SPACs: Blank Checks, Full of Promise

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OVERVIEW

- **SPACs have become a more viable alternative to traditional IPOs and have features that can appeal to both private and public equity investors**
- **Positive market sentiment has been driven by higher quality SPAC sponsors and an evolved structure that better aligns incentives**
- **However, recent SPAC returns have fallen short of expectations—if this trend continues, investor confidence could begin to fade**

Background

A Special Purpose Acquisition Company, or SPAC, is a "blank check" vehicle that raises capital in an Initial Public Offering (IPO) to merge with an operating company and form one publicly traded entity. Though the structure has been around for years, it has evolved to become a more flexible alternative to a traditional IPO that can offer potentially attractive returns to a range of investors. These factors have helped create a significant increase in investor demand in the last several years.

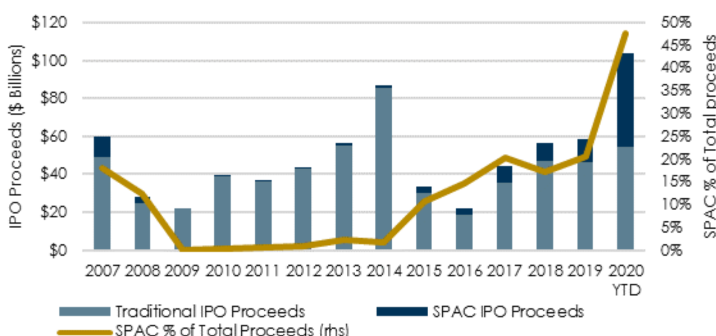
Typical SPAC Structure

IPO proceeds raised by a SPAC are placed into a trust account that earns interest, typically by investing in US government securities. In the IPO, investors are sold units consisting of one common share and a fraction of a warrant to purchase additional common equity. Following the IPO, investors have the option to sell their shares in the open market, redeem for their pro-rata share of cash held in trust, or hold through a merger and own shares in the new publicly traded operating company. If a merger is not consummated, the SPAC is liquidated and investors receive their pro-rata share of cash held in trust. Another key component of a SPAC's structure is the sponsor's investment. The sponsor generally purchases warrants for an amount sufficient to cover the upfront expenses of the vehicle. In exchange for this investment and a nominal amount of additional capital, the sponsor receives founder shares equal to 20% of the post-IPO common equity.

Evolution of the SPAC Market

Early SPACs were often much smaller in size and managed by less sophisticated sponsors, reducing their attractiveness as a buyer. However, over the last decade, the average size of SPACs has increased, and many SPACs are now affiliated with well-known private equity firms, hedge funds, or seasoned operating executives. Another key change for SPACs has been the separation of voting and redemption rights. In earlier SPAC structures, investors had to vote against the proposed business combination in order to redeem their shares. This reduced certainty of closing and resulted in a higher failure rate for SPACs. Today, investors can vote in favor of a business combination and still choose to redeem their shares. This reduces the likelihood of a business combination being voted down, giving sellers more confidence in transacting with SPACs.

SPAC volume has increased but remains secondary to traditional IPOs



Source: Renaissance Capital; data as of 10/14/2020

Putting the Current Market in Context

SPACs have surged in popularity recently, with issuance in 2020 well exceeding record levels both in terms of issue count and proceeds. So far in 2020, over 130 newly issued SPACs have raised nearly $50 billion. This substantial growth in volume has resulted in SPACs accounting for 47% of total IPO proceeds in 2020, versus a peak of around 20% in prior years. This illustrates the increase in investor interest in SPACs as the market has matured, and it shows how SPACs are increasingly viewed as a reliable and flexible alternative to a traditional IPO process.

Private Equity Perspective

Exit through a SPAC can provide greater speed, certainty and upfront liquidity compared to a traditional IPO. Sellers are still subject to a lock-up post-acquisition, but this can be a small cost to de-risk their position. Similarly, versus a traditional M&A exit, sellers might receive a lower upfront valuation, since a SPAC cannot rely on the same synergies assumed through M&A and investors require compensation for assuming future market risk. However, sellers get the benefit of liquidity today at a known price, which can be valuable during periods of greater volatility.

Public Equity Perspective

Pre-acquisition, SPACs resemble a fixed income investment, though investor speculation around possible acquisitions can cause interim share price volatility. Post-acquisition, SPACs behave like a publicly traded stock. This can attract a range of investors with different risk/return appetites. SPACs also give investors the opportunity to invest alongside a high-quality management team in a privately negotiated transaction, offering access to private equity-style deals without the same degree of illiquidity. However, over the last five years, post-acquisition returns for SPACs have often been negative, offset by a handful of very successful outcomes. This illustrates a disconnect between investor expectations and average realized performance.

Since 2015, SPACs with completed acquisitions have underperformed

Deal Size	# of Completed Acquisitions	Average Return Post-Merger	Median Return Post-Merger
<$100 million	19	-51%	-64%
$100-$199 million	23	-13%	-29%
$200-$299 million	19	7%	-20%
$300+ million	32	7%	-10%
Total	93	-10%	-29%

Source: Renaissance Capital; data as of 9/30/2020

ACG's Position

SPACs have emerged as a flexible tool for both buyers and sellers. However, it seems as though current market sentiment is predicated on the prospect of positive future outcomes rather than consistently favorable history. While we expect SPACs to remain a relevant structure going forward, we also believe that market sentiment will wane if performance does not improve. As a result, the current class of SPACs still seeking an acquisition should play a critical role in either supporting or eroding investor confidence in the space.

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