Perspectives

MAY 2021

The SPAC Explained

The SPAC once again rose to prominence in 2020 and momentum has continued to build this year. By mid-March 2021, the number of SPACs raised had already eclipsed the total raised in 2020. The term SPACs has taken over the lexicon of those on Wall Street. SPACs, special-purpose acquisition companies, are shell companies set up to raise money to acquire another, existing company. They are essentially pools of capital that are listed on an exchange. The goal is to find a private company to buy, effectively taking the acquired company public much quicker than via the traditional IPO process. SPAC vehicles have been around for decades but have recently risen in popularity as experienced investors and management teams have chosen this route to decrease the risks associated with a traditional initial public offering (IPO).

HOW SPACS WORK

A SPAC is a newly-formed company that uses a combination of IPO proceeds and additional financing to fund the acquisition of an Initial Business Combination (IBC). Sponsors who put money at risk in a SPAC receive founder shares and warrants for their investment. The SPAC can also identify an investor or a group of investors to provide additional capital in exchange for a private investment in public equity (PIPE) if needed. The proceeds raised for the IPO are placed in a trust account and invested in U.S. Treasury Bills while the SPAC's management team seeks to complete an acquisition. Each SPAC unit, made up of one common share and a fraction of a warrant, is initially priced at $10.

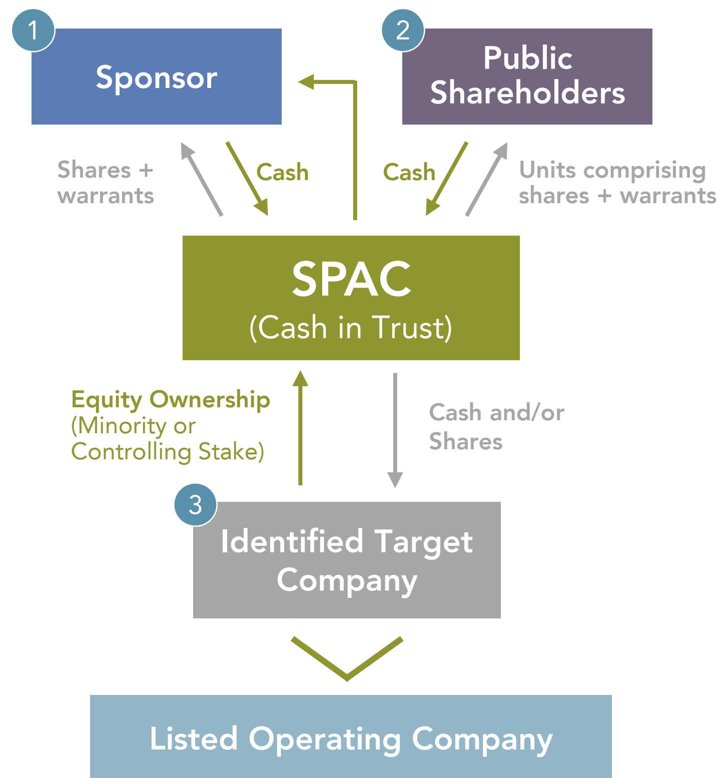
The SPAC typically has 18–24 months to find and complete an acquisition of an IBC. The targeted company must be identified by the sponsor and agreed upon by shareholders in the vehicle. If the SPAC is successful in finding an acquisition, shareholders have the option to redeem their cash plus interest in the trust or remain invested in the newly-public company. The shares and warrants continue to trade in markets where retail investors can invest in the shares. If the SPAC is not successful, the SPAC liquidates and the IPO proceeds are returned to shareholders.

The standard SPAC structure is illustrated in Exhibit 1. The sponsor(s) of the SPAC are ultimately responsible for its success. Public shareholders are institutional shareholders who invest in the SPAC IPO.

WHO ARE THE SPONSORS?

