Mercer

Blank check companies under the spotlight – understanding the SPAC

Private market insights

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Filling in the blanks

A Special Purpose Acquisition Company (SPAC) is a blank check or cash-shell financial entity that has no commercial operations. Its objective is to raise capital to acquire a privately held business and take it public, usually within two years. A SPAC lists on a stock exchange prior to identifying its target. Once the target has been identified and approved by investors, the SPAC merges with the acquired company.

We believe these vehicles are an innovative way for private companies to go public. Many companies appreciate the speed, control and certainty around the IPO pricing, while some investors favor the optionality of participating in the potential IPO or redeeming their initial investment should they not be convinced by the target opportunity.

In 2020, SPACs rose to the forefront of investment opportunities by enabling companies to raise capital quickly while providing the business owners a relatively frictionless exit strategy. Yet, despite recent media and investor interest, SPACs have been in existence for decades and have gone through several regulatory changes. Recent examples include some high-profile companies such as 23andMe, Opendoor and SoFi that choose the SPAC exit route. The economic uncertainty following the pandemic and high market volatility helped fuel the SPAC surge as companies became concerned that capital market liquidity soon could dry up. By early 2021, over $200 billion was available for private companies to go public via SPAC.[1]

However, increased competition along with litigation and regulatory risk present headwinds for SPACs. Incomplete financial disclosures have recently led to several lawsuits. In the US, the Securities and Exchange Commission (SEC) has signaled the possibility of increased scrutiny.[2] Additionally, the CFA Institute has created a working group to examine and make recommendations regarding the surge in US SPACs and the implications for investor protection, corporate governance, and market integrity.[3]

Mercer believes investors should access SPACs through a hedge fund or opportunistic strategy rather than through direct investment. Also, investors may gain exposure to SPACs through private equity fund managers that use SPACs as an exit path and rollover some of their ownership, although this is not likely to be known when the investor commits to the fund manager. Mercer believes these active managers are well positioned to perform vital due diligence and identify potential investment opportunities.

This paper is intended to provide investors with a basic understanding of the mechanics of SPACs as well as their opportunities and risks.

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[1] PitchBook_Analyst_Note_SPAC_Market_Update_Q1_2021.pdf

[2] https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws

[3] https://www.cfainstitute.org/about/press-releases/2021/cfa-institute-announces-launch-of-SPAC-working-group

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Avenues to go public

Companies have three main options to transition from being privately held to publicly listed. There is no right answer – either for the existing owners or potential investors – but there are distinct nuances to the approaches.

Traditional IPO

With a traditional IPO, the company works with an underwriter — usually an investment bank —- to manage the regulatory process, price its shares, and raise institutional investor interest through roadshows. It is typically a very time-consuming and resource intensive process. While the company will establish a target share price, the final valuation of the company is determined by the level of investor interest and market conditions at the time of listing. In a traditional IPO, private shareholders are converted to public, but they will usually have a lockup period during which they cannot sell their shares after the IPO.

Direct listing

Direct listing is a more a recent development in public markets through which a company will sell existing shares directly to public investors without the assistance of an underwriter. So far, few companies have chosen this avenue because of the challenge in raising sufficient capital, yet the popularity of this route has grown following a recent SEC rule change. An additional distinction is that there is no lockup period for private shareholders that are converted to public with the listing.

SPACs

SPACs are the acquisition of an existing private business by a public shell company. The valuation is based on forward projections of its financial performance and the valuation is usually a major negotiation issue between the owners of the existing business and the SPAC sponsor. This approach is quicker and more streamlined than the traditional IPO process, with an upfront price discovery mechanism providing stability in a volatile market.

The ebb and flow of SPACs

The first SPACs were issued in the early 1990s.[4] They were developed as an avenue for taking small, immature, non-institutional companies public. However, the risky nature of many of these companies led to high failure rates and lackluster stock performance at the expense of investors.

Regulations which passed in the 2000s included enhanced disclosure requirements, as well as permission to list SPACs on major stock market exchanges. This helped bring SPACs back into the spotlight and transactions grew to the extent that they have been competing with traditional IPOs. In 2021, SPAC IPO deals have reached almost half of the level of traditional IPOs and invested capital has become sizable as shown in Figure 1.

