SPAC – An Alternate Route to Going Public

Representing 40% of the entire IPO market today, SPACs are quickly becoming an alternative way for venture-backed companies to go public. But what exactly are SPACs? How do they work? How do they differ from a traditional IPO? And why the recent hype? This week's Circle|Call discussed all of these questions and more.

We heard from the following VIP teams: Cowen, who gave us some perspective and framing on the market for SPACs; Explorer, a sponsor of many SPACs, who gave us some insight into how SPACs work; Grid Dynamics and ACME as it relates to DraftKings, key players involved in recent SPAC mergers, who provided first-hand perspectives.

Here are the key takeaways from the conversation:

What are SPACs?

A SPAC, or Special Purpose Acquisition Company, is an alternative way for a Private Company to raise capital and access the public equity markets. A SPAC is a publicly-traded company that consists of significant funding from institutional investors but has no product or business operations, just cash sitting in a trust account. A SPAC's role is to merge with a private company, sometimes called a target company, that does have a product and business operations. This is why a SPAC is sometimes referred to as a "blank check company." A SPAC is an alternative way for companies to raise capital (cash sitting in the trust) and access the public equity markets. Remember, at transaction close, you are now a publicly listed company that trades on the NYSE or NASDAQ.

Why the hype?

While SPACs have been around since the late '80s, there has been a significant increase in both numbers of SPACs seeking targets and quality of the sponsors, particularly over the last six months. There are a few key factors that have driven this shift. First, SPACs are continually evolving; the structure is not the same as it was five years ago, and it won't look the same five years from now. The perception of SPACs continues to evolve. Second, and particularly relevant in this post-COVID world, SPACs provide an opportunity to market using forward-looking projections over a multi-year story in a confidential setting. It allows you to market off an investor presentation and YOUR financial model and host principal to principal conversations with investors. In contrast, a traditional IPO utilizes a regulated document focused on historical results, limits your dialogue with investors, and could be derailed by an unexpected global event such as the COVID crisis given the offering's public nature.

According to our friends at Cowen, there are currently over 125 SPACs with $37bn of capital that are seeking a transaction and nearly 40 that are actively fundraising and will likely be publicly traded within the next 30 days.

How SPACs are formed

A SPAC management team or sponsor is often composed of seasoned executives who have meaningful investing, operating, and public company experience. A board of directors also complements the management team with deep industry connectivity and relationships. This team engages with underwriters and lawyers to commence the IPO process, including SEC approvals, marketing, and raising the money from institutional investors. The sponsor must put up "risk capital" to cover the costs associated with the SPAC formation, underwriter, and legal fees, that way 100% of the money raised from investors is sitting in the SPAC. The SPAC then gets listed on a public exchange, typically at $10 per share (some exceptions recently as the structure evolves) and trades as a public company. The money raised is placed in a trust/custodian account and can only be used when the management team identifies an attractive opportunity.

Once public, a 24-month "shot clock" starts where the SPAC must merge with a target company. Otherwise, the SPAC dissolves, and the institutional investors get their capital back, i.e., the $10 per share.

A key point to underscore here is that the institutional investors that participate in the IPO have a redemption feature. They have the right to vote on the business combination and the ability to redeem their shares for their initial investment ($10 per share). What that means to the target company is that the capital they're seeking to put on their balance sheet to grow the business is at risk of going away if the SPAC's underlying institutional investors do not vote to keep their shares.

How SPAC Mergers Transact

There are generally two independent parties and processes underway – advisors representing companies and advisors representing SPACs.

In the former, a target company will go through a process to hire an advisor. At this point, the target company may be equally considering the traditional IPO process or the SPAC process (they might also be considering the direct listing process, but that's another topic). As it relates to SPACs, the advisor will be simultaneously driving many activities.

First, the advisor will be taking the company through an "IPO Readiness" initiative. Here, the company ensures that they have the right personnel, systems, data, and processes across the organization to satisfy government regulations administratively. And the company can smoothly transition the operations into a world of quarterly earnings reports where the company can consistently "beat and raise" its forecasts that it communicates to analysts.

Second, the advisor will be preparing the marketing materials consisting of the company's story and helping refine the financial model and projections. Those materials will be used both to market to a potential SPAC counterparty but also to institutional investors either in the roadshow process or those considering a PIPE (private investment in public equity).

Lastly, the advisor will canvas a number of relevant SPACs they represent and synthesize that into a tight list of SPACs to facilitate a series of meetings between target companies and those SPACs. The SPAC management team and advisors will independently be canvasing target companies that it knows and approach them about a potential transaction.

