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SPAC in the saddle — The return of blank check companies

Deeper analysis of investment trends and topics

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Alternative investments, such as private equity are not appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

Key takeaways

- Special purpose acquisition company (SPAC) issuance has exploded in 2020, with volume in the third quarter alone exceeding total volume in 2019.[1]
- A confluence of factors – including a financial system flush with cash, economic uncertainty, and maturing private equity portfolios – is collectively reinvigorating SPACs, also called "blank check" companies.
- Investors are attracted to the potential for "liquid private equity" with reduced downside risk, an overly simplistic characterization that we believe bears caution, while sponsors and owners like the efficiency and economics versus a traditional initial public offering (IPO).
- But SPACs are complicated and difficult to underwrite. Investors need to understand the mechanics of the IPO process, as well as key areas to focus on before committing capital.

One of the more interesting developments in the year of coronavirus is the surging interest in special purpose acquisition companies, commonly referred to as SPACs. Latching onto this recent trend is the financial media, which naturally leads to discussions and questions from investment committee members to financial advisors to investors.

[1] Wells Fargo, *Overview of Special Purpose Acquisition Companies (SPACS)*, October 2020.

What are SPACs and why all the fuss? Is this another short-lived fad emblematic of exuberance or a continuation of the trend toward "democratizing" private capital? Are these appropriate for all investors, or just a few? What are the risks?

In this in-depth report, we explain the structure itself, how it works, how investors are approaching it, the potential benefits, and importantly, the risks we believe investors most need to understand.

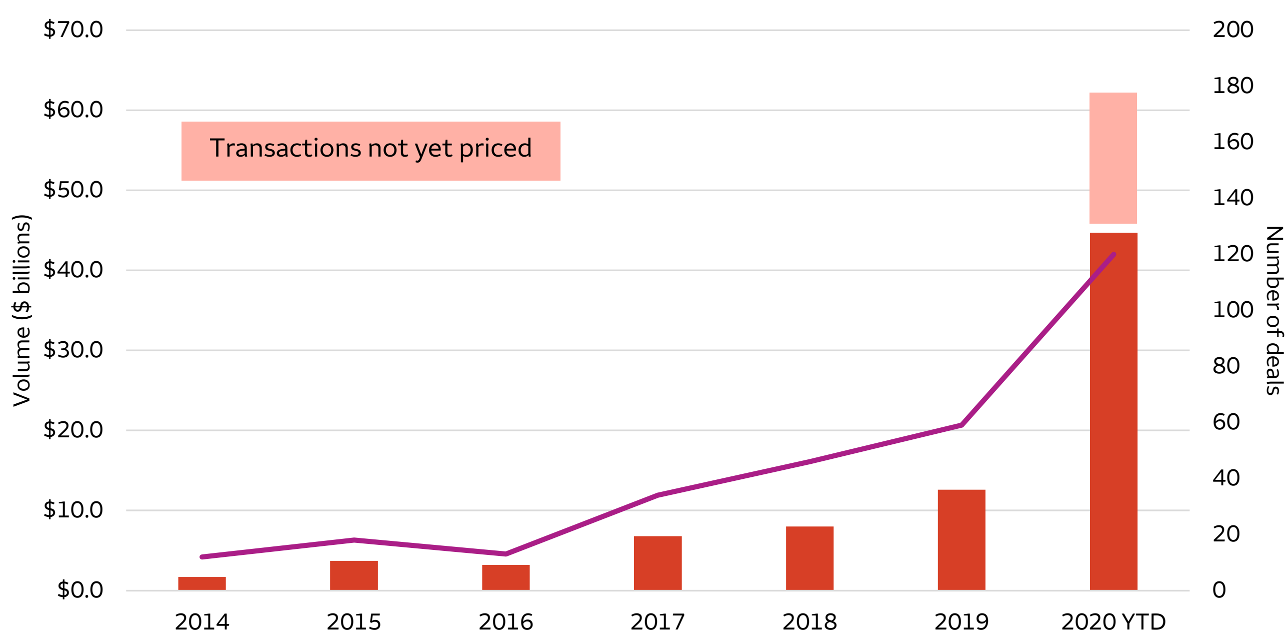
SPAC — The other acronym of 2020

It wasn't too long ago that SPACs were referred to simply as "blank check" companies. The Securities and Exchange Commission (SEC) defines a blank check company as a "development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person. These companies typically involve speculative investments and often fall within the SEC's definition of 'penny stocks' or are considered 'microcap stocks.'"

