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Understanding the Inner Dynamics of SPACs from IPO through Acquisition

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SPAC Economics Primer: Understanding the Inner Dynamics of SPACs From IPO Through Acquisition

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KEY POINTS

- Special purpose acquisition companies (SPACs) have gained rapid traction in the last two years as another viable tool to access public market capital. SPACs are here to stay and may represent attractive opportunities for all participants involved, although it is likely that regulatory scrutiny will force the structure to evolve further.
- We are writing this note primarily for the benefit of stock investors who want to better understand the different dynamics of a SPAC stock as the SPAC goes through the different stages of its lifecycle.
- In addition, we also highlight the challenges that the managements of de-SPACed companies face as they lead companies that have effectively bypassed important steps of the traditional initial public offering (IPO) process.
- After its IPO, a SPAC goes through three distinct phases: the search phase (the SPAC management looks for an initial business combination or "IBC"), the announcement phase (the proposed IBC is announced, and SPAC investors will vote to approve the transaction or not), and the post-merger phase (the IBC is completed, and the SPAC becomes a regular publicly traded company). Through each phase, the risk/return profile of the underlying stock changes significantly.
- The various actors involved in a SPAC have very different sets of incentives through these three phases. We analyze the incentives of each interest group from the IPO until after the acquisition is completed.
- Up to the approval of an IBC, the SPAC investor base is likely to consist mostly of structured and event-driven investors.
- Following the announced IBC, significant investor turnover can be expected from structured investors to fundamental investors. In addition, the original SPAC sponsors can be expected to sell their stock as soon as lockup clauses expire.
- The new de-SPACed company management has to a manage a major investor base transition while formulating a long-term investor messaging and engagement strategy. These are tasks that typical companies tackle during the normal IPO process, but de-SPACed companies must accomplish this on the fly after having become public.

INDUSTRY STATISTICS

Year-To-Date 2021

Current S-1 Filings	305
Total Active SPACs	574
Searching for IBCs	425
Live IBCs	149
Closed SPAC IBCs	79 - $170 Billion
Liquidated SPACs	0

Source: SPAC Alpha

OUR INSIGHTS

The Opportunities

SPACs can be very lucrative business models for their sponsors. SPACs also present an attractive alternative IPO route particularly for the owners of smaller companies, often private equity funds or smaller businesses, looking to go public. The SPAC option represents a less onerous method to go public both in terms of speed (it is faster) and risk (there is less market risk and less regulatory burden). For public equity investors, SPAC stocks can be interesting private equity type investments with changing option components.

The Obstacles

Compared to traditional IPOs, SPACs offer potentially less protection to public investors in the form of fewer disclosures, unidentified target selection, and rich sponsor compensation even in cases where the underlying common stock does not perform well. Post merger, major shareholder turnover is often observed as the SPAC sponsors look to monetize their investments and as structured investors are replaced by fundamental investors (the typical investors post merger). This, combined with limited sell-side and institutional investor following, can often negatively affect trading patterns and create an *orphan stock* syndrome, a situation where a lack of investor interest results in a stock with a low trading volume and that is potentially dissociated from the company's long-term fundamental value.

WHAT IS A SPAC?

A special purpose acquisition company (SPAC) is a type of *blank-check* company that raises funds from investors through an initial public offering (IPO) for the purpose of acquiring another company. SPACs have no assets or commercial operations at the time of their IPO, which explains why they are referred to as *blank-check* or *shell* companies. The target is either not yet identified or at least not disclosed, which makes for simple and straightforward disclosures in the SPAC's S-1 documents.

SPACs are organized by sponsors, typically well-regarded executives who have credibility as managers and/or dealmakers in a specific industry. The sponsors risk their own capital to organize and take a SPAC public. Their compensation is in the form of a *promote*, typically 20% of the company, which becomes valuable only if an acquisition is completed within the pre-agreed timeframe. Outside investors are enticed to invest in the SPAC by the experience and credibility of the sponsors, the appeal of the industry the sponsors will focus on, and the structure of the SPAC stock which provides strong downside protection in the form of a put option to the issuer up to the point where investors approve a proposed acquisition.

