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2020: A SPACtacular Year?

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Given the deadly toll of COVID-19 and the disruption the virus is causing in our lives, 2020 will not be remembered fondly by many of us. And on top of all this we had a tension-filled election, one that drew the highest voter turnout in decades even as we struggled with the pandemic. In one corner of the financial markets, however, it truly has been a spectacular year: In terms of dollars and number of deals, special-purpose acquisition company (SPAC) issuance in 2020 has broken all previous records. SPACs have entered the mainstream and will continue to affect merger and acquisition (M&A) dynamics, bridge the gap between private and public equity, and expand the opportunity set for public equity-oriented investors.

What Is a SPAC?

A special-purpose acquisition company is one formed to raise capital for a merger or acquisition of an operating company in the future. It is also known as a "blank check company." A sponsor organizes and creates a SPAC and issues shares in the public equity market through an initial public offering (IPO). The shares are typically offered at $10/share. Proceeds from the issuance are invested in a trust of US Treasuries while the sponsor actively searches for acquisitions. The sponsor usually has two years to complete a deal before being required to distribute cash back to the shareholders.

Several features of a SPAC can create interesting opportunities and risks for investors.

First, the shareholders have the right to evaluate a proposed transaction and decide whether to participate or not. Shareholders who do not agree with a transaction can redeem units at cost plus accrued interest two days before a deciding vote by shareholders. Second, shareholders at the time of the IPO also receive warrants that provide the right but not the obligation to buy more shares of the SPAC, typically at a price of $11.50 for a term of five years.

Warrants are very similar to call options, with the difference being that purchased shares are directly issued by the company. As an example, if a successful SPAC makes a valuable acquisition and appreciates to $16.50 five years after the IPO, then the warrants would have a value of $5.00 ($16.50 less $11.50 strike price). Conversely, the warrants could be worthless if the price is less than the strike price ($11.50). Investors can detach the shares and warrants and decide to hold any combination of them.

Sponsors are critically important to the future success of a SPAC given the responsibility of sourcing a compelling deal and actively managing the future operating company. Investors seeking long-term opportunities should fully understand the quality, experience, and track record of the sponsor. Sponsors are typically compensated by receiving 20% of the pro forma equity and warrants: This is known as a "promote." In many instances, sponsors can receive the promote without meeting financial targets. Some SPACs require a portion of the compensation to be contingent on achieving specific financial goals.

Unique Attributes of SPACs

The combination of receiving shares and warrants with the ability to redeem shares before approving a deal provides arbitrage opportunities for adept traders. Several multi-strategy hedge funds with which we are familiar have been actively trading SPACs for years. With the increased activity, SPAC trading has been a material contributor to returns for several managers in 2020. With additional flexibility in regulations, SPACs are becoming preferred vehicles for companies in certain growth industries to go public. This creates new opportunities for investors to gain exposure to industries that previously have only been accessible through private markets.

For companies looking to raise capital, a SPAC may be the preferable mechanism relative to a traditional IPO. In the traditional IPO process, companies are prohibited from including forward-looking guidance such as projections. In a SPAC, projections from management can be provided to investors. Investors need to carefully consider the robustness of projections and the likelihood of them being achieved. An initial IPO is typically for only a small portion of a company, usually 20% to 25%. For SPAC transactions, there is a wide range in the amount of total equity being transacted.

Growth of SPACs

Issuance has exploded in 2020 with a total of $63 billion being raised for 170 SPACs for an average deal size of $370 million through October. This compares with $13.6 billion for 59 SPACs for an average size of $230 million in all of 2019.[1] SPACs continue to account for a growing portion of all US IPO activity for good reasons. First, investor sentiment toward equity, private or public, is high. This is rational given conditions and relative return opportunities in other asset classes: Higher sentiment creates higher demand for SPACs. Also, terms for SPACs have become more investor-friendly and institutionalized.

With improving terms and growing popularity, any residual stigma that SPACs had is likely gone. The spectrum of SPAC sponsorship has grown to include private equity managers, hedge funds with private capital investing experience, and accomplished dealmakers and operators.

How Do We View SPACs?

SPACs are a vehicle for companies to go from being private to public. Before acquisition, the future return potential of the SPAC is contingent on the outlook for the sponsor to source a compelling deal. Additionally, values of the warrants are estimated, which can be a complex exercise for investors. The future performance drivers of a SPAC after acquisition should be viewed in the same way as any other public stock. An analysis by Goldman Sachs showed that performance of SPACs after an acquisition has been completed is similar to that of traditional IPOs. In aggregate, while the group underperforms the broad market 12 months after merger completion, there are wide divergences between winners and losers.

Access to new industries provides adept active managers with a broader opportunity set. Hedge funds can take advantage of the growth in SPACs with arbitrage opportunities. However, given the niche focus, exposure is more suitable within a multi-strategy hedge fund rather than investing in SPACs on their own.

Given our focus on asset allocation and diversification, we do not believe a dedicated allocation to SPACs is optimal. Compared with investments in the broad market, SPACs are materially smaller and have higher risk and return profiles. Sector concentrations can be large as well. However, it could be attractive to invest in equities or hedge funds with skilled active managers who can incorporate SPACs into a broader strategy.

For more information, please contact your Key Private Bank Advisor.

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Source: 1. Special Purpose Acquisition Company Database | SPAC Research, 2020

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