SPACs are essentially blank check companies that raise funds through an IPO. Proceeds from the IPO are used to effect a certain corporate transaction, whether it be a merger, an asset acquisition, a share repurchase or exchange, or even a reorganization of an existing (normally private) operating company. In other words, SPACs are highly concentrated investment vehicles that combine elements of both public and private equity investing. Given the truncated timeline relative to traditional private equity — a feature of SPACs discussed below — SPACs are considered by some to be "liquid private equity," an eyebrow-raising description that certainly bears caution. The key selling point of a SPAC is that it allows the public to co-invest with what are perceived to be successful sponsors who have the skill set to acquire and run a public company, and to do so in a relatively liquid structure.

The merits of this hybrid structure have certainly struck a chord with investors, sponsors, and owners, evident in the explosive growth (Chart 1) so far this year.

Chart 1. U.S. SPAC IPO issuance (SPACs greater than $100 million)



Sources: Dealogic, Wells Fargo. Market data as of October 1, 2020. YTD=year-to-date.

Soup to nuts — SPAC formation and cash flow

Creating a SPAC begins with the sponsor – normally an industry executive, private equity portfolio manager, or investment banker – creating a shell company. The role of this company is to serve as an "acquisition vehicle" that raises money through an IPO to purchase — within two years — a private, unlisted operating company. Once the target company has been identified and acquired, it is combined with the SPAC to create a listed operating company.

The idea of raising capital from a group of investors to effect change on a private company is certainly not a novelty. Traditional private equity firms have been doing this for decades through venture, growth, and buyout strategies. The important distinction is that SPACs invest in one company rather than a portfolio of companies, capital is raised through an IPO which circumvents the need to be a "qualified and accredited" investor, the investment horizon is much shorter than the five-year investment period often utilized by traditional private equity funds, and shareholders have an opportunity to redeem capital as well as approve the deal. Equally important is the concept of unitization and unit separation, which brings an element of "trading" into SPAC investing.

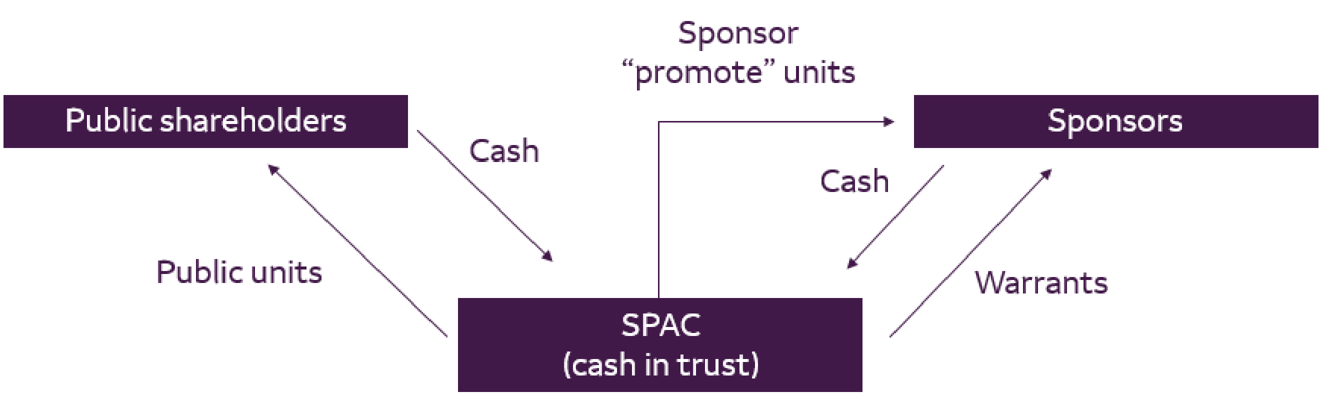
Unitization

Upon creation of the SPAC entity, the sponsor begins the process of raising capital through an IPO. Public investors purchase 80% of the equity of the SPAC while the sponsors retain the remaining 20% via "Founder Shares" issued at a nominal value. The security offered to the public in the IPO is referred to as a unit, and is comprised of 1 common share (priced at $10) and 1 warrant (exercisable at $11.50 per share for either 1/3, 1/2, or 1 common share after the business combination). Warrants have a term of 5 years and automatically convert if common shares trade above $18 after the business combination has been completed. All of the proceeds raised in the IPO are deposited into a trust account and invested in U.S. Treasury securities, typically with 60 days or less duration (a measure of interest-rate sensitivity).

