The Boom in U.S. SPACs: Will It Go On?

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Corporate and Investment Banking Practice

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Special Purpose Acquisition Vehicle (SPAC) – What is it?

SPACs have no commercial operations and are formed exclusively to raise capital via IPO, with the only purpose of acquiring an existing company, which generally is unidentified, within a predetermined period up to 24 months. After the acquisition, the acquired company automatically turns into a public company.

In case a SPAC cannot comply with the deadline or does not use at least 80% of its net assets, it must then be dissolved. In the event of a dissolution, the SPAC investors receive their pro-rated share of assets, which previously were held in an escrow account.

Throughout a SPAC's offering process, investors can purchase units usually offered at $10. The units comprise one or more shares and one or more warrants. Sponsors backing the SPAC generally retain a 20% stake of the company after the acquisition is completed.

Even though the SPAC must invest at least 80% of its IPO proceeds, there is no maximum limit for the capital invested in the acquisition. The acquisition size will often be larger than the IPO proceeds, as sponsors generally inject more capital via PIPE investments, and there can also be debt in the target's capital structure.

Timeline of SPAC Process

IPO of the SPAC entity

18 - 24 Months' Time Limit

The SPAC looks for suitable target companies and negotiates the terms of the acquisition

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Acquisition is announced and approved by the shareholders

After the transaction is closed, the target company becomes publicly traded

(roughly three to four months)

Sources: Bloomberg, FINRA, Northwestern Journal of International Law & Business , SEC

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SPACs Presents Both Advantages and Disadvantages

Target Company

Advantages

- Becoming a public company in as little as three months, whereas traditional IPOs take at least six months
- Simpler and less costly due diligence processes
- Regular IPO underwriter fees usually correspond to 7% of the total proceeds, for a SPAC it is generally 5.5% of the SPAC IPO size
- IPO pricing can be affected by market conditions; however SPAC acquisitions are conducted on predetermined prices, which are not affected by volatile markets
- Smaller companies face difficulties in attracting investors in an IPO; going public through a SPAC is a good alternative

Disadvantages

- Investors can vote against the acquisition, making the target company to waste time and resources in the negotiations

Investor

Advantages

- Enter into an investment that resembles private equity but without the need to commit large amounts of capital
- Higher liquidity than traditional private equity investments
- Possibility to invest in start-ups with high growth potential
- Right to vote against an acquisition and possibility to retain upside by keeping warrants even if selling the stocks
- Receiving money back in case an acquisition is not completed

Disadvantages

- High uncertainty about the business being acquired and high dependence on sponsor skills
- Although receives money back when an acquisition is not completed, fees and expenses will be discounted
- Conflict of interests between the sponsors of the SPAC and the investors: The limited time period the sponsors have to complete the acquisition, combined with the fact that sponsors will lose their remuneration in case an acquisition is not completed, may lead to suboptimal deals

Sponsors

Advantages

- Typically invests 3% to 4% relative to the IPO proceeds, but retains a 20% stake in the company
- Possibility to address a larger pool of investors and higher liquidity than in traditional private equity investments
- Opportunity to inject more capital via PIPE investments at the time of the acquisition, retaining a larger stake

Disadvantages

- Investors can vote against the acquisition
- Maximum 24-month limited time period to identify a target and complete the acquisition
- Loss of initial investments and time in case an acquisition is not completed

Sources: Bloomberg, FINRA, GigCapital, Jefferies, Northwestern Journal of International Law & Business , SEC

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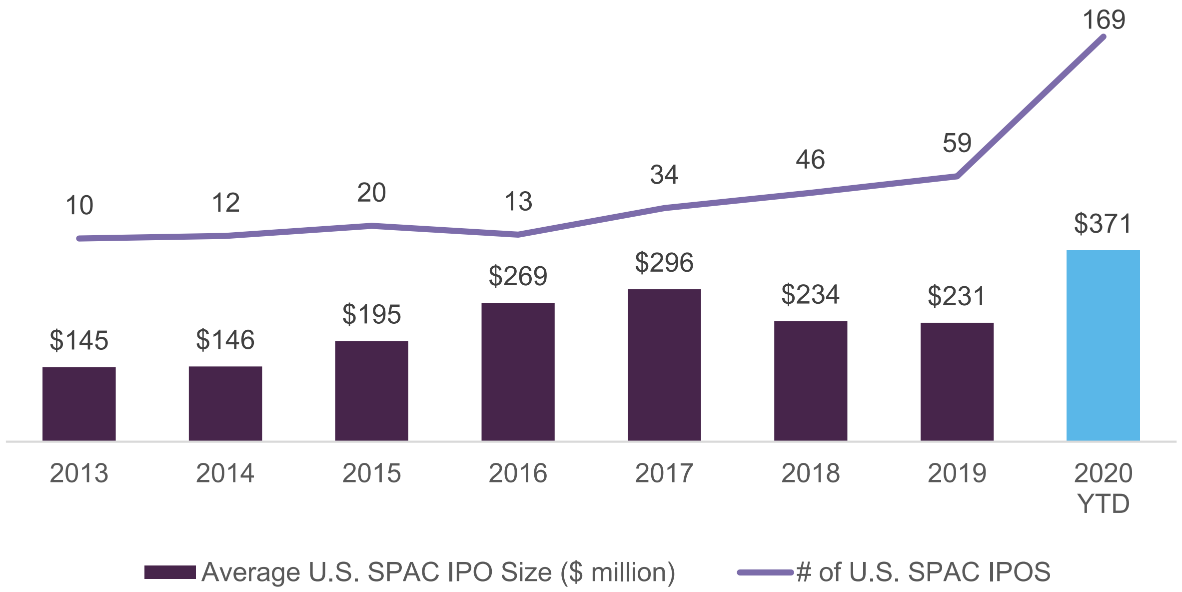
The Current Boom in U.S. SPACs Is Partially Driven by the Pandemic

