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Going Public Circa 2020; Door #3: The SPAC

By Bill Gurley

19-23 minutes

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August 23, 2020: If you are looking past or through Covid — and why not, all of Wall Street is — the topic du jour in Silicon Valley is Special Purpose Acquisition Companies, or SPACs. SPACs are all the rage, and everybody and their brother have either raised one or are talking about raising one. What are they, and do they matter right now? Historically they have been a kind of back-door way for a company to go public, and as a result have historically had a sub-standard reputation. But in light of where we are in 2020, especially with regard to the degrading efficiency and sky-rocketing cost of capital through the structurally broken IPO process, SPACs may emerge as a legitimate third option for helping Silicon Valley companies efficiently and cost-effectively transition into the public markets.

SPACs — Background and Recent Trends

There is no need to rewrite the history of SPACs here, or even the recent trends. If you are not up to speed, I would point you to these resources, such that you have a footing on recent SPAC trends.

- Wikipedia Entry on SPACs
- Video summary from Bloomberg: "Here's How SPACs Work and Why They're So Popular"
- Deep dive from Connie Loizos at Tech Crunch: "Almost everything you need to know about SPACs"
- Reuters goes through the massive numbers involved: "Wall Street holds the cards as Main Street chases blank-check deal frenzy"
- Dan Primack on how the SPACs landscape is changing: "SPACs undergo fast evolution as they outpace traditional IPOs"

The are two key things to understand. First, there have been a record number of SPACs raised, and at a much higher capital raise per SPAC. As a result, the gross dollars sitting in SPAC is over $30 billion, and will likely finish the year over 300% higher than any previous year. The second key thing to understand is that this abundant supply of SPACs (arguably an over supply) is leading to competition. This competition is leading to improving terms for the targeted company and an overall lower cost of capital. So while the underpricing and true cost of capital of a traditional IPO is trending worse, the economics behind SPACs are actually improving. This is why SPACS are be a truly legitimate and preferable doorway into the public markets.

SPAC IPO Transactions – Summary by Year

For complete profiles on each individual SPAC IPO, please visit the **SPAC Profiles page** and click on a name.

Year	IPO Count	Gross Proceeds (mms)	Average IPO Size (mms)
2020	78	$31,258.6	$400.8
2019	59	$13,600.3	$230.5
2018	46	$10,751.9	$233.7
2017	34	$10,048.5	$295.5
2016	13	$3,499.2	$269.2
2015	20	$3,902.9	$195.1
2014	12	$1,739.2	$144.9
2013	10	$1,447.4	$144.7
2012	9	$490.5	$54.5
2011	15	$1,081.5	$72.1
2010	7	$496.5	$70.9
2009	1	$36.0	$36.0
TOTAL	**304**	**$78,352.46**	

** Includes over-allotment proceeds*
*** Last updated August 21, 2020 5:46 PM ET*

Let's do a quick walk-through of the three options a company has to transition into life as a public company.

Door #1: The Structurally Broken IPO Process

The traditional way of going public is systematically broken and is robbing Silicon Valley founders, employees, and investors of billions of dollars each year. This problem is getting worse every year, which led Barry McCarthy, the true pioneer of the Direct Listing, to deem the traditional IPO process "moronic." Here is the data:

The Cost ($ Billions) of Underpricing (1st Day Net Gain)

Year	# IPOs	Day 1 Underpricing	$$$ Underpriced
1980-2019	8,610	20.7%	**$197.89B**
2016	75	16.6%	$2.07B
2017	107	15.0%	$4.24B
2018	134	21.4%	$7.35B
2019	112	27.0%	$7.97B
2020 (1H)	58	31.0%	$7.8B
	Source: Jay Ritter, Univeristy of Florida, https://site.warrington.ufl.edu/ritter/files/2019/04/IPOs2018Statistics-1.pdf		

As you can see this problem is growing each year. The numbers from 2020 are truly astonishing. The average company that has gone public in 2020 was underpriced by 31%. This equates to a cost of capital of 31% + 7% (IPO fees) = 38%! And the total dollars of one-day wealth transfer in just 6 months of 2020 was $7.8B. This is way worse than any given year prior in absolute dollars, but it has only been 6 months! At this rate, 2020 IPO underpricing will transfer wealth of $15B in one day give-aways to Wall Street investment firms and their clients. Most of these companies are about 20% employee owned, so that is $3B right out of employees pockets.