There is no set definition of who a sponsor can be, but the most successful sponsors tend to have a strong investing track record and following in the investment community. Many sponsors have experience as operating executives in private equity, private companies, or public companies, or experience in investment banking. They tend to have a proven track record of generating returns and growing businesses for shareholders, with a strong network across private equity and private and public companies that allows them to source new investment opportunities. A sponsor must also be comfortable with the spotlight, pressure, and volatility of being in public markets.

Exhibit 1: The Standard SPAC Structure



Source: Citi Event Driven

WHO BENEFITS FROM THE SPAC STRUCTURE?[1]

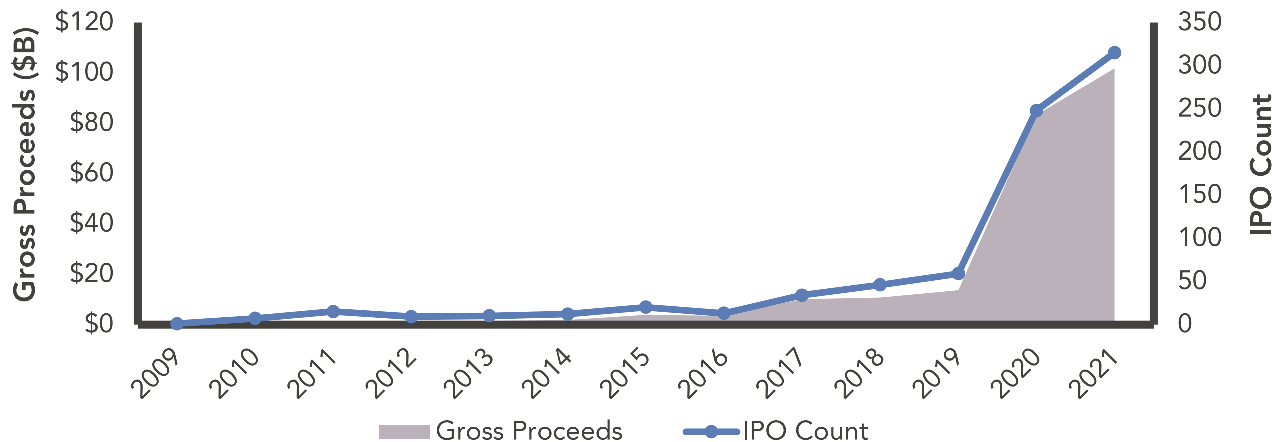
- **Sponsors** – If a SPAC is successful in finding an IBC, sponsors can earn a multiple of their initial investment via the shares and warrants they own. Through this structure, sponsors have access to a larger group of potential investors, unlike a typical private fund.
- **Investors** – The SPAC structure offers retail investors exposure to strategies and investment opportunities they might not otherwise have access to in a private fund. From the initial $10 price, there is limited downside risk given each investor's opportunity to redeem their common shares for cash at the time of the De-SPAC Transaction. If the De-SPAC Transaction is not approved by investors, the trust proceeds, plus interest, will be returned to all investors.
- **Target companies** – Private companies can use the SPAC structure to go public without going through the traditional IPO process. A SPAC is already listed and typically meets the requirements for trading on the relevant stock exchange.

THE SPAC BOOM

SPACs have seen exponential growth over the past two years, as shown in Exhibit 2 on the following page. The U.S. SPAC IPO market in 2020 eclipsed 2019 by 4X and by mid-March 2021 issuance had already surpassed all of 2020. Globally, there are 419 SPACs with almost $135 billion in capital outstanding and searching for a deal.[2] There is a lot of liquidity in the marketplace that has been raised and needs to be put to work and SPACs have been able to siphon off some of that capital. Private equity funds have

investments that are maturing, and the SPAC outlet allows them to go public while still staying invested in those companies. As uncertainty around the impacts of the pandemic continues in 2021, the traditional IPO market will likely remain unpredictable and M&A activity will be selective.