[4] https://www.npr.org/2020/12/29/949257672/the-spectacular-rise-of-spacs-the-backwards-ipo-thats-taking-over-wall-street?t=1627403572306

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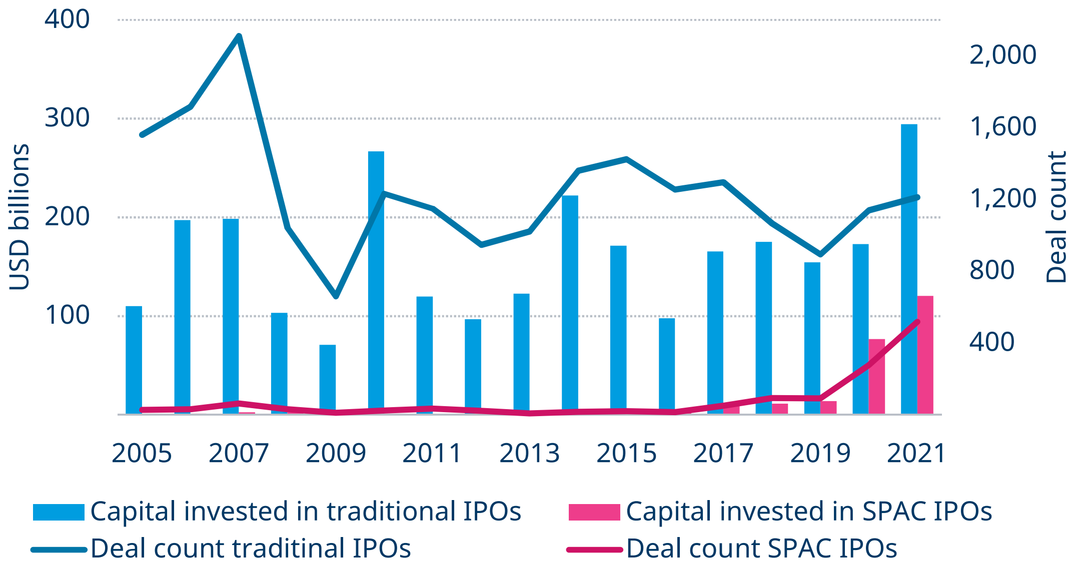
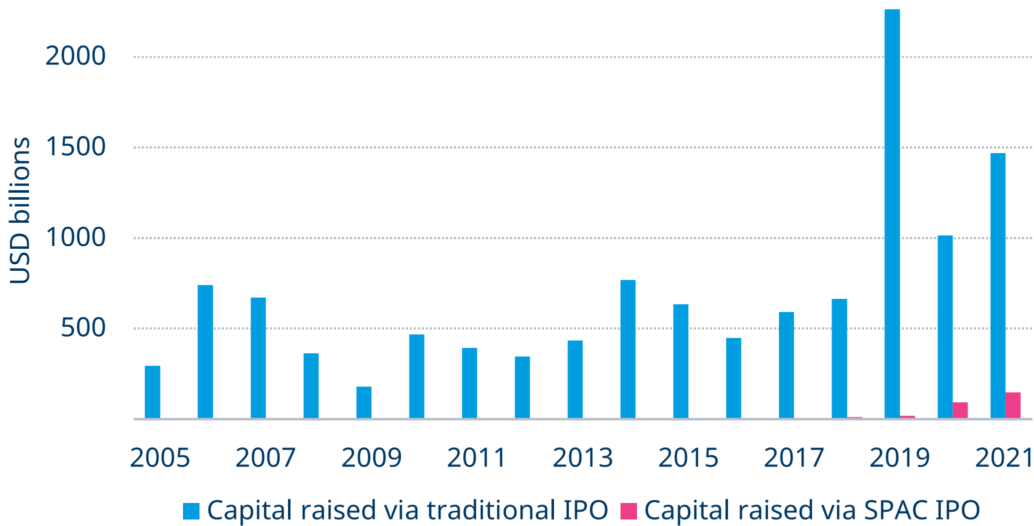
Figure 1. Growth of traditional and SPAC IPOs



Source: Pitchbook as of August 31, 2021

Figure 2 shows that total post valuations of SPAC IPOs reached approximately 10% of what traditional IPOs have raised in 2020 and 2021.

