SPACs
UNPACKED

Filling in the blanks on blank check companies

Evolutionary Insights

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SPACs, or special purpose acquisition companies, have been a popular topic of conversation as of late. They have existed for decades but with limited use as they were perceived as being riddled with fraudulent schemes – in fact, Goldman Sachs had a strict policy against any involvement with SPACs. Fast forward to now, this policy has long been disposed of and SPACs have boomed, raising a cumulative $83bn in 2020. Tesla competitor Nikola, sports betting company DraftKings, and spaceflight company Virgin Galactic are just some of the many companies that have gone public through the SPAC method. This vehicle has piqued the interest not only of investors but also recently of regulators.

**So, what is a SPAC?**

A SPAC is a shell company with no commercial operations. They are formed with the sole purpose of raising money through an IPO (initial public offering) and using this money to acquire a private company, thereby taking it public. This process is quite straightforward as SPACs don’t require the same level of due diligence as the traditional IPO process since there are no operations to scrutinise. Investors purchase common shares in the SPAC at $10 and their money goes into an interest-bearing trust account. The management, also known as sponsors, then have 2 years to acquire or merge with a private company, taking that company public while circumventing the traditional IPO process – this is known as a ‘de-SPAC’ deal. If such a deal is not reached within this time frame, the fund is liquidated and the money returned to investors.

SPACs have received the moniker of ‘blank check companies’ as the target private company is not disclosed at the time of investing. This is either strategic, as early disclosure of the target could cause complications in the deal, or simply because the target company has not been identified when the SPAC is launched. The idea is that investors send a blank check without any knowledge of what they are actually investing in – they invest purely based on the reputation of the sponsor team and the hope that they will replicate their previous successes.

**What’s the appeal of SPACs?**

SPACs offer an alternative route to taking a private company public – aside from the more traditional IPO process or other methods, such as direct listings or reverse takeovers. As with all methods, a SPAC merger has its pros and cons.

We explore the advantages presented by SPACs from the perspective of three key parties: private business owners, sponsors, and retail investors.
Private business owners

SPAC mergers generally offer a much quicker way for companies to go public as they are not subject to the regulatory scrutiny involved in the IPO process – SPAC mergers are often completed in 3-6 months, a considerable shortcut compared to the 12-24 month timeline of traditional IPOs. This speed also provides more certainty regarding listing values as it reduces the chance of companies missing the interest window and protects against market volatility. Further pricing certainty is provided to private business owners as they are offered a specific value at the start of the de-SPAC process instead of the valuation being set by investment banks further down the line in the IPO process.

SPACs offer cost savings as they do not require the legal and administrative costs involved in conventional IPOs and businesses can benefit from the expertise of sponsors, who are typically sector experts and often join the board of the newly public company. Furthermore, private companies can make exceedingly positive projections publicly without any liability for them which means they don’t need to trouble themselves with the multitude of roadshows and pitch meetings necessary to attract investors in the traditional IPO process.

Sponsors

For sponsors, the largest draw comes from the ‘sponsor promote’. The promote is the block of shares in the SPAC, typically around 20%, that sponsors receive for next-to-nothing.

For example, Chamath Palihapitiya, a well-known venture capitalist and sponsor of Social Capital Hedos Sophia Holdings, the SPAC involved in taking Virgin Galactic public, received his shares at the nominal value of $0.01 per share. Compare this to the $10 a share paid by initial investors or the high of nearly $60 that the stock reached in February 2020 post-merger and it is easy to understand the lure of SPACs for sponsors.

Retail investors

For retail investors, investing in a SPAC allows you to ‘get in on’ an initial listing of an exciting company, an opportunity that is normally limited to large investment banks and hedge funds. The deal for initial investors is sweetened by warrants that allow investors to purchase more shares at a fixed price once the company is public.
SPACs look great so far, so what are the issues?

In reality, not all of these benefits are quite as rosy as they first appear.

