The 2020 SPAC Frenzy

Blank-check vehicles offer many benefits but are not a cure-all for IPO process

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Credits & contact

Research

CAMERON STANFILL, CFA Analyst II, VC
cameron.stanfill@pitchbook.com
JOSHUA CHAO, PhD Analyst, VC
joshua.chao@pitchbook.com

reports@pitchbook.com

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Introduction

If there is one corner of the financial markets that has benefited from the pandemic, it is special purpose acquisition companies (SPACs). This atypical pathway to the public markets was once a niche strategy for small investment firms. These early embracers saw SPACs as a way to extract fees from adding structure to a reverse merger. The strategy has now become the hottest financial topic of 2020 after a massive uptick in the volume of these blank-check vehicles and as the stature of the investment professionals involved legitimized the space. The surge in IPO activity from SPACs has been covered by research providers ad nauseum, with PitchBook producing a few reports on the topic as well:

- SPACs Resurface in Volatile Market
- SPACs in Space
- What's Special about a Venture Capital SPAC?

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. This analyst note aims to highlight some of these missing pieces for people in the investment community who are looking to change the way private companies become public companies and might be considering SPACs as an option.

Why SPACs? And why now?

This time last year, direct listings were the newest and shiniest toy for VCs when they were evaluating potential public market exits for their portfolio companies. Then came the pandemic, which plagued markets with economic uncertainty, especially public markets. The sustained volatility and the distinct price declines earlier in 2020 made IPOs and direct listings impractical options for the majority of private companies, which is where SPACs have found an opportunity. Unlike SPACs, direct listings do not allow private companies to raise any new capital during their transition to the public markets, which presents a problem for many startups given the elongated economic ambiguity driven by the pandemic. This is poised to change given NYSE's recent approval add primary shares into the opening auction, which would level the playing field of each public market pathway. Furthermore, direct listings and IPOs involve selling shares via an auction process, which can be messy in a volatile market.

Published on September 1, 2020

Since a SPAC is essentially just a large box of money, the listing of a SPAC necessitates a much lower level of diligence than a similarly sized IPO of an operating entity since there are no financial statements to scrutinize. For a sponsor, one could say, raising a SPAC is more akin to raising a closed-end fund, allowing for a shorter and more comfortable timeline during the fundraise. The simplified process of raising a SPAC IPO has allowed these listings to go forward since SPACs usually trade near the NAV, and the reverse merger represents the true test for SPACs when a new operating company actually becomes public and investors then evaluate and trade shares accordingly.

In the following three sections, we'll unpack why SPACs have gained in popularity during the pandemic by breaking down the benefits to each party involved. We'll then highlight SPAC activity within the tech and healthcare sectors.

Sponsors

We start with the creators of the SPAC: the sponsors. For these players, incentives tend to be clear, since the sponsor acquires a special class of shares that equates to 20% of the shares in the SPAC for a nominal cash consideration, known as the "promote." These sponsors also reap other benefits in leading the SPAC, such as the option to organize a PIPE deal concurrently with the acquisition and the chance to offer some input on the strategy of the acquired business, often times through a position on the board. This strategic decision-making aspect is why former operators and executives often lead SPACs, using their expertise to identify attractive targets and help guide them to success. Sponsors do receive a lot of economic interest in the business for essentially finding the deal; that said, there are signs, such as the reduction or elimination of the promote or warrant allocations, that the SPAC structure is becoming less of a fee grab on subpar deals and instead more of a company-friendly vehicle with potential to create value. A shift in the makeup of SPAC sponsors toward institutional and reputable market participants has also begun to further legitimize the future of SPACs.

Since traditional IPOs of operating companies have been relatively scarce, SPACs have seen a huge boost in demand so far in 2020. Typical IPO investors have rushed to participate in these deferred listings in the hopes of backing the next great growth story. The high demand 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 in good favor. From the sponsor's point of view, raising a SPAC is just another fundraise with a slightly different LP base.

Sponsors are also potentially assuming that the market dynamics driven by the pandemic will create a host of targets at attractive valuations, suggesting the explosion may have stemmed from opportunism rather than deeper analysis around particular investment theses. This frenzy in new SPAC listings could hinder performance for these vehicles as competition heightens, which could inflate some valuations. It will be a couple years before we can tell whether or not this was a truly sound strategy for the sponsors, but for now it seems better to accumulate assets while the iron's hot.