Figure 2. Post valuations of traditional and SPAC IPOs



Source: Pitchbook as of August 31, 2021

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The market disruption of COVID-19 provided an unexpected boost to the popularity of SPACs. As private equity valuations were being questioned, companies were concerned that liquidity could dry up. In times of economic uncertainty and heightened market volatility, SPACs offered a welcome, low-risk exit strategy and increased financial certainty for companies. As the money has already been raised, the process allows a private company to go public in a much simpler and quicker fashion than through a traditional IPO. However, the transaction may be riskier for shareholders as the regulatory standards and disclosures are not as strict.

SPACs have also benefited from sponsors with strong credentials and successful track records in recent years. The sponsor more commonly now has extensive experience in the target industry as well as operational management skills and merger and acquisition qualifications that can add value to the target company which is more likely to lead to a successful investment. The percentage of SPACs that fail to find a target and are forced to liquidate has also decreased substantially from 57% in 2010 to just 2% in 2019 and no SPACs liquidated either in 2020 or thus far in 2021.[5] These developments increased the acceptability of SPACs to institutional investors, which in turn, fueled a further increase in issuances.

However, the quality of SPACs can vary and although we are seeing positive improvements in sponsors' skills as well as more transparency and better prepared target companies, investors should perform the same level of due diligence that they would for any investment.

Lifting the lid on the SPAC

In a traditional IPO, investors have substantial information about a company. In a SPAC IPO, investors are providing potential capital to enable sponsors to identify a promising prospect. While a SPAC can be less burdensome, there are still several steps involved in a typical process as shown in Figure 3.

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[5] SEC.gov | SPACs, IPOs and Liability Risk under the Securities Laws
SPAC IPO Transactions Statistics - by SPACInsider SPAC Status by Year of IPO

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Figure 3. How does the SPAC process work?

Set up and IPO

- Experienced sponsor launches a SPAC
- Sponsor
  - sets up a legal entity: a non-operating shell company
  - launches IPO to raise capital
  - files report, issue press release letting investors know when separate trading may commence
- IPO is often structured to offer investors a unit of securities consisting of shares of common stock and warrant
- After filing for IPO, common shares and warrants trade separately on the open market
- Initial shares come with a redemption right – basically an interest-free callable loan with a call option
- Proceeds are put into a blind trust until shareholders approve the proposed acquisition
- Sponsor receives a compensation of roughly 20% of the outstanding shares plus warrants at acquisition

Evaluation and selection of company

- Sponsor searches for a target company to acquire
- Sponsors typically have sector specific expertise and connections to add value
- A transaction needs to be completed within two years or SPAC will be liquidated
- In case of liquidation of the SPAC, capital held in blind trust is returned to investors. In this case, the sponsor will lose its shares and warrants
- Once the SPAC has identified an initial business combination opportunity, shareholders will have the opportunity to redeem their shares at face value while still keeping warrants which is essentially a free call option
- After a company has been identified transaction structure and terms are negotiated

Transaction financing

- Additional capital is typically raised from Private Investment in Public Equities (PIPE) deals or transactions
- PIPE investors, which can include existing SPAC or new investors, may receive preferred conditions
- SPAC shareholders need to approve the acquisition
- If the transaction fails, the sponsor needs to evaluate a new acquisition target

Acquisition, merger and listing

- After the shareholders approve the transaction, the SPAC merges with the target
- Once the transaction is complete, the SPAC takes on the name and ticker symbol of the acquired company
- The shares trade freely on the stock market

Source: Mercer – For illustrative purposes only

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The SPAC story

For more than a decade, companies have been staying private for longer[6]. This is due to the access to abundant capital from a variety of funding sources[7] and that companies often face fewer regulatory constraints by staying private. However, the COVID-19 pandemic increased the uncertainty that private companies could raise large amounts of capital in the near term. For these companies, choosing a SPAC route offers a fast exit path and SPAC IPOs surged to an unprecedented level after the breakout of the pandemic.