Let's us first talk about how this is happening, and then we can touch on why it is happening. The traditional IPO process has seven basic key steps. The company runs a competitive bake-off to pick the underwriters. They prepare an S-1. They execute a road-show (in Covid we have proven this can all be done successfully online). Then — the next two steps are key — the underwriter hand-picks a price for the offering (ignoring modern market based approaches) and then they hand-pick who actually gets the underpriced shares. These are the two problematic steps. The next morning, the exchange (either the NYSE or NASDAQ) finally does a market-based matching process where we find out the real price of the shares (ironically this is the exact process used in a Direct Listing, also ironically the only people allowed to sell are the ones given the shares the night before). Shares then begin open trading and the company is forever public — the transom has been crossed.

Traditional IPO Process

There are two-fatal flaws to the traditional IPO process that are both addressed with Direct Listings. In every conversation about IPOs vs Direct Listings these are the only two things that matter, and they are precisely the two things that IPO advocates are embarrassed to discuss.

1. The traditional IPO process does not use a market-based approach (like an order-matching system) to efficiently match supply and demand and to discover price. This is despite the fact that almost all other financial assets are all priced/sold this way. Matching supply-demand through an electronic system is exceptionally straight-forward circa 2020.
2. Most potential buyers of stocks are blocked out of the IPO process. Access is limited to the best clients of the investment bank. Most investors have little to no shot of getting an IPO allocation.

So that is why the process doesn't work — but why things are getting worse? It has to do with the trends in how much effort the investment banks put into marketing and distribution, versus how much effort they put in historically. Twenty years ago, each investment bank had massive sales teams which were 10X larger than they are today. On an IPO, these commissioned sales executives would "hit the phones" to help make a deal successful (earning commission for each placement). Additionally, the multiple banks on a deal would sometimes have "jump-ball" economics. The more of the IPO shares you were able to place the higher economics your bank would earn on an IPO. Jump-ball economics, the sales commissions, and the majority of these sales people are all gone.

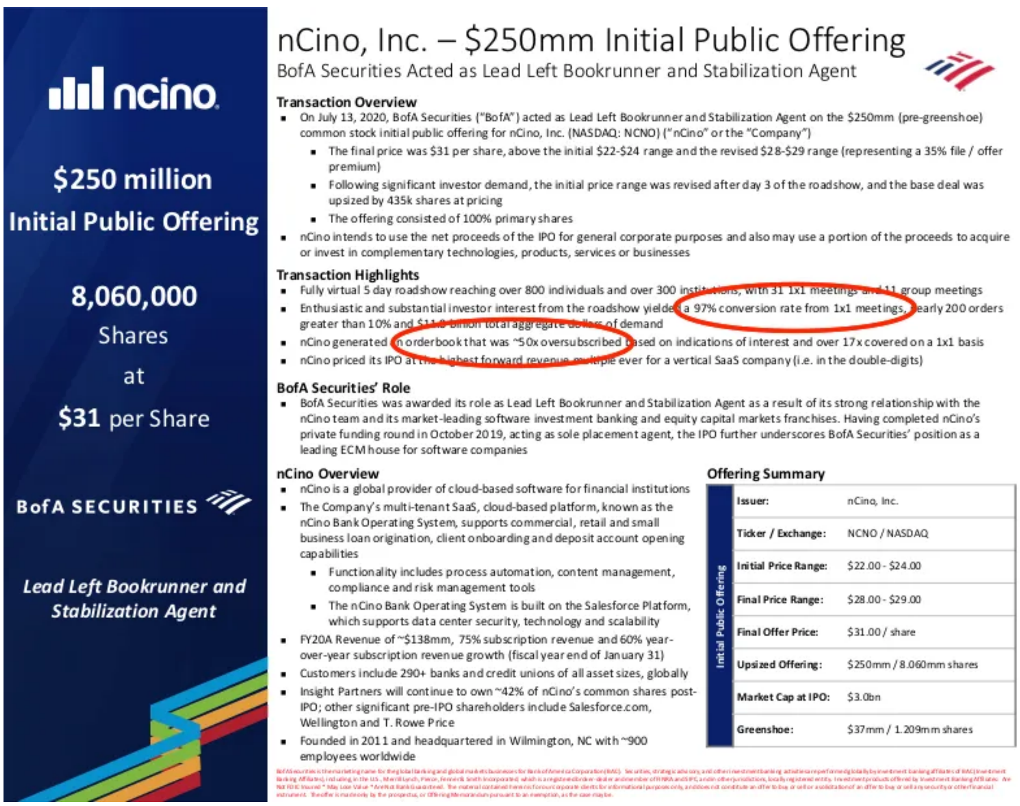
So what have they been replaced with? This is critically important to understand, partially because it's so outlandish. During each and every modern IPO, the banks all tell the management teams that there are two key objectives in the road-show process. And there are only two. Talk to any management team from any IPO in the past three years, and you will find they had this exact conversation.

