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2020: Rise of the SPACs

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This year has been a challenge in many respects. However, there have been some positive developments in the venture capital (VC) ecosystem, including a resurgent exit market for VC-backed companies. Over the summer, several VC-backed companies completed successful initial public offerings (IPOs) — many at eye-popping valuations — and the pipeline for future offerings appears strong.

Alongside the strong IPO market, we have also seen a surge in the number of Special Purpose Acquisition Companies (SPACs). A SPAC is a corporation formed for the sole purpose of raising investment capital through an IPO, followed by the acquisition of an operating company in a so-called "de-SPAC" transaction. In this piece we will:

- Explain the mechanics of SPACs and what is driving their recent resurgence
- Compare and contrast SPACs with IPOs and direct listings
- Discuss the potential ramifications for early-stage VC investors

SPACs 101

SPACs, sometimes called blank-check companies, are vehicles formed for the purpose of merging or acquiring other companies. Nearly anyone can sponsor a SPAC, provided he or she can persuade shareholders to purchase shares. At the beginning of the process, the sponsor, typically with the assistance of an investment bank, embarks on a roadshow to raise capital in a registered public offering. During this process, the sponsor meets with prospective institutional investors, including hedge funds, private equity funds and family offices. A small percentage of retail investors may also participate in the offering.

Once the sponsor raises the capital, typically at $10 per share, the shares begin trading and the sponsor places the proceeds into a blind trust and begins a search for a target company to acquire.

Once a target has been identified, the SPAC and the target will enter into a non-binding letter of intent, followed by a binding acquisition agreement. Both the SPAC sponsor and the target then seek approval from their respective shareholders by means of an SEC-regulated proxy/registration statement. Bankers may also get involved at this point to help introduce the operating team to public stock analysts so that the merged company will have appropriate coverage in the public markets.

SPACs will pursue targets typically four to six times larger than the amount of proceeds raised for the SPAC. To the degree any additional capital is required — either to backstop the risk of SPAC shareholders exercising their right to get their capital back (notwithstanding a vote in favor of the acquisition), or to fund additional operating capital requirements — existing and potentially new institutional investors can provide it via a private investment in public equities (PIPE) at this point. Upon the closing of the de-SPAC acquisition, the SPAC's capital is released to the resulting company, which continues as a public company. If shareholders do not approve a transaction or a sponsor fails to identify a suitable target within two years, capital is returned to the SPAC's original shareholders. For SPACs that are successful in acquiring a target, the de-SPAC combination process typically takes four-five months but can be less in some cases.

With respect to fees, the SPAC will pay investment banks a fee, typically 5.0-5.5% of the capital it raises. The sponsor is typically entitled to 20% of the pre-merger value of the SPAC (referred to as the "promote") and other institutional investors will typically get warrants with their investment. However, both the promote and the warrant coverage can become the object of renegotiation at the time of the de-SPAC. Bankers will also usually receive fees for managing the mini-roadshow to seek SPAC shareholder approval, handling the merger, and raising any additional needed capital from PIPEs.