OUR CASE STUDY: A GENERIC SPAC TRANSACTION FROM IPO TO ACQUISITION

This case study presents the main actors and steps involved in a typical SPAC transaction from its formation to the completion of an acquisition. We will discuss the role and incentives of the SPAC's sponsors, the investors in the public stock, the owners of the business that the SPAC will acquire, and the management of the business who typically end up managing the de-SPACed public company going forward.

The Sponsors Form the SPAC

Three business partners with reputable credentials in an attractive industry form a SPAC—one of them will serve as the SPAC's Chairman, another as Chief Executive Officer (CEO), and yet another as Chief Financial Officer (CFO). They will not receive any salary from the SPAC but will receive a promote that will become valuable if and only if the SPAC completes an initial business combination (IBC). The sponsors will use their expertise in their industry of choice to identify a company for the SPAC to acquire.

In our case study, these three partners own Sponsor LLC in which they have invested $10 million of their own capital. Sponsor LLC uses this capital to buy B shares and warrants in the SPAC. In turn, the SPAC uses this capital to fund its operations prior to the upcoming IBC. The SPAC needs this source of capital because the funds they will raise in the IPO will go directly, and in their entirety, into a trust fund to be returned to investors in case the SPAC does not complete an IBC or if some or all investors decide to redeem their stock before the IBC is completed. (The SPAC common stock investors have effectively a put option up to the completion of the IBC.)

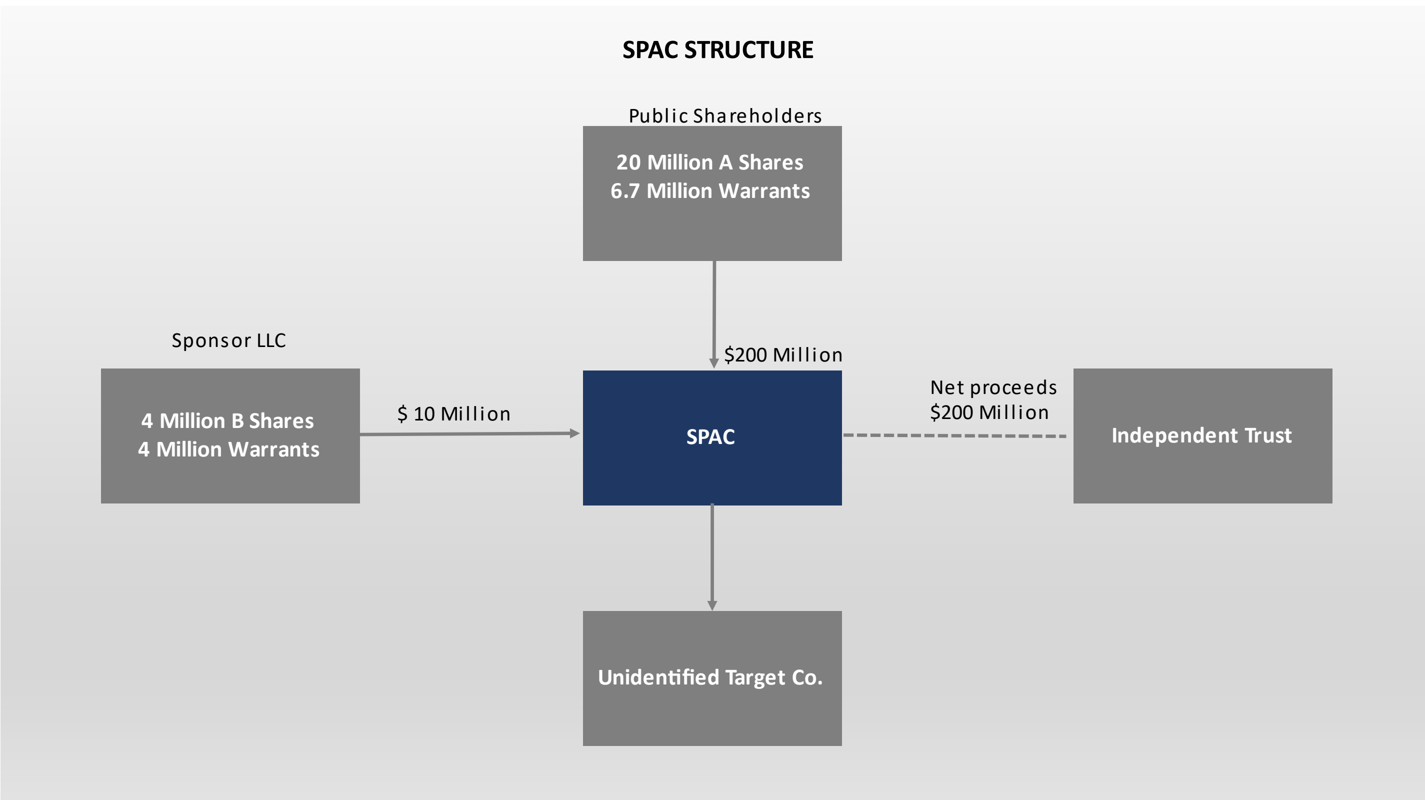
The SPAC's main expenses prior to the acquisition, funded by the sponsors' capital, will be the IPO fees to the IPO manager, legal and accounting expenses (to prepare the IPO documents), directors and officers (D&O) insurance, and trust expenses. Once the SPAC goes through its IPO, its management team will focus on identifying a target company for the SPAC to buy.