A surge of SPAC activity began in 2019. One particular factor that may have been contributing to the increase in SPAC volume in 2020 is the Covid-19 pandemic. The unprecedented slowdown in the global economy since the beginning of the pandemic has led many business to suffer financially, which in turn can generate opportunities for SPAC investors to acquire distressed companies with a solid business plan but a difficult financial situation at an attractive valuation.

The pandemic has also generated a great deal of uncertainty in practically every market around the world. The increase in uncertainty contributes to markets becoming more volatile, which in turn makes IPOs more difficult, making SPACs an alluring alternative for many investors. Additionally, as bulge-bracket banks such as Goldman Sachs and billionaire investors such as Richard Branson and Chamath Palihapitiya have recently sponsored SPACs, the attention of the general public for this type of investment has grown, helping SPACs to attract more capital.

U.S. SPAC Amount Raised (USD billion)

U.S. SPACs - # of IPOs and Average IPO Size (USD million)



Sources: SPAC Research. Notes: YTD as of October 31, 2020.

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Bulge Bracket Banks and Billionaires Are Sponsoring SPACs

Social Capital Hedosophia, which is led by former Facebook senior executive and venture capital investor Chamath Palihapitiya, went on a SPAC spree starting in 2019 with the acquisition of Virgin Galactic valued at $2.3 billion at IPO.

Social Capital Hedosophia has since then launched five other SPACs. Two of them had their IPOs in April 2020, and the other three had theirs in October 2020. The company´s five SPAC IPOs were priced between $360 million and $1 billion.

On September 15, 2020, Social Capital Hedosophia Holdings Corp. II announced the acquisition of Opendoor, a provider of an internet platform for buying and selling homes, valuing the company at $4.8 billion. And on October 6, Social Capital Hedosophia Holdings Corp. III announced the acquisition of health insurance company Clover Health, valuing it at $3.7 billion.

GS Acquisition Holdings Corp II, Goldman Sachs-backed SPAC, raised $700M during its IPO in June 2020. The SPAC will have a 24-month period to complete an acquisition. No specific industry was specified for the target company.

It is Goldman Sachs's second SPAC. The bank's first SPAC raised $600M, and its IPO was launched in June 2018. In December 2019, it announced the acquisition of datacenter infrastructure company Vertiv, which was completed in February 2020.

Virgin Group-sponsored SPAC went public in October 2020 at a price of $480 million. The management team stated that it is targeting a business that operates in one of Virgin Group's core sectors.

Virgin believes the pandemic has caused dislocations in these sectors, which creates the opportunity to acquire good businesses at advantageous prices.

The SPAC boom has also seen the largest SPAC IPO in history. In July 2020, the IPO for Pershing Square Tontine Holdings that is sponsored by Bill Ackman was priced at $4 billion. The SPAC has not identified a target yet, and the management team has not specified any particular industry for the target, but it has stated it is seeking an acquisition of "private, large capitalization, high-quality, growth companies".

Sources: Companies Press Releases.

SPACs Are Risky Investments and the Sponsor's Skills Are of Utmost Importance

SPACs are risky investments and investors rely deeply on the ability of the sponsors in completing a fundamentally strong acquisition in a short period. It is evident that the sponsor's experience and skills, and therefore their reputation, are of utmost importance for SPAC investors. The sponsor will generally also participate actively in the management of the company after the acquisition, similar to a private equity investment. The SPAC sponsor profile seems to be changing over time. According to Jefferies, 76% of 2019 SPAC IPOs were sponsored by industry executives, against 65% in 2018 and 32% in 2017.

SPACs vs. S&P500

The performance of SPACs on stock markets after they have completed their acquisition has not consistently beaten the market. Goldman Sachs conducted a study in July 2020 concluding that, on average, SPACs beat the S&P 500 only 11% of the time in the first three months after the acquisition was announced. The study also showed that across the 12-month period following the acquisition announcement, while 75% of SPACs beat the S&P 500 by 22%, the remaining 25% underperformed the market by 69%. In September 2020, Bloomberg stated that the shares of 11 out of the 18 companies it counted going public through a SPAC acquisition in 2019 were trading below $10.

SPACs vs. Traditional IPOs

In a report from July 2020, Renaissance Capital stated that only 89 of 223 SPAC IPOs counted, since 2015 were able to complete an acquisition. The report also compared the performance of the 89 SPAC acquisitions against those of regular IPOs in the same period. Renaissance Capital concluded that SPACs delivered an average loss of 19%, compared with a 37% aftermarket return for regular IPOs.

Sources: Bloomberg, Goldman Sachs, Jefferies, Renaissance Capital.

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