SPACs Impressive Comeback: Opportunities and Risks

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Amid high levels of liquidity and a strong desire for new growth companies, special purpose acquisition companies ("SPAC"s) are flourishing in 2020, often with high-profile names attached to them. In recent months, SPACs have outpaced traditional IPOs in money raised. But what are SPACs, and are they here to stay?

A SPAC, also known as a "blank check company," is a company formed strictly to raise capital through an initial public offering ("IPO") for the purpose of acquiring an existing company within a set period, usually 18-24 months. When a SPAC is launched, the SPAC sponsors do not have a specific partner company in mind; instead, they commonly have a shortlist or a sector focus. This helps differentiate them in the eyes of potential partner companies and investors. As a SPAC investor, you are essentially buying a jockey, not the horse. If the SPAC fails to make an acquisition, the capital is returned to shareholders with interest.

SPACs were first introduced in the 1990s with the primary function of granting smaller companies access to the public markets without going through the traditional IPO process. While SPACs were popular then, they declined in popularity as they became associated with fraud and the burst of the dot-com bubble. However, SPACs have made an impressive comeback in recent years and have fundamentally changed how they operate. They now offer substantially more reasonable security guarantees but still come with their own set of risks.

How a SPAC Works

Creating a SPAC is not that different from the traditional IPO process. The first phase takes around two months and includes filing the registration statement with the SEC and going on a roadshow to find interested institutional investors. When investors buy into the offering, the capital is moved into a blind trust until the SPAC sponsors have pinned down a partner company. SPACs range in size from as small as $30 million to as large as $4 billion. The size depends on the SPAC sponsors' ability to attract capital and the type of company that the SPAC wants to acquire. A SPAC that has raised a certain amount is generally not looking to acquire a company valued at the same amount. In fact, the value of the partner company is most often two to four times the SPAC's IPO proceeds to reduce the dilutive impact of the founder shares and warrants.

Once the SPAC has identified a partner company, the de-SPAC'ing process begins, which takes 3-4 months. In this phase, the SPAC must obtain shareholder approval and offer shareholders the opportunity to redeem their capital. This is followed by a review and commenting period by the SEC. Ultimately, the merger is consummated, and the SPAC and the partner company combine into a publicly traded operating company.

The Current Market Environment

The number of SPAC IPOs has increased steadily over the past decade, and 2020 has become a record year for SPACs on all fronts. Year to date, there have been 192 SPAC IPOs, compared to 59 and 46 in 2019 and 2018, respectively. Furthermore, this year, SPACs have raised more proceeds than ever before (currently $67.5 billion, up from $13.6 billion in 2019), and the average SPAC IPO size has also reached a record high of $352 million[1].

There are many factors driving the rise of SPACs. First, this year's surge in market volatility due to the COVID-19 pandemic and U.S. presidential election has made the SPAC route more attractive since it offers extra certainty for companies looking to go public with a faster process and up-front pricing and valuation, as opposed to the traditional IPO route. Second, the increasing popularity of private investments in public equity ("PIPE") transactions, in which the SPAC identifies investors who will provide additional capital to the SPAC in exchange for a private placement of the SPAC's public securities, allow the SPAC to demonstrate committed equity capital which mitigates concerns created by the investors' redemption option. Third, as the number of successful SPACs has risen, more and more reputable investors and sponsors have entered the space. This leads to more successful SPACs, forming a virtuous cycle. Fourth, SPACs set themselves apart because of their emphasis on building relationships. SPAC sponsors tend to stay involved with the partner company post-merger, which lets the partner company benefit from the sponsors' experience and expertise. Finally, SPACs are propelled by demand from retail investors because, unlike traditional IPOs, SPACs offer them the opportunity to indirectly connect with the private market.

Understanding the Risks

Nevertheless, investing in SPACs is no bed of roses. SPAC investors face a notable opportunity cost of tying capital up for a long period, especially if the SPAC ends up not securing a deal. Moreover, a SPAC's performance is often worse post-merger. According to Renaissance Capital[2], only a third of SPAC IPOs over the past five years have had positive returns, sharply lagging traditional IPOs over that period. Furthermore, SPAC sponsors typically receive about 20 percent of the SPAC's value in equity in the combined company post-merger[3]. This means that, while sponsors are paid the most when their investors do well, sponsors have historically been paid as long a deal was struck, which incentivizes sponsors to strike any deal, good or bad. Additionally, it is questionable whether SPACs receive the same regulatory scrutiny as traditional IPOs, which poses a heightened risk to investors. Finally, with the continued rise of SPACs and the influx of investors, sponsors, and companies, the space remains a hotbed of innovation where the rules, limits, and strategies are still being molded.

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[1] SPAC Insider, 2020. *SPAC IPO Transactions: Summary by Year*. Available at: https://spacinsider.com/spac-statistics-new/ [Accessed: 11/20/2020]
[2] Renaissance Capital, 7/28/2020. *SPAC returns fall short of traditional IPO returns on average.* Available at: https://www.renaissancecapital.com/IPO-Center/News/69871/SPAC-returns-fall-short-of-traditional-IPO-returns-on-average [Accessed:11/20/2020]
[3] Klausner, Ohlrogge & Ruan, 11/19/2020. *A Sober Look at SPACs*. Available at: https://corpgov.law.harvard.edu/2020/11/19/a-sober-look-at-spacs/ [Accessed: 11/20/2020]

Conclusion

Pathstone's investment research team has been closely following the increasing investor demand for SPAC investments. We believe that while SPACs are unlikely to continue their current level of growth, it is likely the trend is here to stay this time. However, like with any investment, SPACs come with their own risks, and savvy investors will approach them with a high degree of scrutiny. We have seen a number of the active managers we recommend for clients, particularly hedge funds, approach the use of SPACs in a thoughtful manner to generate returns. As always, we will continue to diligently monitor how these opportunities and risks play out in our clients' portfolios and take action where necessary.