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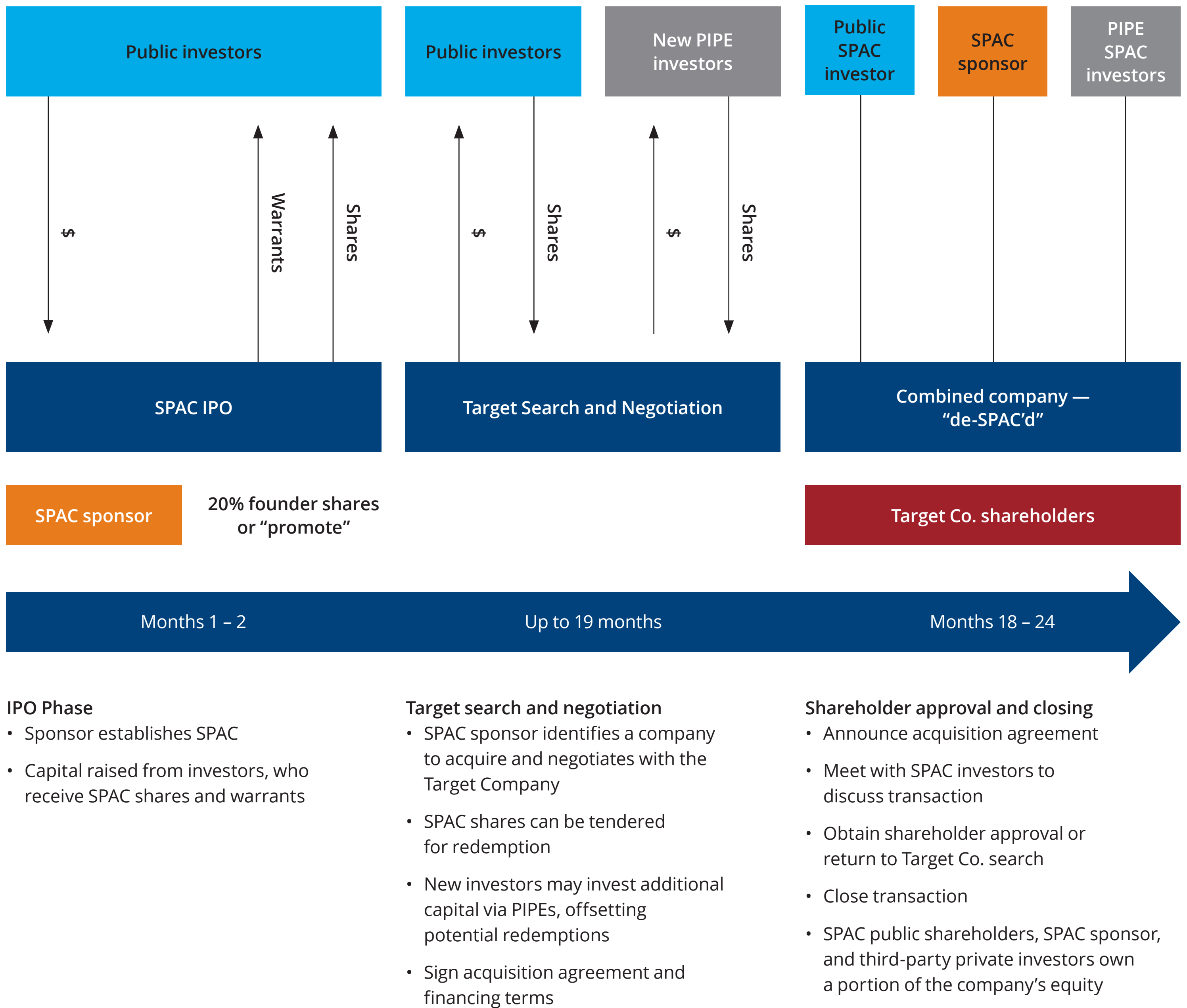
Chart 1: Typical timeline and major players in a hypothetical SPAC transaction



IPO Phase

- Sponsor establishes SPAC
- Capital raised from investors, who receive SPAC shares and warrants

Target search and negotiation

- SPAC sponsor identifies a company to acquire and negotiates with the Target Company
- SPAC shares can be tendered for redemption
- New investors may invest additional capital via PIPEs, offsetting potential redemptions
- Sign acquisition agreement and financing terms

Shareholder approval and closing

- Announce acquisition agreement
- Meet with SPAC investors to discuss transaction
- Obtain shareholder approval or return to Target Co. search
- Close transaction
- SPAC public shareholders, SPAC sponsor, and third-party private investors own a portion of the company's equity

Sources: Michael Klausner, Michael Ohlrogge, and Emily Ruan, "A Sober Look at SPACs," Harvard Law School Forum on Corporate Governance. November 19, 2020. Goodwin Proctor, LLP, SPAC Practice Overview. December 4, 2020. For illustrative purposes only.

SPACs are nothing new

Given all of the recent press around SPACs, one might have the impression that they are a new phenomenon. In fact, they are not. SPACs have been around for some time and gained a degree of traction in the early 2000s. However, during earlier periods, they were not a popular exit route, with low-quality sponsors and convoluted terms endemic in the SPAC world. Many major banks avoided or limited their involvement with SPACs. Laws governing SPACs have changed since then and we have seen a marked increase in activity in 2020 (Chart 2).

Year-to-date through October 2020, SPACs had raised as much capital in their IPOs as they did over the entirety of the previous decade. In addition, there were almost two dozen VC-backed companies that signed deals to be acquired by SPACS during this period. Activity has not been limited to the VC world. For instance, Richard Branson's Virgin Galactic went public via a SPAC late last year and Fenway Sports Group, the owner of the Boston Red Sox and Liverpool F.C., is also reported to be in talks around one.