1. For each 1-1 meeting you take, you are told you need 97% of the investors to "put in an order." They call this a 97% "hit-rate." Said another way, 97% of each and every investor you meet should have an interest in purchasing the offering.
2. You are told the "optimal" target is to be 30X over-subscribed. This is not a joke. You are told that you actually need 30X more orders than you actually plan to sell. This is an explicit admission that they plan to ignore 97% of the actual orders and fill only 3%. (One huge side note here — most investors are blocked from even putting in an order, including the majority of all retail

investors. So the “real” oversupply is likely much, much higher than 30X – simply because most investors are not even given the opportunity to show their interest [fatal flaw #2 above]. The real oversupply might be over 100X.)

Now imagine you are selling any other asset, be it a piece of art, a home, a piece of software, or perhaps your car. Where would you have to price that asset to ensure that 97% of the people that considered that purchase would make an offer, and you would have 30X more demand than you need? It is truly tautological that underpricing is happening, because this flawed process is being used by each and every investment bank. It’s worse than being “moronic,” it is financially illiterate. It is hard to imagine how anyone can suggest this is a good idea with a straight face. And it is increasingly hard to understand how a board of directors can legitimately exercise their fiduciary duty, while subjecting the company to such a strucurally backwards approach.

I would encourage you to “check-around” with people you know about these two idiotic objectives/goals that are about as far from a market-based approach as you can be. Below is a marketing email sent around by one of the participating investment banks after the recent nCino IPO (which was underpriced in record-setting fashion, 195% first day “pop” – “the biggest first-day surge since the 2000 tech bubble”). You will see highlighted in red the two key objectives that guarantee underpricing. Did anyone think about raising the price with demand and supply being off by 50x? Did anyone here take Microeconomics 101?


ncino

$250 million
Initial Public Offering

8,060,000
Shares
at
$31 per Share

BofA SECURITIES

Lead Left Bookrunner and Stabilization Agent

nCino, Inc. – $250mm Initial Public Offering

BofA Securities Acted as Lead Left Bookrunner and Stabilization Agent

Transaction Overview

- On July 13, 2020, BofA Securities (“BofA”) acted as Lead Left Bookrunner and Stabilization Agent on the $250mm (pre-greenshoe) common stock initial public offering for nCino, Inc. (NASDAQ: NCNO) (“nCino” or the “Company”)
  - The final price was $31 per share, above the initial $22-$24 range and the revised $28-$29 range (representing a 35% file / offer premium)
  - Following significant investor demand, the initial price range was revised after day 3 of the roadshow, and the base deal was upsized by 435k shares at pricing
  - The offering consisted of 100% primary shares
- nCino intends to use the net proceeds of the IPO for general corporate purposes and also may use a portion of the proceeds to acquire or invest in complementary technologies, products, services or businesses