The IPO

The SPAC's IPO is managed by an investment bank (IB). In our example, the SPAC sells 20 million A shares at $10 a share, thus raising $200 million in cash which it puts in a trust account. Each share also comes with one-third of a warrant to buy an additional share of the SPAC at $11.50 a share (warrant coverage and terms can change). The investment bank charges a 6% fee for the transaction but only one-third of the fee is paid upfront ($4 million), with the balance to be paid when and if the SPAC completes an IBC. Should the SPAC not complete an IBC within the next 24 months (the typical timeline), the public investors in the SPAC will get their $10 per share back, the investment bank will forgo the other two-thirds of its underwriting fee, and the SPAC sponsors will have basically lost the bulk of their $10 million investment.

The sponsors promote is thus the 4 million B shares and the 4 million warrants they will own after the IPO at a cost basis of basically $10 million. At face value, just the 4 million B shares are worth $40 million. Note, however, that the B shares cannot be put to the company if no acquisition is identified. The B shares can be exchanged for A shares typically only after the IBC has been approved and completed, at which point the put option embedded in the A shares has expired. Finally, the sponsors' shares are typically subject to various lockups. Usually, the sponsors must wait six months post acquisition before they are allowed to sell their shares.

Figure 1: SPAC Structure



Source: Water Tower Research

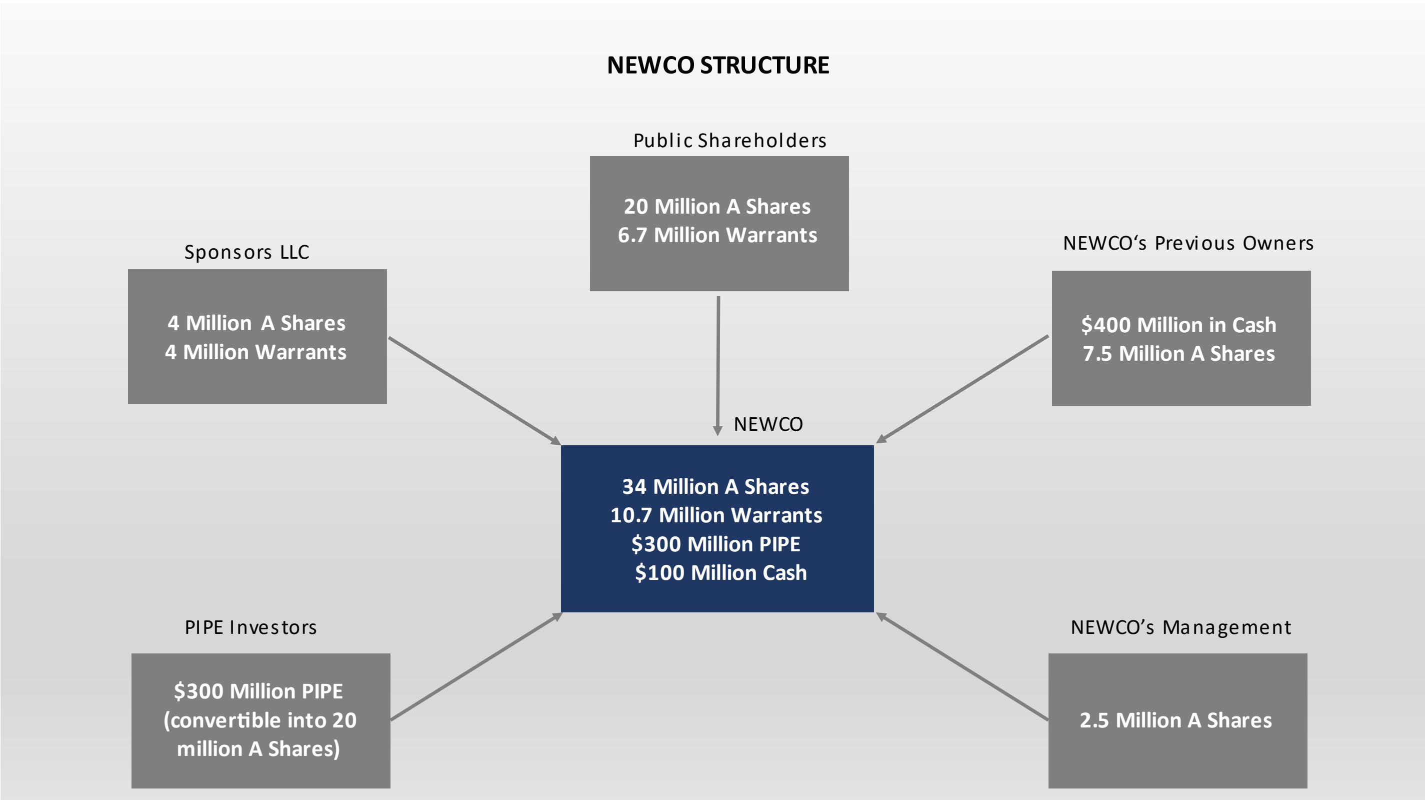
The Search

Once the IPO is completed, the SPAC management looks for an acquisition candidate. Although management will focus on its industry of choice (and of experience), the offering documents typically allow for management to consider acquisitions in any industry.

The Announcement

A few months after its IPO, the SPAC announces that it has made an offer to acquire a target company for $500 million consisting of $400 million in cash to the owners of the target company, plus an additional $75 million in stock to the owners and $25 million to the management of the target company. The SPAC management and the target company management conduct a conference call discussing the target company's business with an extensive presentation including a five-year forecast for the target company's business. (Note that such a forecast would not be allowed to be discussed

Figure 2: NewCo Structure



Source: Water Tower Research

At this point, NewCo has been acquired for $500 million. Where will the stock trade one quarter post acquisition? Here are two potential scenarios:

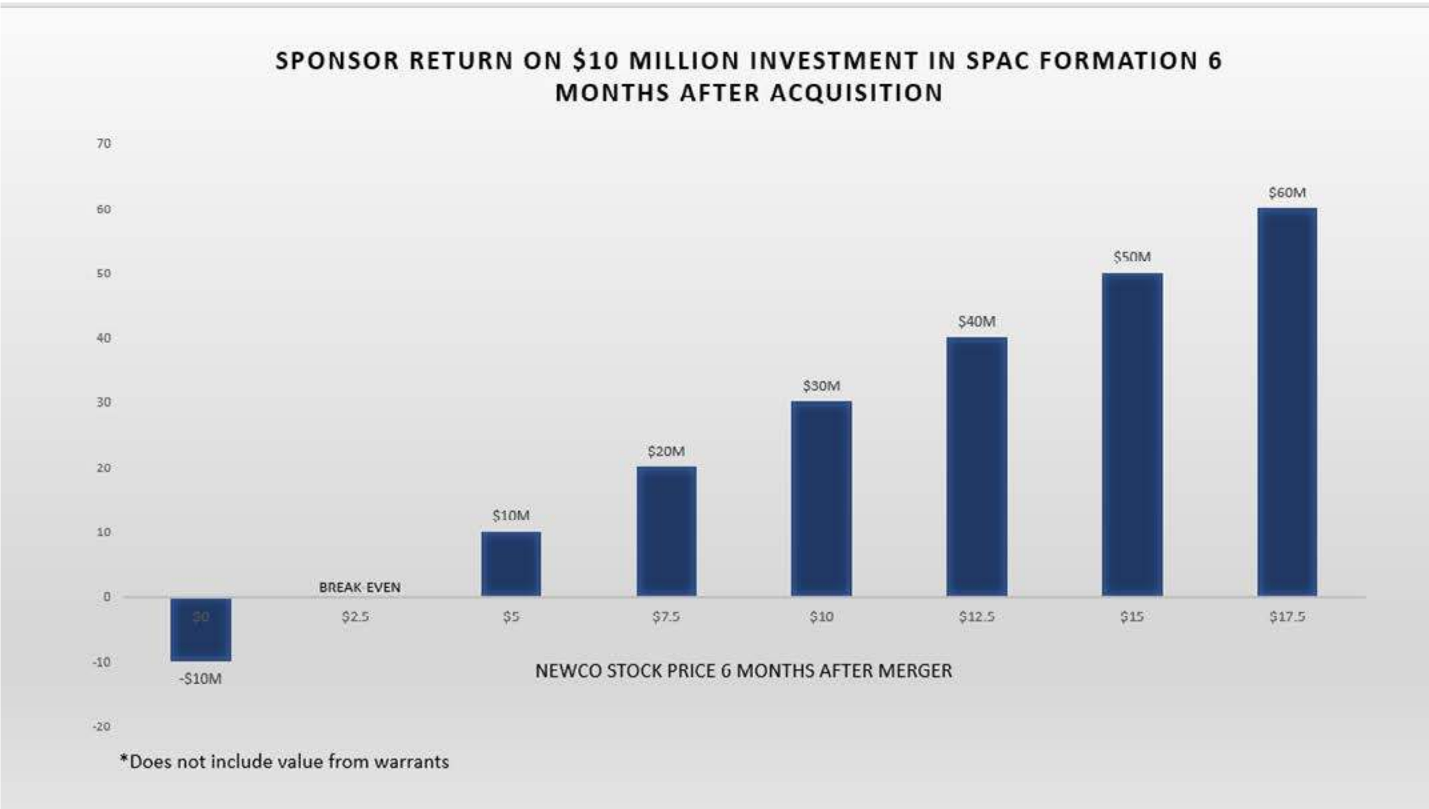
1. The $700 million potential value discussed by the sponsors and NewCo's management appears realistic and is reinforced by incremental data from the company's first quarter. The company has $200 million in net debt and 34 million shares. Ignoring the dilution from the warrant for now, the stock could trade in the $14 to $15 range.
2. The potential value discussed when the acquisition was first proposed now appears overly optimistic; the $500 million paid by the SPAC was the high bid and incremental data and results have not been encouraging. An enterprise value of $400 million seems now more realistic. Under this scenario, the stock might trade in the $5 to $6 range.

THE ECONOMICS FOR EACH ACTOR

The Sponsors

In our case study, the sponsors invested $10 million of their own capital as a group to provide the SPAC with the working capital necessary to function prior to the IBC. In exchange, the sponsors received 4 million B shares and 4 million warrants (their promote). The B shares represent 20% of the shares issued at the IPO and have a value of $40 million at the SPAC stock issue price of $10 a share. The B shares are different from the A shares in the sense that unlike the A shares, the B shares cannot be redeemed for $10 a share prior to the acquisition or if the SPAC does not complete an acquisition. After the acquisition has been completed, the B shares are exchangeable into A shares and the sponsor usually has a six-month lockup. Figure 3 below shows the payoff from its $10 million investment in the formation of the SPAC based on different stock prices for NewCo six months after the acquisition when the sponsors' lockup typically expires.