Several factors explain the recent resurgence of SPACs. By far, the biggest reason for their newfound popularity is the quality of SPAC sponsors, which has improved dramatically and given SPACs an important new stamp of credibility. For example, Chamath Palihapitiya, an early Facebook employee and venture capitalist, sponsored the SPAC that took a stake in spaceflight company Virgin Galactic. More recently, he also sponsored SPACs for insurance company Clover Health and online real estate company Opendoor. Another prominent SPAC sponsor is hedge-fund manager Bill Ackman. Respected VC firms, both in life sciences and IT, have also entered the fray and sponsored their own SPACs. Examples include General Catalyst, Ribbit Capital, FirstMark Capital, Frazier Healthcare Partners and 5AM Ventures. Some secondary factors have also contributed to the increased activity. These include improved voting structures and governance, along with consistent terms. Additionally, some companies that had their IPO plans thwarted by Covid-19 earlier in 2020 turned to SPACs as an alternative.

IPOs, SPACs, direct listings… Which is best?

With the recent spike in the number of SPACs, many are now asking if they are superior to the more traditional IPO. A number of industry observers have complained about the complexity and expense of a traditional IPO. This sentiment led, in part, to the advent of direct listings in 2018, a third principal avenue for going public, which we will discuss below. IPOs, direct listings and SPACs each have their advantages and drawbacks and the best option will likely differ depending on a company's specific situation. Consequently, we expect that all three options will remain around in some form in the years to come. Let's look at each process more closely.

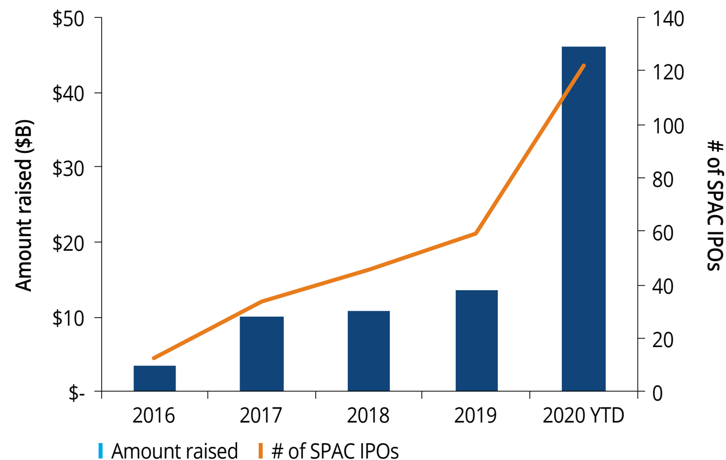
IPOs

Initial public offerings have been around for a very long time and the process is well-established. VC-backed companies continue to complete IPOs today and are generally happy with the outcomes. This satisfaction, coupled with familiarity with the process, likely ensures IPOs will continue to be the principal avenue for exit for many VC-backed companies. A successful IPO provides needed additional capital and can stoke publicity for a company, enhancing its brand and bringing in new customers.

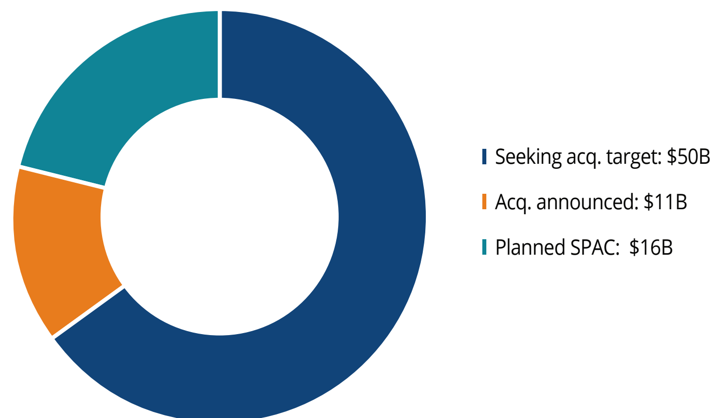
There are drawbacks, however. An IPO is a lengthy and expensive process that is subject to a high level of regulation. Furthermore, companies are beholden to banker timelines and the IPO "window" is notoriously fickle. For instance, IPO activity ground to a halt in the second quarter of 2020 as the Covid-19 pandemic unfolded. In addition, IPO filings impose much more restrictive limits on what issuers can disclose about business operations relative to those for companies in a de-SPAC process. The biggest complaint against IPOs, however, is that they are a "gift to Wall Street." Critics assert that Wall Street banks underprice offerings in order to reward their customers — large institutional investors — with an initial stock price "pop." This ensures that those same customers will buy less attractive offerings in the future. In addition, banks are also charging handsome fees to conduct the offering. Taken together, the offering discount and fees can add up to a 40% cost of capital according to some industry observers.