Transaction Highlights

- Fully virtual 5 day roadshow reaching over 800 individuals and over 300 institutions, with 31 1x1 meetings and 11 group meetings
- Enthusiastic and substantial investor interest from the roadshow yielded a 97% conversion rate from 1x1 meetings, nearly 200 orders greater than 10% and $11.[illegible] billion total aggregate dollars of demand
- nCino generated an orderbook that was ~50x oversubscribed based on indications of interest and over 17x covered on a 1x1 basis
- nCino priced its IPO at the highest forward revenue multiple ever for a vertical SaaS company (i.e. in the double-digits)

BofA Securities’ Role

- BofA Securities was awarded its role as Lead Left Bookrunner and Stabilization Agent as a result of its strong relationship with the nCino team and its market-leading software investment banking and equity capital markets franchises. Having completed nCino’s private funding round in October 2019, acting as sole placement agent, the IPO further underscores BofA Securities’ position as a leading ECM house for software companies

nCino Overview

- nCino is a global provider of cloud-based software for financial institutions
- The Company’s multi-tenant SaaS, cloud-based platform, known as the nCino Bank Operating System, supports commercial, retail and small business loan origination, client onboarding and deposit account opening capabilities
  - Functionality includes process automation, content management, compliance and risk management tools
  - The nCino Bank Operating System is built on the Salesforce Platform, which supports data center security, technology and scalability
- FY20A Revenue of ~$138mm, 75% subscription revenue and 60% year-over-year subscription revenue growth (fiscal year end of January 31)
- Customers include 290+ banks and credit unions of all asset sizes, globally
- Insight Partners will continue to own ~42% of nCino’s common shares post-IPO; other significant pre-IPO shareholders include Salesforce.com, Wellington and T. Rowe Price
- Founded in 2011 and headquartered in Wilmington, NC with ~900 employees worldwide

Offering Summary

Initial Public Offering		
	Issuer:	nCino, Inc.
	Ticker / Exchange:	NCNO / NASDAQ
	Initial Price Range:	$22.00 - $24.00
	Final Price Range:	$28.00 - $29.00
	Final Offer Price:	$31.00 / share
	Upsized Offering:	$250mm / 8.060mm shares
	Market Cap at IPO:	$3.0bn
	Greenshoe:	$37mm / 1.209mm shares

Who benefits from underpricing? Clearly the people that are handed the shares in the hand-chosen allocation process. On the IPO process the underwriters are agents for both the company and the buyside (the shareholders who are allocated shares). The IPO may stand-alone as the only very high-dollar transaction in our world where a single agent represents both sides of the transaction. In real estate, dual agency is frowned upon for obvious reasons — *“At best, they say,* ***dual*** *agents can’t fulfill their fiduciary obligations to both parties. They can’t advance the best interests of both buyer and seller because those interests always diverge. At worst,* ***dual agency*** *creates a harmful conflict of interest.”* Institutional shareholders have many different financial relationships with these investment banks and much more frequent interactions than the banks have with any single company. As a result the conflict is real. It is therefore natural to assume that underpriced IPOs are allocated to the best brokerage customers (and that many of these dollars return to the investment bank vis commissions). This is backed up by academic research. It has also been uncovered in email threads. And it also makes sense in light of the dual agency. *Why would they give them to anybody else? Who would you give it to if you were in charge?*