Institutional investors

The proliferation of SPACs would not be possible without newfound interest from capital providers. Why have investors suddenly become so willing and eager to allocate capital to these vehicles? For one, the limited flow of new companies into the public markets has left some asset managers that had capital set aside for new listings without any targets. Buying into a SPAC IPO is quite a different process than a traditional IPO. 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. Nonetheless, the SPAC backers gain access to the deal that the sponsors eventually negotiate, which in theory would be with an innovative company that otherwise would not have been able to list on the public markets.

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 standards. If investors do choose to redeem, they have effectively locked up some of their allocation to public equities for one to two years just to secure the risk-free rate. 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.

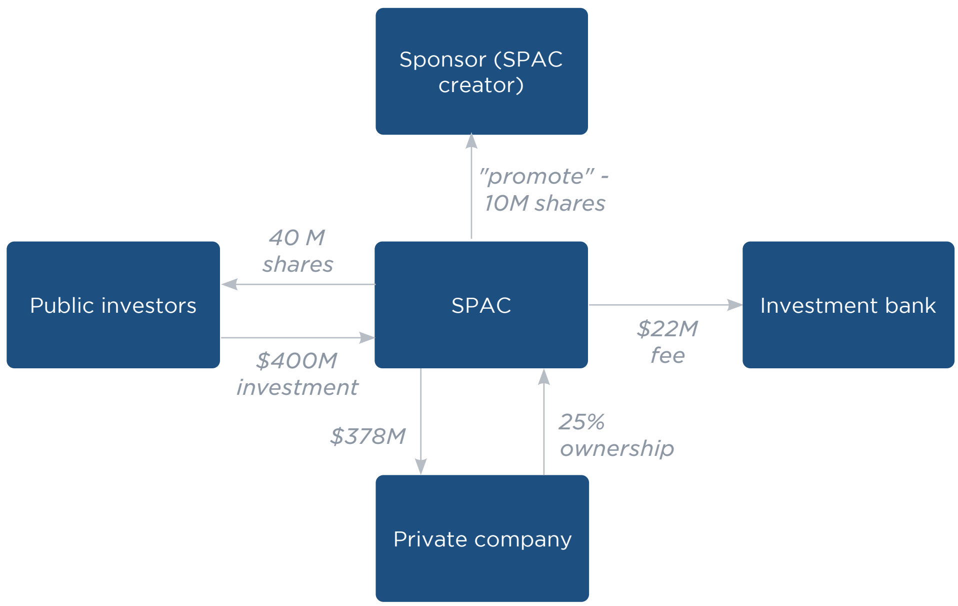
Private companies/SPAC targets

For at least the past three years, the lack of IPOs and shrinking number of public companies in general has been a hot button issue in the financial markets. The cost and arduous process of becoming a publicly traded business represents a huge burden to private companies that could otherwise find massive amounts of capital in the private markets. In our eyes, the reduced time commitment is the main advantage of SPACs for companies pursuing a path to the public markets. Since the SPAC transaction functions more like an acquisition, the private company has to negotiate with only one party rather than a host of investors on a road show, which will typically smoothen the deal pricing 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. This reverse merger path also allows for more creative deal structuring and will likely result in a price closer to its true market value. SPACs offer the option to raise more capital than might be available in a traditional IPO by selling a larger proportion of equity either from the SPAC itself or a concurrent PIPE.

Despite the benefits SPACs offer, they are not a cure-all. From a cost perspective, a merger with a SPAC nets out to essentially the same financial cost to the company as a traditional IPO. The original IPO fees are paid initially by the SPAC itself—typically 5.5% of the amount raised in the SPAC—but these costs are implicitly passed on to the company along with the sponsor’s promote and any investment banking fees related to the acquisition itself.

For example, if a hypothetical SPAC raised a $400.0 million IPO by selling 40 million shares at $10, the vehicle would pay $22.0 million in fees to the investment banks, leaving $378.0 million for the transaction. At the SPAC's founding in this scenario, the sponsors bought 10 million shares for a nominal fee rather than buying them for $100.0 million, therefore implicitly taking away capital that could have been raised by the company. In this simplified version, the company is implicitly paying $122.0 million to raise $500.0 million, leaving the company with $378.0 million or a 24.4% cost of capital without even factoring in warrants. This is relative to a traditional IPO raising $500.0 million, which at a 7% fee would cost the company $35.0 million, with the proceeds to the company totaling $465.0 million.