Ultimately, this results in an LOI (letter of intent) between a target company and a SPAC. Once terms and valuation are agreed to, an important dynamic occurs. The target company and the SPAC are now on the same team with mutual interest to ensure institutional investors want to participate in funding the deal and that the deal gets to the finish line as smoothly and successfully as possible.

Once all participating parties are on the same team, its everyone's job to market to institutional investors either ahead of the announcement in a confidential setting ("wall cross") in a PIPE process or in a roadshow "de-SPAC." A wall cross is an administrative step that is SEC compliant, allowing those institutional investors to be in receipt of MNPI (material non-public information), particularly when forward financial plans and projects are identified. Said differently, the institutional investors cannot know the SPAC is in serious discussions with a potential target and receive the target's marketing materials or financial model without a wall cross.

A Side Note – PIPEs

As mentioned, a PIPE might be structured to be executed concurrently with a SPAC merger. A PIPE is not required as a part of a SPAC, but in the last 12-24 months, it has more often than not been a part of the deal. Why raise a PIPE? There are several use cases:

- Additional growth cash on top of the cash sitting inside of the SPAC
- Provide fundamental investors the opportunity to build a meaningful position
- Curate your cap table and shareholders
- Additional proceeds to pay down debt or cash out selling shareholders

With a PIPE, there are a number of benefits realized. First, the private company is assured that there will be a minimum amount of cash coming to the balance sheet for growth capital. Second, it meaningfully de-risks the likelihood that the SPAC's underlying institutional investors would vote down the proposed merger and seek to redeem their capital from the trust of the SPAC. That's because the institutional investors in the PIPE provide outside validation to the institutional investors in the SPAC that this is a good company, is a good deal, and that the merger should proceed.

SPACs vs. IPOs

Compared to a traditional IPO, SPACs provide companies a number of key advantages.

Timing: While a company can take 12-18 months to get ready for a traditional IPO, in a SPAC, the process can be completed in approximately 4-6 months instead. In simple words, "speed without dilution." Additionally, you will know within two months what your valuation is, and if your deal will be successful before dealing with the SEC.

Marketing and Pricing: SPACs provide a better ability to position the company with investors given the ability to market off of forward-looking projections and due to a longer marketing period. The extensive pre-marketing opportunity in a confidential setting allows a company and its investors to understand whether its valuation is appropriate and better pricing insight. While contemporary tech IPOs are trading up between 80-100% post-announcement, SPACs make it easier to get the right valuation upfront.

Flexibility: Finally, because a SPAC transaction is effectively a merger, there is considerable flexibility regarding deal structure compared to a traditional IPO. Indeed, a company can add different earn-out structures and other features to the deal that would be impossible to implement in a traditional IPO.

Considerations

Do SPACs work for all companies?

There were a few questions throughout the session about a company's characteristics that make it a good candidate for pursuing a SPAC. First, the company must be sure that it is ready to go public. In terms of size range, the company needs to be in a spot no different from if it were considering a traditional IPO, as the company still wants to have enough market cap, float, and liquidity to attract high-quality investors. However, by using forward market projections in the SPAC process, companies can get investors comfortable with their stories earlier than the norm which opens up the universe of available companies that can go public via a SPAC. Indeed, while SPACs historically preferred companies with earnings and profits, the ability to sit with investors and de-risk the future projections has shifted the tide in the past 6 to 12 months, clearing the way for venture-backed companies to pursue SPAC mergers as well.

How to choose SPAC partners

One of the key points brought up during the discussion of how to navigate the SPAC process was the importance of negotiation. A SPAC merger is one of the most important events in a company's lifetime, and thus it is crucial to pick the right partner rather than the lowest price. The SPAC merger process is only the beginning of a company's journey to the public market, and thus the company needs to consider the long-term and where the SPAC sponsors and management team can take it in the future. Working with SPAC sponsors who are backed by investors with real experiences in your industry and one who can understand your story and add value is ideal. One member likened the process of choosing SPAC sponsors to choosing board members, an apt comparison considering the long-term relationship between the parties.

Tips for a smoother SPAC process

Finance leader: Having a finance leader with public company experience, or their number two, goes a long way to help transition the company into the public market and the rapid 90-day cycles of reporting that will be the norm.

Finance group: Beef-up your finance team. This is not the time to be lean. The transition from private company accounting principles to public company accounting principles will occur rapidly after a SPAC merger. Having that experience on the team can make the transition smoother.

Banker balance: Make sure you find a bank with underwriters with both significant SPAC experience and significant sell-side coverage experience. There will be banks that are good at SPACs but not very good at research coverage, and there will be banks that are good at research but not very good at leading your company through the entire SPAC process.

Finding the right balance is critical.