Alignment of interest

In addition to the 20% ownership the sponsor retains in the SPAC, often referred to as the "promote", the sponsor will typically purchase warrants or additional units via a private placement. This is referred to as the sponsor's "at-risk capital" and is designed to better align the incentives between investors and sponsors. The amount of at-risk capital generally represents 2% of the SPAC IPO size plus an additional $2 million to $4 million to cover bank fees, expenses, and working capital. Sponsors contribute this at-risk capital to the SPAC and receive warrants with terms similar to those issued to IPO investors.

Chart 2. SPAC cash flow diagram



Source: Citi, SPACs: Event-Driven Primer & Analysis, September 2020.

Unit separation and trading
Post-IPO, most SPACs allow their units to trade separately as shares, warrants, and rights as soon as the 45-day overallotment (or "greenshoe") period ends. If they don't allow trading by then, they are normally obligated to allow trading 52-days after the IPO. Once trading begins, the common stock trades on a "yield to terminal trust" basis, while the warrants and rights trade at levels that reflect the market's expectations on the sponsor's ability to find and close an attractive deal.

Acquisition and shareholder rights

SPACs typically have between 18 and 24 months after the IPO to acquire a target, and the transaction size needs to be at least 80% of the cash held in trust. Interestingly, shareholders play a key role in the acquisition process —they can vote to redeem their cash (or not), and to approve the deal (or not).

To address the first shareholder right – redeeming cash if one no longer wants to invest in the SPAC - sponsors utilize a third party "backstop investor" to invest outside the trust, normally through a PIPE (private investment in public equity). This helps to ensure that the seller's minimum cash conditions still can be met in the event of SPAC investor redemptions.

For the second shareholder right – deal approval – if a majority of the shareholders vote "no" on a proposed deal, the sponsor has to find another deal within the remaining two-year window. If the sponsor fails to secure a deal, the SPAC is liquidated, and all cash held in the trust account is returned to shareholders inclusive of interest and net of taxes.

SPAC timeline — Start to finish for "liquid private equity"

There are six key stages along the SPAC timeline, each offering unique opportunities and risks for investors.

1. Formation: Sponsors generally are able to form a SPAC within one month, beginning with filing the registration statement and ending with the IPO itself. During this period, SPAC investors analyze the structure as well as the sponsor's track record (if available). This helps with determining capital allocation.

2. IPO: Once the IPO has occurred, and after a 45 day overallotment/greenshoe period, the SPAC is allowed to separate its units into common shares, warrants, and, if applicable, rights. IPO investors use this period to right size their allocation in the open market. Certain institutional investors that are precluded from investing in IPOs due to FINRA Rule 5130 can gain exposure in the secondary market during this time.

3. Separation/trading: After the units have been separated, various "trading oriented" investors look for exposure. This can include investors who buy warrants as a relative value and/or volatility instrument, or those seeking to lower their IPO cost basis by monetizing warrants.

4. Announcement: SPACs have 24 months post-IPO to close an acquisition. Once the announcement is made, the market price of the SPAC's securities will react based on the perceived quality of the deal, with prices migrating to or above the amount of cash held in the trust. Trading activity in the warrants and rights also increases. SPAC investors who prefer more visibility into the deal become engaged in this phase, often through PIPE transactions.

5. Record date: A record date is typically set within three months of the acquisition announcement. Sponsors engage in road shows prior to setting the record date, giving IPO investors the chance to engage with management and better understand the transaction. This analysis period is critical for shareholders who will soon vote on whether to redeem their capital (or not), and to approve the deal (or not).

6. Vote date/closing: Within three to five weeks of the record date, the shareholder vote occurs. If the transaction is approved, the SPAC typically closes within a week and trades as the new combined firm.

Structural improvements post-crisis

Like many investment vehicles, SPACs have evolved over the years, partly due to increased regulatory oversight and partly due to the natural tension between investors and sponsors to maximize both return and alignment of interests. Prior to 2008, SPACs were viewed as inefficient, with egregious fees and loose terms. Recent changes to SPAC structure, however, have been viewed favorably by nearly all parties involved (shareholder, sponsor, and business owner), a key driver of their explosive growth this year.