Figure 3: Sponsors' Return at Different Stock Prices



Source: Water Tower Research

As shown in Figure 3, the sponsors will realize a very meaningful return even if the SPAC is well under water after the IBC is completed. This is a remarkable feature of the SPAC structure; in most co-investment situations (private equity, hedge fund, traditional money management agreements and vehicles), this level of financial compensation is not achieved by the manager or the General Partner (GP) unless the co-investors or the Limited Partners (LPs) also achieve positive returns.

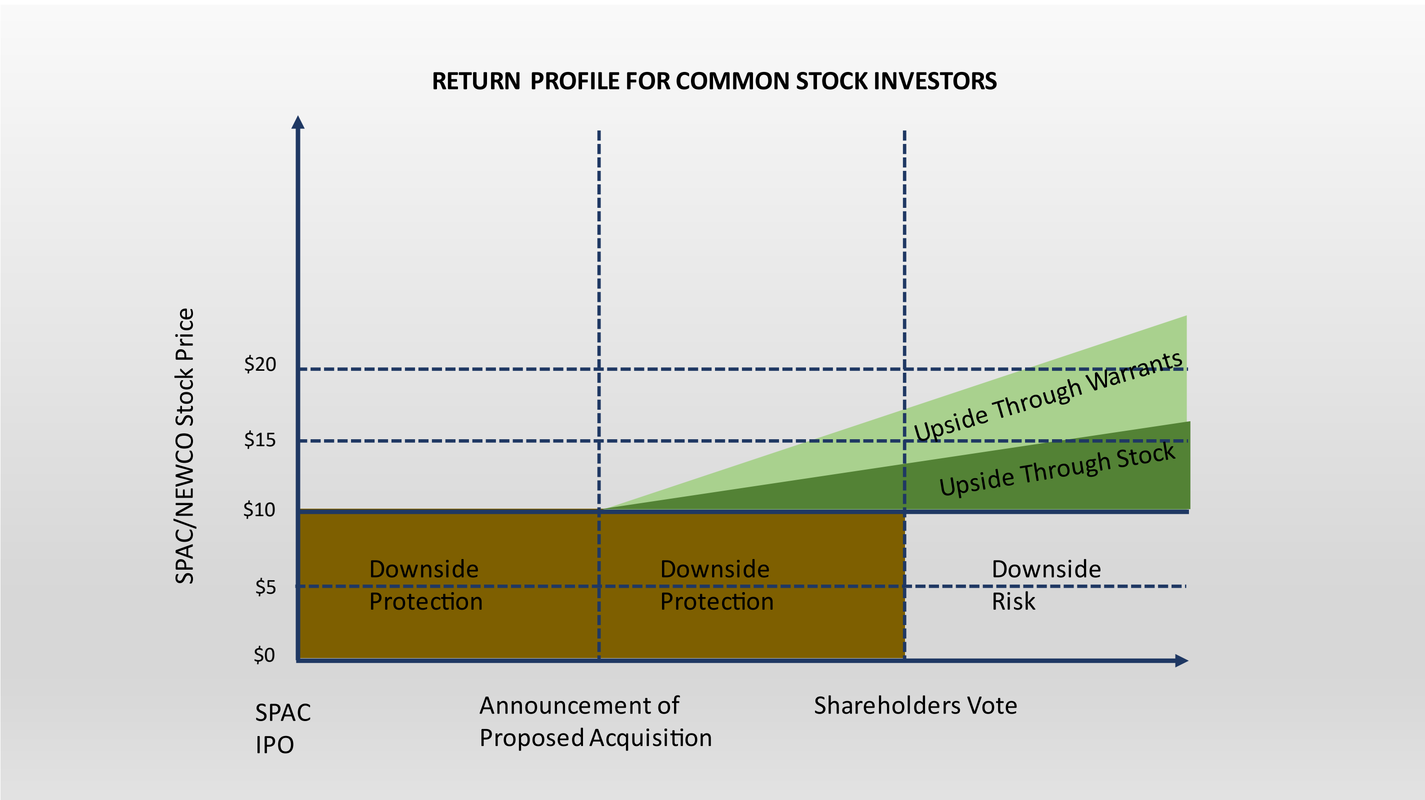
This highlights the very strong incentive for the sponsors to affect an acquisition. No acquisition means an almost total loss of the $10 million invested. An acquisition that results even in a $5 stock price six months after the IPO allows the sponsors to double their investment.