However, with the unprecedented surge has come increased scrutiny and, as a result, new issues. Both standard and innovative SPAC financing structures keep surfacing. Specifically, the ambiguity around potential changes to the accounting treatment of options has increased. The SEC announced that it will look carefully at filings and disclosures by SPACs as well as their private targets and may provide additional guidance with the intention of enabling the public to make better informed investment and voting decisions around these transactions[8].

As a consequence, SPAC IPO activity slowed down materially in the second quarter of 2021 and performance of SPACs has been weak since peaking in February 2021 according to the IPOX® SPAC Index that tracks the aftermarket performance of US SPACs. [9]

Figure 4. Performance of IPOX SPAC Index

Source: IPOX® SPAC Index – Bloomberg as of August 31, 2021

[6] Public and Private Markets in Transformation | Mercer
[7] https://www.sec.gov/spotlight/investor-advisory-committee-2012/elisabeth-de-fontenay-deregulation-private-capital.pdf
[8] https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws
[9] https://ipox.com/indexes/ipox-spac/

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Yet, these legal challenges may well turn out to be a positive for the evolution of SPACs. With stronger business models, firmer accounting guidance, and more experienced sponsors at the helm, SPACs could evolve into a mainstream private market exit strategy. For SPACs to be fully adopted by mainstream investment channels, there also needs to be closer alignment between sponsors and investors around terms, structure and incentives. We believe more competition will benefit companies looking to go public, as well as investors.

It is important to understand the nuances between traditional and SPAC IPOs. Figure 5 presents the pros and cons of each from a company perspective.

Figure 5. Comparison between traditional and SPAC IPO

Pros	Cons
Traditional IPOs	
Visability – A traditional IPO increases the company profile, signals success and potentially provides access to cheapter finiancing terms.	**Slow** – Will require company to work with an investment bank to prepare the IPO, which demands legal and audit reviews. It is a time-consuming process.
Full investment cyle – Early stage investors can benefit from the full long-term growth potential of the company.	**High costs** – Raising new capital from public investors envolves roadshows and marketing campaigns, which can be costly.
Stable investor base Long-term investing allows better alignement between companies and shareholders, which potentally results in better returns through stewardship and engagement.	**Due diligence** – The rigorous underwriting requirements could lead to potential restatements, incorrectly valued businesses or even lawsuits.
Transparency – All investors have access to the full IPO documents prior to the transaction.	**Market condition** – Market volatility at the time of listing can significantly impact the success of the IPO. Underwriters try to manage price swings after listing, but volatility may increase after the lock-up expires.

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Pros	Cons
SPACs	
Certainty - Target companies are able to negotiate their IPO terms before the transaction, which helps reduce disruption and offer stable forward guidance.	**“Blank check” investment** – The company is not known and investors depend on the SPAC sponsor to find an appropriate target.
Fast track – Companies can go public much faster than through traditional IPOs, typically in less than three months.	**Opportunity costs** – Allocated assets are typically invested in treasuary securities upon the merger. However, investors may miss out on potential market returns since the captail is locked up in a trust account .
Capital raising – Since the SPAC is already public, the target company does not use an underwriter and, as a shell company, faces less regulatory requirements when fundraising.	**Conflict of interest/Misalligment –** SPAC sponsors are highly incentivised and may therefore favor more lucrative transacations, potentially sacriricing full due diligence.
Optionality – Initial IPO investors can redeem the stock at its face value but keep their warrants, which is bacially a callable loan with a call option.	**Dilution** – The sponsor compensation is typically 20% of the acquired company plus warrants issued to initial SPAC investors to buy more shares. For shareholders, dilution arises from paying the sponsor’s fee in shares
Skills – Sponsors may have distinguished ‘know how’, expertise and credibility to help the acquired company grow.	**Shareholders and coverage** – The initial IPO investors are most likely not the same as post-merger which may result in higher investor concentration, lack of analyst coverage immediately after the SPAC’s listing.

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From an investor perspective figure 6 outlines the potential benefits and risks of SPACs.

