share Perform Significantly Better Pre-Merger than Post-Merger



Source: Bain & Company

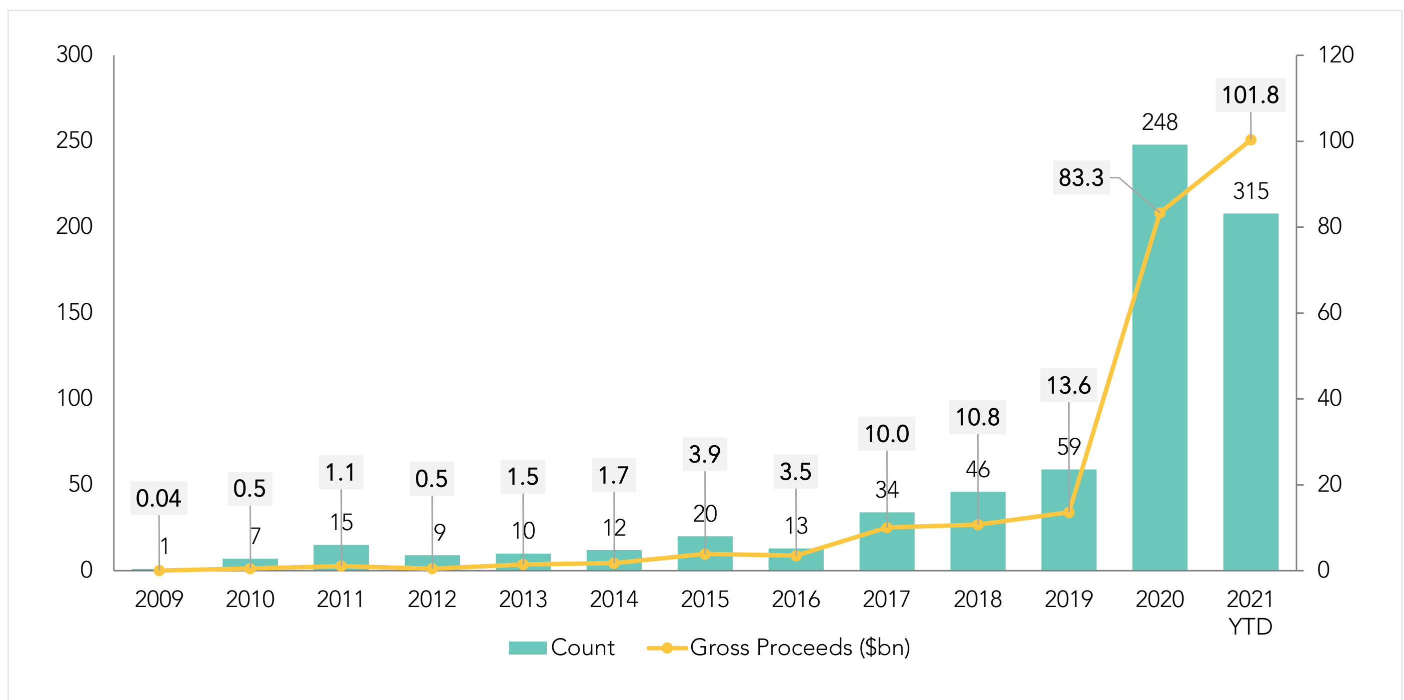
Of the 121 SPAC mergers studied by Bain, more than 60% have lagged the S&P 500 Index since their merger dates, with 50% trading down post-merger. Over 40% of the 121 stocks were trading below their $10 IPO price as of January 25, 2021. These are troubling data points, especially as the incentives for SPAC sponsors shift toward rewarding long-term performance. As pressure to deliver share price appreciation grows, sponsors will have to bring stronger due diligence capabilities to analyze and examine their highest potential targets. The big wins will involve stronger underwriting processes to turn a good company into a great one.

8

Are SPACs just another large bubble?

Currently, SPACs are in a positive feedback loop: the more investor attention SPACs get, the more they grow, and the more they grow, the more attention they get. It is hence unsurprising that the first five months of 2021 have already seen more activity in SPAC deals than the entire 2020.

SPAC Transactions - Summary by Year



Source: SPACInsider (Updated as of 13th May 2021)

That said, it should also be acknowledged that there is growing skepticism over the future of the SPAC model and whether they lack the proper transparency and scrutiny of a traditional IPO process. Critics also question whether common SPAC features afford a disproportionate return to sponsors over other shareholders vis-a-vis traditional investment structures.

It is clear that SPACs should expect increasing regulatory hurdles over the coming years, the recent example being the SEC's law to classify warrants as a liability and not an equity instrument which brought SPAC activity to a momentary standstill as investors sought further clarity. It is expected that the SEC might bring in more restrictions around estimates and other disclosures SPAC does at the time of merger.

The 'promote' that was a key motivating factor for sponsors has also shown signs of distress. On the extreme end, Bill Ackman's Pershing Square Tontine Holdings has no promote. Other SPACs such as Executive Network Partnering Corporation and Periphas Capital Partnering Corporation are embracing a new structure called CAPS, innovated by Evercore. This structure starts with a lower promote (5%) that can grow over time if the stock performs. Some SPACs even require redeeming IPO investors to surrender their warrants or rights.

SPACs are also disintermediating late stage VC in the process of going public. The percentage of proceeds raised by companies through late-stage venture rounds D, E, and F amounted to around 40% in 2015, which fell to around 20% in 2020.

SPACs have threatened the PE deal flow, with multiple bidders driving up asset prices. A SPAC pullback could ease investor concerns and diminish the number of competitors for a finite number of targets, which is a positive development for PE firms.

This brings us to the question – Can a structure like this endure to play a meaningful long-term role in the capital markets?

There is always a risk that as too many SPACs keep coming up without enough companies to acquire in the market, the SPAC trend might face a major downfall. While it is true that the SPAC IPO market is benefitting from the general historic upswing in the US stock markets, it is equally true that the SPAC IPO market could also fall with these markets. Despite these problems, there are clear compelling reasons to believe why it can succeed.

First, there is a clear market need – companies and investors are clamoring for alternatives to the traditional IPO. Second, the Klausner/Ohlrogge research shows that returns for SPACs run by established, high-quality managers have been significantly better than the average, suggesting that growing professionalism may improve results. Third, market pressure is already forcing sponsors to structure SPACs in new ways that make them more equitable for all stakeholders and focused on long-term performance. It may eventually lead to creating a more stable ecosystem. Finally, it is indeed difficult to call out a significant market correction, and a SPAC IPO does offer a trickle of certainty and relief in an otherwise stressful market.

Perhaps 2021 will be another landmark year in the history of SPACs, or maybe not. In any case, there is still over $100 billion currently sitting in SPAC trust accounts for being spent on merger partners within the next two years, which means the M&A market is still strong and SPACs should definitely remain in vogue in the medium term.

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Siddharth has over 6 years of experience in offshore investment banking and private equity support. He has supported the M&A teams across the globe, working on varied end products. He has been a part of various buy/sell engagements, capital raisings, due diligence and restructuring mandates across various sectors. Siddharth is experienced in end-to-end deal execution support. He holds an MBA in Finance from Symbiosis Centre for Management and Human Resource Development. He is a CFA Charter holder and holds a certification in Financial and Valuation Modelling from Wall Street Prep.

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