Hypothetical SPAC funding



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The mispricing at the time of transaction—which is common in traditional IPOs ("IPO pop")—can also be factored into the financial cost. While that has historically not been the case for SPAC mergers, over the last few years some similarly hyped and "underpriced" SPAC deals saw massive price appreciation on the day the reverse mergers were announced.

However, a clear financial cost advantage does not have to be a SPAC's primary benefit for a company that chooses a reverse merger. In a SPAC merger, companies 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 wants and needs. This customizability caters well to companies that have a complicated story or would be a more difficult sell to traditional public market investors. For instance, some companies have extremely long-term growth stories, such as electric vehicle businesses and biotechnology companies. More traditional businesses that need a bit of guidance and capital to continue their path could also benefit, especially since the SPAC option has the potential to raise more cash proceeds than a traditional IPO.

The concept of a SPAC itself can be boiled down to a pre-sold IPO for the private company, which is why it is appealing as a more stable and certain option for companies looking to go public amid the pandemic. But as mentioned, given its shortcomings, it's unlikely that SPACs will supplant traditional IPOs or direct listings as the main avenue for companies to reach the public markets. Much of the time SPACs are equated one-to-one with an IPO, but for many of the reasons we've discussed, such as the larger stake acquired and strategic ownership, it's fairly clear that engaging in a reverse merger with a SPAC is more like a buyout-IPO hybrid rather than a pure public listing. This will likely dissuade at least a group of private companies, especially given the popularity of new listings with dual-class share structures. Such structures allow founders to retain control, which would be in direct conflict with accepting a SPAC deal.

Lastly, we see a scalability issue in the way of SPACs becoming a commonplace route to the public markets. By that, we mean that each SPAC is built to do only one single deal, which can be an onerous process requiring lots of due diligence. Additionally, the structure of a SPAC increases the complexity of completing that one deal. First, the entity itself has to be created, then the SPAC IPO needs to be sold and listed, and finally the sponsors have to identify a target and negotiate the reverse merger. That said, while traditional IPOs or direct listings also involve a plethora of steps and processes internally, at the end of the day these options involve only one capital market transaction that is more under the company's control.

Highlight: Technology

Currently, only a handful of SPACs are explicitly targeting technology businesses, although more such vehicles have appeared in the last couple of months. Until recently, technology businesses had transitioned to the public market out of necessity to continue their growth plans, scale up, gain access to debt markets, and legitimize their businesses. However, with the expansion of private markets in general, and particularly the surge in nontraditional investor involvement in VC, private technology businesses now have the opportunity to reach essentially all of their growth targets using VC only. This change has slowed and, in some cases, stopped the flow of new public listings by fast-growing tech startups. In this new reality, there are now a large host of mature and highly-valued private companies that need to find liquidity for insiders, gain access to public debt markets, and finance longer-term projects but may want to avoid a traditional IPO process. This could be for myriad reasons, including the time commitment, concern about the valuation at which the offering will price, or the financial costs. This vacuum is why some SPACs entering this space will find success, given the universe of target businesses continues to swell.

A few examples of SPACs explicitly targeting the technology sector include Social Capital Hedosophia's second and third SPACs; Dragoneer's Dragoneer Growth Opportunities; and the huge Pershing Square vehicle that is pursuing a combination with a mature unicorn. Pershing Square's SPAC is unique and unprecedented in a handful of ways. Given its size, the vehicle will have only a small number of potential targets, and the elimination of the promote in favor of a concurrent investment by the related hedge fund provides a more straightforward alignment of incentives relative to other SPACs. We still believe a SPAC of this size is more of an outlier, but as companies continue to mature and achieve massive valuations in the private markets, it may be possible for other high-profile investors to follow suit.

Another notable SPAC that formed during the 2020 frenzy was a vehicle targeting $350.0 million from Ribbit Capital, an established fintech VC investor. We found this deal intriguing because of the potential this SPAC strategy brings to the traditional VC investor's arsenal. For any large, diversified, stage-agnostic VC investor, adding a SPAC expands scope to the post-VC exit stage of a company, thereby adding exposure to an even more mature class of companies. With the ability to take companies public themselves, VC firms that raise a SPAC may be able to differentiate themselves from an ever-larger population of VC investors. While firms that choose to go this route may need to go the way of Andreessen Horowitz and convert to a registered investment advisor to shirk the 20% non-VC holdings rules, the benefits may be worth the cost. This adds a new potential stage in which VCs can remain invested, extending the trend of VCs holding on to their winners for as long as possible, turning some VCs into crossover investors. As we alluded to in our initial coverage of the Social Capital SPAC, conflict-of-interest concerns could arise for Social Capital in completing a reverse merger with one of its own portfolio companies, which will likely prohibit VCs from pitching public listings as a service to portfolio companies. It is still very much up in the air whether or not this will become a viable trend for top-tier VC firms, but raising SPACs almost seems like a natural progression to the long-term preference by VCs for gathering assets and increasing their number of strategies.