Figure 6. Potential benefits and risks for SPAC investors

	Benefits	Risks
Structure	• Private equity-like investment. Investors participate pre-IPO and receive equity/warrants at a predetermined price	• At the time of the IPO, the target company is not known • Initial investment relies on sponsor's reputation • Investment is limited to one company, no diversification
Liquidity	• Fast and simple way to deploy capital • Liquidity gained though publicly traded securities	• Sponsors have a two-year window to identify and acquire a company • Investor capital is held in a trust and not deployed until acquisition
Alignment of interests	• Sponsor has a significant stake in newly public company and has the incentive to see the company outperform • The lock-up period for a SPAC IPO is typically longer than that for a traditional IPO. However, the typical lock-up period for target shareholders is 180 days from closing.	• Two-year window increases pressure to strike a deal, especially near the deadline • Demand may outpace number of companies available to become acquired
Due diligence	• The SPAC process is less burdensome as the company only negotiates with one investor or small syndicate to raise capital	• Due diligence is outsourced to sponsor that may select a company with financial/liquidity issues and lower quality than a typical IPO • Search and negotiations are time constrained • Appropriate due diligence on target companies rushed in some circumstances
Risk	• Limited, as institutional investors can redeem shares if unhappy with the acquisition decision, resulting in downside protection • if sponsor is unable to acquire a target within two years the capital will be returned to investors	• Opportunity cost for investors since assets are invested in Treasury bonds prior the merger • If equity is held post acquisition, there is a high likelihood of concentrated position risk to the target company. Investors may want to reduce exposure.
Fees	• No management fee or salaries are paid until acquisition has been completed	• Sponsor receives roughly 20% of the outstanding shares plus warrants at acquisition, which is more attractive than for traditional private equity funds

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How can institutional investors gain access to SPACs?

Investors can gain exposure to SPACs by investing in hedge fund and opportunistic investment strategies or, they can participate directly in a SPAC IPO. Mercer has observed the following trends on how managers may invest in SPACs.

Hedge funds
A small number of hedge fund managers have launched vehicles to capitalize on the SPAC phenomena. This approach can build exposure to a diversified basket and hedge fund managers can underwrite both the sponsor and the target.

- Some managers have been active in the space for many years and have recently increased exposure as part of a broader multi-strategy offering.
- A small number of managers have launched individual SPACs, serving as sponsors if they have good networks.

Our preference is for the first alternative - access SPACs as part of a multi-strategy offering with a manager who can opportunistically dial the exposure up or down.

Private markets – Buyouts and venture capital
Private equity funds may gain exposure to SPACs through using it as a mechanism for at least a partial exit. As private companies can take years to become institutionally ready for an IPO, SPACs can offer an exit option for companies that do not wish to deal with the time and complexities of a traditional IPO financing but do want to generate some liquidity for investors. Private equity fund managers may choose to rollover some of their ownership into a SPAC as way to continue to participate in a company that they know very well. However, investors do not have direct control over that decision, so the SPAC exposure may be uncertain.

Mercer is equally comfortable for investors to gain SPAC exposure via private equity funds as this falls within the remit of their skillset, given the high degree of overlap between SPACs and private equity exits strategies. However, this is not an investable strategy to gain SPAC exposure.

Opportunistic strategies
These investment strategies aim to profit opportunistically from fundamental themes, inefficiencies and dislocations in the financial markets at a macro, market sector, stock specific, factor, or even exchange level.

Investment managers may take an opportunistic approach to SPACs through selective positioning in all aspects of their lifecycle.

Mercer is comfortable with the approach in case the manager has the required skills in this space.

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Direct investing in a SPAC
Investors that participate directly in a SPAC IPO are taking single company risk and cannot fully evaluate that risk until the sponsors identify and negotiate a deal with a private company. Alongside diversification issues, investors should understand the investment structure and properly evaluate the sponsors as well as the target company when it has been announced.

Mercer believes investors should access SPACs through a broader hedge fund or opportunistic strategy rather than through a direct investment.

Our approach

SPACs have thus far featured more prominently in the media than they have in institutional investment portfolios. Since SPACs lack transparency and are dealing with regulatory changes, professional investment skills are needed to perform appropriate due diligence and make informed decisions.

For this reason, we prefer to access SPACs as part of a broad, actively-managed hedge or opportunistic fund. Private equity and venture capital funds will use SPACs as well, but primarily as an exit strategy. We do not recommend direct SPAC investing as it is likely to result in concentration and high investment risk and proper due diligence can be problematic.

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