Exhibit 2: 2021 has already seen a record number of SPAC deals and gross proceeds



Source: SPACInsider as of May 11, 2021

SPACS AND PRIVATE EQUITY

Alternative exit type for private companies

In 2020, SPACs accounted for 55% of all IPOs and have continued to monopolize the IPO market in 2021 at over 70% of IPOs, as shown in Exhibit 3 below. Private equity (PE) and venture capital (VC) backed companies represented 71% of all SPAC mergers in 2020. New SPAC buyers present an additional exit opportunity for PE and VC sellers, and one that allows for greater control over valuation and more cash at closing, which can pull forward exit timing and reduce the amount of proceeds left to fluctuate in the public market during a lockup period.

The public markets have also benefited from a growing number of IPOs, as SPACs have created opportunities for private companies that otherwise would not have been candidates for a traditional IPO. A private business that is complex, going through a complex industry change, or would have required more time to become an easily understood or marketable story can now go public by convincing a single individual sponsor.

Exhibit 3: SPACs as a percentage of all IPOs continue to hit new highs

Source: SPAC Analytics as of May 11, 2021

Private equity as sponsors

Private equity firms have also capitalized on the SPAC opportunity as sponsors to extend their investment platforms. SPAC vehicles provide a lucrative path to raise additional capital with a low initial cost (sponsors typically contribute 2.5–3.0% of the gross IPO proceeds) and the potential for strong returns from the founder shares, which can be 20% of the post-IPO value, and further upside from warrants that can be used to purchase additional shares. Unlike traditional private equity investments that only provide incentive compensation for successful investments that exceed a hurdle rate, the founder shares compensate the sponsor even if the investment declines in value. The primary risk for the sponsor is the loss of its initial costs should it fail to identify and close a transaction.

Many of the industry's largest managers have raised SPACs, taking advantage of their sourcing, industry expertise, operational resources, and networks to attract significant capital and bring credibility to the vehicles. Some of the well-respected private equity managers with SPACs include Gores Group, Thoma Bravo, Ares, TPG, General Catalyst, H.I.G., Warburg Pincus, L Catterton, Khosla Ventures, and Apollo Global Management.

Private equity investors should also consider the incremental competition from SPACs for acquisition targets, which could drive up acquisition multiples across the late VC and buyout spaces. Furthermore, existing private equity investors must evaluate fund allocation policies, investor alignment, and internal resources that are likely to be utilized by private equity sponsored SPACs.

CONCLUSION

The growth in SPAC issuance cannot continue at the current exponential rate and the market has already seen a partial correction since a peak in mid-February. If clients are interested in exposure to the space, we recommend investing with a diversified hedge fund that has a proven track record and the capabilities to allocate to well-researched SPACs. Managers should possess an established sourcing and risk management framework for investing in the space that can both protect capital and offer attractive returns.

The market opportunity for SPACs will only persist if attractive post-merger returns can be generated and sustained for investors. While there will certainly be winners — DraftKings and QuantumScape are up many multiples from their $10 SPAC price — there will also be losers. Regulations around SPACs may also change. Ultimately, it is still to be determined whether SPACs are here to stay as an attractive option for both investors and private companies or just another boom-and-bust cycle in the investment management world.

NOTES

[1] Seward & Kissell LLP. Aug 17, 2020. "SPACs Are Back, Back Again: What You Should Know."
[2] SPAC Analytics as of May 11, 2021

The information included is provided with permission by Marquette Associates, Inc. ("Marquette"). This material is for informational purposes only and should not be considered investment or legal advice. We believe all sources to be reliable and correct as of the date of this material, but we cannot independently guarantee the accuracy or completeness of any information. Past performance is not a guarantee of future results. All investments involve risk, including loss of principal, and the value of an investment and the income from it can fall as well as rise and you may not get back the amount you originally invested. For a description of each of the indices listed, please contact us at operations@operoseadvisors.com.

About Operose Advisors

Operose Advisors LLC is a Wisconsin-based investment adviser working in partnership with independent investment consulting firm, Marquette Associates, Inc. Our purpose is to deliver an institutional approach to individuals, families, trusts and closely held businesses with planning, execution, and feedback of investment programs. For more information, please visit www.operoseadvisors.com.