Costs

Although SPACs avoid some of the administrative fees of an IPO, other costs can make them expensive in their own right. Firstly, the sponsor promote can be seen as a 20% fee on the company’s valuation as it costs next-to-nothing. Secondly, a SPAC sponsor will often use a PIPE (Private Investment in Public Equity) in order to supplement SPAC funds to execute a merger. This PIPE is the selling of shares to institutional investors at discounted rates – exactly like the initial stage of an IPO which the SPAC is meant to circumvent.

Additionally, although the investment banks do not take a fee for the process of making the private company public, they will take a fee to facilitate the merger – and they will have already taken a fee for the initial IPO of the SPAC itself (the underwriters of SPAC IPOs typically charge 5.5% of the funds that are raised). Finally, if sponsors decide to sell their stake in the company shortly after it goes public, it could cause the share price to fall.

All of these costs will be passed on to the private business owners and the retail investors.

Risk

There is considerable risk involved for retail investors. As mentioned above, sponsors have a short time frame within which to execute a deal, and massive incentives to do so. As a result, deals may be rushed through to completion. This, combined with the lack of due diligence and regulation in the SPAC process, may lead to investors having their money tied up in a bad deal, or worse, a fraudulent one. The potential risks involved are illustrated by the lawsuits shareholders have brought against sponsors for neglecting their fiduciary duty to provide adequate disclosures.

Preparation for compliance

Once the merger is completed, the new company is subject to the same regulations and scrutiny as any other public company. Although the speedy route to becoming a publicly listed company may be appealing at first, it may come back to bite if the new company finds itself underprepared for reviews and compliance.
**Not so speedy**

Not all SPAC mergers go as quickly as planned. The anticipated merger of SPAC Stable Road Acquisition Corp with space transportation company Momentus, for example, has been held up by investigations by the SEC. As the 2-year deadline approaches, there are concerns the merger may fall through altogether. Such regulator intervention undermines the appeal of a supposedly quick route to going public.

**Expertise**

Opportunities for businesses to benefit from sponsors’ expertise may not be realised if initial sponsors are quick to sell their stake in the company.

**Regulator intervention**

The SPAC boom has piqued the interest of regulators, with the SEC voicing its concerns twice in the last month. Its first statement addressed companies’ rosy projections. A Financial Times analysis found that nine car tech companies that went public via SPACs and had a combined revenue of $139m in 2020 had projected a combined $26bn in revenues by 2024 – the issue here is clear. Such projections have led allegation against the likes of Nikola for fraud. The second statement asserted that warrants should be accounted for as liabilities rather than equity, punching a large hole in the balance sheets of some SPACs.

The SEC’s involvement could have serious implications for the SPAC market as it is heavily concentrated in the US. This is due to its as yet SPAC-friendly rules, such as investors’ ability to pull their money out of a deal if they are not happy with the proposed merger. On the flipside, the FCA is looking to loosen the UK’s stricter regulatory measures in this area in attempt to profit from the lucrative SPAC market amidst the Brexit uncertainty. This is certainly a space to watch.

**A SPAC slowdown**

Despite a huge boom over the last year in SPAC-related business, the SPAC market is starting to see a slump due to the one thing markets hate above all else – uncertainty. Principal among the causes of this uncertainty are the statements made by the SEC. Only a dozen SPACs underwent IPOs in April, the least since June 2020. Furthermore, companies that have gone public through this method are struggling with intense selling pressure. Out of the 41 SPACs that have completed transactions since the start of 2020, the average decline in share price from market highs is 39%, according to Financial Times analysis of data provided by Refinitiv.
Key Takeaways

The transaction almost seems to be a ‘rigged game’ where the sponsors and institutional PIPE investors make large sums no matter what since their shares are massively discounted, while retail investors who buy at $10 need the share price to appreciate in order to make money. This financial incentive for sponsors, combined with a lack of regulation and emphasis on speed over due process, doesn’t provide a sense of security for retail investors and their money. Maybe now that there is more coverage on SPACs the market’s enthusiasm for this vehicle will continue to wane as people fill in the blanks on these blank check companies.
About Evolution Partners

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