Table 1. Key changes to SPAC structure

	Old	New	Effect
Sponsor Promote* ***profits received in excess of invested capital***	20% at close of business combination	20% at close of business combination, but portions of capital are "locked-up" until stock price hurdles are met. Promote in shares and not units; at risk investment in warrants struck out of the money.	Improves alignment of interests with public equity investors, and reduces sponsor dilution.
Warrants	Priced at deep discounts	Priced out of the money (OTM) and expire 5 years after closing of business combination.	Reduces speed of warrant dilution and increases option value (convexity) of warrant.
Acquisition timeframe	Up to 30 months with the potential for extensions	18 to 24 months	Provides sponsors with ample time to close a business combination without damaging investor internal rates of return.
Acquisition approval process	~70% shareholder vote required	Simple majority	Approval predicated on meeting the minimum cash threshold that is agreed upon with the target company. This allows investors to vote "yes" for the deal, but still redeem their shares. Competitors can no longer practice "greenmail" and form voting blocks.
Proceeds held in trust	96% to 100%	100%+	Reduces downside risk for investors and expands universe of potential targets

Sources: Citi, Wells Fargo Securities, Company Filings, October 2020.

Top risks investors should understand

Because SPACs are unique investment vehicles, they carry unique risks. The list below is not exhaustive, but we believe it does cover the most important considerations that our investment strategy team has regarding SPACs. We would also remind investors to carefully read the prospectus prior to investment.

- Limited/negligible performance history to analyze — Investment professionals and even clients are able to analyze past performance of securities and funds, as they often have a slew of analytical software at their disposal to understand drivers of risk and return. Unfortunately, because SPACs are formed for the sole purpose of acquiring a specific company, there is no track record or operating results that investors can look at to evaluate the likelihood that the sponsor will achieve the investment objective. Investors can certainly look at the performance of previous SPACs and the returns that specific sponsors generated. But each deal is different, with important nuances that do not cleanly translate to future SPAC performance.

- Competition for deals – Despite being around for over two decades, SPACs are new kids on the block within the private equity world. The amount of private equity dry powder – currently estimated by Preqin to be $1.7 trillion as of July 2020 – dwarfs the $37 billion of unlevered SPAC capital available for acquisition.[2] This means that SPACs should face heavy competition from other investors, especially those needing to deploy cash quickly. Furthermore, these investors are often well-established firms with large infrastructure and resources that can give it an advantage in acquiring target companies.

- Loss of investment capital — As mentioned above, one of the most interesting and appealing tenets of SPAC investing is the ability of shareholders to make two distinct decisions: to redeem their cash or not, and to approve the deal or not. Despite these shareholder-friendly options, loss of investment capital can occur if the SPAC is unable to complete a deal prior to the expiration date listed in the offering documents. If this occurs, the SPAC will liquidate to its shareholders on a pro-rata basis, inclusive of any interest accrued but minus the expenses incurred seeking a business combination. Moreover, any outstanding warrants will expire worthless if the SPAC liquidates. And the stock price post-acquisition is susceptible to normal equity market volatility and potential loss of value.

SPAC in the saddle

The feverish growth in SPAC IPO volume recently has raised eyebrows as perhaps a sign of market exuberance. And while that may certainly be the case, there are potential benefits to investors, sponsors, and sellers that are also leading to increased deal volume.

For investors looking for private equity exposure, SPAC IPOs offer the potential for equity upside with reduced downside risk, given the ability to redeem if the transaction is unsatisfactory. For private company owners, taking a company public through a SPAC can be less disruptive to the employees as well as faster than a traditional IPO, while also providing more certainty in valuation relative to a traditional IPO. It also provides more flexibility for owners to retain exposure to their company. Finally, for sponsors, the economics can be favorable with the 20% promote plus upside in the warrants.

But investors need to understand that not all SPACs are created equal, and they should strongly consider the sponsor's ability to successfully target and run the combined company. There can be a significant opportunity cost for investors who lock up capital for two years only to redeem if the SPAC fails to target an attractive company, or if the deal fails to get shareholder approval. Perhaps an even more important consideration for investors is the ability of the sponsors to attract sophisticated investors who can support the transaction either directly or via PIPES. This is becoming a key differentiator within the SPAC landscape, and it is also leading to sponsor fee compression. Often sponsors will share promote with key investors in exchange for their expertise in underwriting and/or investing in certain sectors or industries.

SPACs are clearly garnering much attention within the investment world with many investors sharpening their pencils and working their way up the learning curve. While they may be appropriate for some investors, SPACs are clearly not appropriate for all. Our investment strategy team in Wells Fargo Investment Institute, along with our colleagues across the company, remain committed to analyzing the space and will provide updates to our analysis and guidance periodically.

[2] Citi, "SPACS: Event-Driven Primer & Analysis," September 2020.

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Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. All investing involves risk, including the possible loss of principal.

Alternative investments, such as private equity, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting.

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