As discussed above, the sponsors have typically a six-month lockup post acquisition for their stock. In addition, as the chart show, they have a very strong incentive to monetize their promote, and their position tends to create an overhang on the stock and will typically be sold shortly after the lockup expiration.

The Public Shareholders

For the investors in the public stock, the SPAC stocks goes through three distinct phases as illustrated in Figure 4 below:

Figure 4: Return Profile for Common Stock Investors



Source: Water Tower Research

The SPAC stock has very strong downside protection from the IPO up until the shareholder vote. In fact, a case can be made that holding the stock until just before the shareholder vote is a safe and sound investment strategy since there is, up to that point, almost no downside risk (if your cost base is $10) and some positive upside. Once the vote has occurred, investors who do not sell or redeem their stock are now subject to downside risk for the first time. This downside risk is now both the normal business risk of the target company and the upcoming potential selling pressure when the various lockups run out. The structured investors mentioned above will then also likely look to exit their positions, either through a redemption at $10 or open market sales of their stock.

One could say that the real IPO day for the SPAC and the target company actually occurs after the shareholder vote when public investors cannot redeem their stock anymore, when the sponsors' B shares become A shares (i.e., the dilution is actually realized), and when the terms of the IBC (valuation, financing, and nature of the acquired business) become the driving factor of the stock. This is when the guardrails are off and the real upside and downside of the business and of the stock market will start affecting the stock, positively or negatively.

A consequence of this change of characteristics of the SPAC stock through these three phases is that the stock is likely to appeal to very different types of investors before and after the merger. Before the merger, it should appeal mostly to investors who focus on the technical characteristics of the stock—the put feature and the optionality embedded in the upcoming merger announcement and the warrants. After the merger, the stock must attract fundamental investors interested in the actual business that the SPAC has acquired, and they must be satisfied by the valuation of the new company. That shareholder base transition will happen, and if it is not managed well, it can translate into significant pressure on the stock. In addition, that transition will happen in the context of various lockups expiring, in particular for the SPAC sponsors, usually six months after the merger.

The Target Company Owners

For the target company's owners, the SPAC might be able to make a more attractive offer than other potential buyers such as private equity or industry acquirers, as evidenced by the number of recent SPAC transactions. In addition, the strong incentive of the SPAC sponsors to complete a merger can be a factor in the price offered for the target company. The regular IPO route may still be preferable for some assets or businesses, but there are clearly advantages in taking the SPAC route in term of timeliness, transaction risks and costs, etc. as presented in Figure 5 below.

Figure 5: SPAC vs. IPO Process

	SPAC Merger	Traditional IPO
Timing	• 3 – 4 months [1]	• 6 - 9 months [2]
Process	• Limited interruption to management, owner and employees • Due diligence required but executed by a small dedicated team • SEC review process can be deferred until after the closing	• Comprehensive preparation involving whole organization • Dealing early with analyst/market participants • Full SEC review process
Pricing	• Certainty on price early in the process • Limited risk from fluctuating market conditions	• Price determined at time of the IPO • Full market risk
Costs	• Lower direct expenses and indirect costs • Typical Underwriter Fees: 5.5%	• Full range of direct expenses and indirect costs • Typical Underwriter Fees: 6.0%
Other	• Dedicated experienced and proven senior management • Provide stamp of approval and potential supplement of management	• Potential lack of capital market experience, international and well-known management • Risk of IPO being rescheduled due to underwriter queue

Source: Bridge point Capital

NewCo's Management

Many of the factors discussed in Figure 5 also affect the interests of NewCo's management. However, NewCo's management has typically a longer-term incentive than the previous owners in NewCo becoming a successful publicly traded company, as Newco is not just a financial investment for them, but also an employer and factor in their career success. The SPAC process, however, bypasses key elements of the IPO process that are crucial to the long-term success of NewCo as a public company, in particular an extensive effort of presenting and explaining NewCo to a wide range of public long-term investors with a focus on the careful framing of the true long-term opportunities and risks of the business. Thus, after the IBC is completed, NewCo's management might find itself running a public company with limited sell-side research coverage and interest, limited trading liquidity, few long-term-oriented institutional investors, and a few large holders (the sponsors and the previous owners of the target company) who are about to become aggressive sellers of their stock once their lockup runs out.