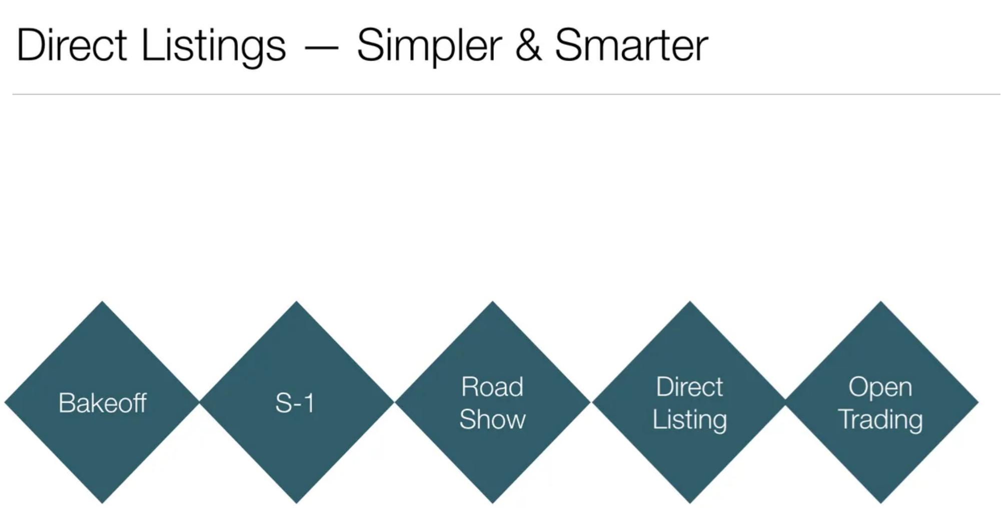
Door #2: The Direct Listing

When Spotify went public via a Direct Listing in 2018, it marked the heroic two-year work of Spotify's then CFO Barry McCarthy to bust open Door #2. The direct listing process is much simpler, is elegant, and uses modern market-based approaches to both price discovery and allocation. It is not overly complicated or sophisticated. I would argue that any first year finance student or computer science student would naturally assume this is how traditional public offerings already work (they would be wrong). You are just using a standard order-matching system to "match" supply and demand (as opposed to having the balance off by 50x).

So the Direct Listing avoids the two fatal flaws of the traditional IPO process:

1. It uses a market-based approach to matching supply and demand and discovering price. Precisely it uses an order matching system following the price-time algorithm.
2. Anyone with a brokerage-account (including Etrade, Schwab, or Robinhood, or any other) is invited to and able to participate/put in an order. It is open to all.

So how does it work? It is actually much simpler than a traditional IPO. You just remove the two steps where the shares are intentionally underpriced and then given to the investment bank's best clients. You still have the bake-off to pick an adviser and you still prepare an S-1. You also do a presentation to investors that are typically online and more detailed than an IPO. But then you jump straight to the market-based match. Many people don't know this, but the direct listing uses the exact same process and systems that are used to open every stock for trading each and every day. And they are the exact process and systems used to open a stock the next morning after the hand-priced, hand-allocated traditional IPO. So you simply remove the steps that have been causing the conflicts, biases, and underpricing. Smart.



As a result of fixing these two flaws, the Direct Listing Door (Door #2) is the simplest, most elegant, most fair (for all shareholders and the company) approach you can take. It is also the obvious choice for those board members that take fiduciary duty seriously — why would you chose to price something as important and valuable as your company's shares with a manual biased approach that has systematically produced poor results?

So when would you not use a Direct Listing? Today, you cannot use a Direct Listings to go public and simultaneously raise capital. As such, if you have a pressing need for more capital as you go public, Door #2 may not be for you. That said, the NYSE is working with the SEC on a proposal to add primary capital raises to a Direct Listing, and are rumored to be actively looking for a pioneering company to do this (as they did with Spotify on the first DL). If you talk to the market-makers that execute the Direct Listing they have zero technical concerns about how it would work. The company would just put these new shares in the order system. It is purely a regulatory question at this point. Outside of needing money, there is no reason to chose an IPO over a Direct Listing. As Michael Moritz noted in the Financial Times, "…the choice of a direct listing or a traditional IPO has become a test of two attributes: courage and intelligence."