Highlight: Healthcare

Joshua Chao, PhD Analyst, VC
joshua.chao@pitchbook.com

Healthcare companies—particularly those in the biotechnology and pharmaceuticals sector—typically view the public listing process as another fundraising event rather than a full exit. Since these companies are overwhelmingly pre-revenue, access to public markets is realistically the only way for companies to fund trials in multiple clinical indications and R&D programs for various drug candidates, given the holding times for a successful go-to-market strategy and the dedicated capital pool. Drug development timelines can often take more than 10 years, with most drugs failing in clinical trials and even fewer receiving approval from the US Food & Drug Administration (FDA).

Yet, for healthcare companies looking to gain access to the public markets for the first time, the IPO process can be complicated further because many are advised by investment banks to complete a crossover round—essentially, a round of late-stage private financing by crossover or strategic investors just shortly before the IPO. Backing from crossover investors, such as RA Capital, Fidelity, or Orbimed, during this financing stage can show public investors that the company's core technology is sound, as many public investors lack sufficient time to conduct their own due diligence during the IPO sales process.

While some investors also argue that pre-money valuations and post-IPO performance are positively affected by biotech companies that include pre-IPO crossover investor participation, others assert that the crossover round is an extra stage of financing that forces companies to accept additional dilution just to go public. Furthermore, the time period involved in raising a crossover round and then conducting an IPO can be quite lengthy, which could prove detrimental to cash-strapped biotech startups.

Proponents of utilizing SPACs as an alternative go-public vehicle for healthcare companies view it as an efficient and less cumbersome way to raise capital. Investment firms such as Chardan, Deerfield, and LifeSci Capital are a few of the recent sponsors that have raised SPACs in H1 2020 and see outsized potential for this vehicle within the healthcare and life sciences sectors. By offering biotech companies with high burn rates quicker and more flexible access to the public markets, SPACs can also present companies with more transparency than the traditionally murky IPO process, as they essentially combine the crossover round and IPO into a single-step merger.

Previously, healthcare companies that underwent a reverse merger did so as a last resort. Recent attitude shifts from the aforementioned increased legitimacy of the sponsors have placed reverse mergers via SPACs in a more favorable light. Given the market volatility seen over the last two quarters, investors recognize that healthcare companies are still developing new drugs and progressing with clinical trials and, thus, view this sector as one with less downside. SPACs are no longer an avenue only for distressed healthcare companies, but healthy ones looking to take advantage of current macroeconomic conditions, raise a significant amount of capital, or gain strategic guidance from an experienced operator.

Ultimately, given the high burn rate associated with R&D costs, capital expenditures, and multi-site clinical trial management, cash on hand is the lifeblood of these companies. Public investors have been a key source of capital for biotech companies progressing into large-scale clinical trials and those who are negotiating licensing fees and expensive manufacturing contracts. Assuming sponsors, investors, and private companies see eye-to-eye on valuations, SPACs can provide them with quicker access to the public markets than a traditional IPO and mitigate much of the dilution and valuation discounting that occurs with crossover rounds and IPO transactions.

Conclusion

Without a doubt, SPACs are having a moment in the current environment and offer an innovative way for private companies to go public. However, while we believe the population of companies that might combine with a SPAC is growing, it still represents a small subset of private companies, limiting the potential disruption of the traditional IPO process. However, as new entrants flood the market, they are iterating upon terms and structures to make them more company friendly. We will be watching the evolution of SPACs with great interest and expect the financial institutions entering the space will make mergers with SPACs a more attractive transaction option. That said, we believe the hype around SPACs will likely recede once more certainty returns to the financial markets; the time it takes to go public is not accelerated enough using SPACs to simply supplant other options and make this strategy the go-to route for public listings. The process to bring companies public is certainly broken, and while we are encouraged by the momentum driving innovation around public listings, SPACs will not provide a solution for every private business. It will likely work best for capital-intensive businesses and those with a complicated or long-term story.