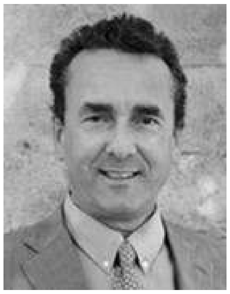
In addition, as discussed above, both the SPAC sponsors and the target company owners had a strong incentive to see the proposed transaction approved by the SPAC shareholders. Therefore, there should be no surprise if in some cases the sponsors and the previous owners painted an overly positive picture of the business when the IBC was announced, and then left it to the management to offer a more balanced picture once the transaction had been completed.

In summary, while the upfront hassle and expenses of the IPO process was bypassed by the SPAC acquisition, NewCo management has a lot of work to accomplish after the merger to really become a public company with a fair and balanced message to investors. The extensive work needed to identify and attract supportive long-term investors very often needs to be done after the transaction has been completed, and a well-functioning investor engagement process has to be developed from scratch, a process that in a traditional IPO situation happens before the IPO date. Failing to develop an effective investor engagement process and attracting long-term fundamental investors will likely create longer-term challenges for the new company with all the problems associated with orphaned public stocks, such as difficulties in accessing the public markets if needed later and in incentivizing employees with stock.

KEY CONCLUSIONS

- SPACs offer an interesting alternative to the traditional IPO process. The SPAC process allows private businesses to access the public markets in a less onerous fashion, and thus the SPAC structure is likely here to stay.
- The current standard SPAC structure is financially very attractive for the sponsors if they can complete a transaction, which most do. In fact, the sponsors can realize very attractive returns even if the public stock trades below its IPO price. This is due to the significant payout to the SPAC sponsors, which almost guarantees them a strong return while at the same time creating significant dilution for the other investors and thus a challenge for longer-term strong stock performance.
- The SPAC stock appeals to very different investor bases before and after the merger. The shift from one type of investor to another needs to be managed effectively. In addition, the streamlined IPO made possible by the SPAC structure bypasses the extensive shareholder introduction and education that is part of the typical IPO process. This can often lead to pressure on the stock post merger. The management of the surviving entity finds itself with the task of educating and engaging with investors post merger, needing to accomplish the investor education work that most companies do during their initial IPO.
- In an ideal SPAC transaction, every party can benefit. Respected SPAC sponsors identify an attractive business to which they bring credibility; they make it possible for it to go public in a cost-effective way, bypassing the expensive IPO process. Often management is upgraded in the process. Post merger, long-term fundamental investors are attracted to the story, the public market awards the new company a solid valuation, which allows public stockholders, the SPAC sponsors, and the previous management to benefit from the overall process through their holding in the new company.
- Challenges typically occur if the dilution (the sponsors' compensation) exceeds the value created by the SPAC process, if over-eager sponsors overpay for a business that may not be quite ready to be a public company, and if not enough long-term fundamental investors are identified to absorb the stock that typically hits the market at various lockup expiration stages.

ABOUT THE ANALYST



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Thierry has been an analyst and portfolio manager for over 20 years focusing on special situations and emerging growth companies. Thierry started his career at Lehman Brothers in New York and London focusing on cross-border Mergers and Acquisitions, and he also worked in the firm's new securities development group.

He then joined Russell Investments, providing investment consulting advice to some of the world's leading institutional investors and published research on hedging strategies in multi-currency portfolios. Thierry then joined Becker Capital and was responsible for their small-cap product. Thierry also co-founded Kohala Capital Partners, a small-cap focused money management firm, and was a senior portfolio manager at GROW Funds LLC, a hedge fund management company.

Thierry holds an MBA from Carnegie Mellon University's Tepper School of Business and an MS in Applied Economics (magna cum laude) from the University of Berne in Switzerland. Thierry is fluent in English, French, and German.

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