Chart 2: SPACs on the rise in 2020

SPAC fundraising activity YTD



Active SPAC status summary



Source: SPACresearch.com, November 2020. For illustrative purposes only.

Direct Listings
Direct listings came onto the scene in 2018 as an alternative path to the public markets that addressed an IPO's shortcomings. Online music-streaming platform Spotify pioneered the approach with a direct offering in April 2018. Others have followed, including messaging platform Slack in June 2019 and both Palantir, a big data analytics company, and Asana, a provider of online collaboration tools, in September 2020.

Ideal candidates for a direct listing are generally well known to the investment and research communities and have easy-to-understand business models. In a direct listing, the company offers shares directly to investors without a banker's underwriting assistance. The process is generally considered easier and less expensive than an IPO. The company only incurs nominal advisory fees and can avoid an underwriting discount by having its share price determined by a standard market-matching process.

But a direct listing is not appropriate for all situations. Notably, a direct listing does not allow a company to raise new capital, at least at this point in time. Hence, this is not a solution for companies that are not yet cash-flow positive. Second, viable candidates for a direct offering need to have strong awareness among investors already. They also need some level of secondary activity in the private market in order to help establish what a fair offering price might be, as there are no underwriters to help set the initial price. In addition, there are no lock-ups, so the potential exists that large sales by existing shareholders may put pressure on the share price.

These constraints and requirements have limited the number of direct listings that have occurred to date. However, the SEC has recently expressed willingness to work with exchanges and amend restrictions on companies' ability to raise primary capital through a direct listing. This, coupled with buy-side investors' amenability to new public structures, could lead to more direct listings going forward.

SPACs
As noted earlier, SPACs have been around for a while. Their increasing popularity over the last few years is due in large part to the higher quality of individuals that are involved with them, not novelty. SPACs address some of the shortcomings associated with an IPO. Bankers play a much less central role and the initial SPAC IPO process is generally faster than a traditional IPO (there are no company operations or assets to disclose). Further, a target company can share a broad picture of its operations that extends further into the future, something not possible in the S-1 required for a traditional IPO. This is particularly useful for companies that have a "complex story" to share with potential investors. Companies can also optimize their investor base around a smaller group of durable long-term players. Finally, unlike direct listings today, SPACs allow the target company to raise new capital.

The principal drawback of SPACs is their cost. If one considers the promote that SPAC sponsors earn, the cost of capital can be high. Thus, a SPAC does not really address one of the principal drawbacks of an IPO. However, as SPACs become more prevalent and begin to compete for target companies, we may see their costs come down. In fact, we have recently seen increasing pressure on SPAC sponsor promote and warrant coverage terms. Finally, for a SPAC target company to be successful in the public markets, it will still need to establish the necessary equity research relationships typical of all public companies.

Are SPACs here to stay? What does this mean for early-stage VCs?
On balance, we believe the recent resurgence of SPACs is good news for early-stage VC investors. Having another viable exit alternative beyond traditional IPOs, M&A and direct listings should help drive more liquidity for them. SPACs can allow retail investors to participate in a part of the market previously closed to them, and mutual-fund complexes can more easily access high-growth technology companies earlier in their life cycles.

High-quality actors are now involved with SPACs, and the SPAC structure is beneficial for certain kinds of companies. All of this suggests that SPACs are here to stay at some level. And the existence of a SPAC alternative will give early-stage portfolio companies leverage to negotiate heretofore immutable features of traditional IPOs such as lock-ups. For example, we have seen rigid 180-day lockup rules relax for the recent IPOs of Snowflake and Unity and the trend is expected to continue for other future high profile IPOs through the end of the year.

Undoubtedly, we are witnessing a high-water mark for SPAC activity today, driven in part by some investors' "fear of missing out." According to the Wall Street Journal, nearly two-dozen VC-backed tech companies had signed deals to be acquired by SPACs as of October 23, 2020 and even more were being approached by approximately 165 blank-check companies that went public in 2019 and 2020, but didn't yet have an acquisition target. This suggests that the quality of companies going public via a SPAC may diminish.

A resurgent SPAC market may also start to reverse the trend of VC-backed companies staying private for longer periods of time. This could have important ramifications for growth-stage investing, with some late-stage rounds perhaps becoming irrelevant. As noted earlier, more VC managers are sponsoring SPACs and there are appropriate reasons for doing so. For instance, a SPAC can allow a VC investor to continue supporting a company it knows well in a subsequent stage of its life cycle alongside a new set of investors. However, it will be important that SPACs do not simply become a way for managers to increase assets under management and a distraction from core early-stage investment activities. It is a trend that we are monitoring closely.

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