Door #3: The SPAC Merger

So with that lengthy backdrop, welcome to the table a third way to enter the public market — through a SPAC merger. I will first walk through some important key points to think about with respect to SPACs in 2020, and then give you several reasons why they are a legitimate, timely, and cost effective way to enter the public markets.

Observations on the modern day SPAC market:

- SPACs are flexible and dynamic. Nearly every term in a SPAC, including the Sponsor share % (this can range from 20% all the way down to 0%), the Sponsor warrant coverage, the negotiated price with the seller, and even who is on the go forward board can change at almost any point in the process. Every thing is negotiable. As one SPAC board member declared, each SPAC is a “choose your own adventure” experience.
- The competition is real. There are so many SPACs that companies that want to use Door #3 can and should actively negotiate not just price, but also what % the Sponsor shares should be (while these have traditionally been 20%, Ackman took Sponsor shares all the way down to 0%!) as well as the Sponsor warrant coverage. There are now well over 100 active SPACs that have raised over $100mm. And when a SPAC is nearing its termination date, those Sponsor’s should be expected to be extremely flexible (if they don’t close a deal they will soon lose their initial capital commitment). Some companies are even running a process to meet with multiple SPACs — which is being called a SPAC-off. Banks can help you run such a process.
- The SPAC Sponsors you meet will understand the competitive issues in the market and will absolutely be prepared to negotiate and lower their economics (in terms of Sponsor percentage, warrant coverage or both). If you meet with a SPAC Sponsor that is unwilling to move on their key terms then you should “move on” from that Sponsor. Remember, there are well over a hundred fish in this sea.
- The PIPE has risks. Some are promoting PIPEs as “smart” addition to the SPAC. This is a follow on investment dollar grab above and beyond the newly raised dollars in the original SPAC. It is considered “smart” because these PIPE dollars don’t have the Sponsor “rake” on them. However, in light of the learned behavior of the buy-side in expecting sweetheart underpricings on traditional IPOs, a PIPE process creates an opportunity for a specific group of players to negotiate down price (which would offset the no-rake point).
- Your biggest risk with a SPAC is you don’t actually make it out. You agree on a price with the Sponsor, but then cannot get shareholder approval or have too many redemptions. Some SPACs (like Ackman’s) have features that make redemption less likely. Again, because of this risk the PIPE is problematic. It just invites more players in the mix, and therefore raises both the time to completion and the risk of completion. There are enough SPACs out there with different amounts of available capital. Find one that matches your capital need, and negotiate the terms (rather than use a PIPE).
- Does the Sponsor matter? The answer to this question is “potentially.” There are three factors to consider when choosing a Sponsor.
    - Are they willing to negotiate? (we already discussed this)
    - Do they understand your story better than most? You will be able to discern this in meetings.
    - Will they actively participate in telling the company story? And if so, how actively? This is a large unknown in the SPAC world today. Some Sponsors have a louder microphone, perhaps a higher profile, and perhaps a better reputation. That could impact the success of closing and the after-market price.
- VCs are more likely to participate as selling investors on the initial transaction in a DL or a SPAC. The key reason VCs never sell in a traditional IPO is because they all know the game is rigged (the underpricing), and do not want to sell at such a steep discount. As we find new doors to the public market that have truer/fairer pricing, you will see an increased willingness to participate. This may or may not matter to you depending on the circumstances specific to your company, your own capitalization chart, and the size of the SPAC versus how much capital you need.
- Is there a reputation issue with respect to going public through a SPAC? Some people, particularly traditionalists, will argue that going public through a SPAC might affect the long-term reputation of the company. While I understand this perspective, the argument is actually quite weak. Stock markets do not have have historical artifacts hidden in them. Once you are public, you are public, and you trade based on the discounted future expectations of your company, not based on how you went public. If your board has concerns about the company’s or the board’s public reputation, than they should be more worried about the inaneness of giving away $400mm in a one-day wealth transfer via an underpriced traditional IPO. That’s a true taint on the judgment of the company.

If you meet with a SPAC Sponsor that is unwilling to move on their key terms then you should "move on" from that Sponsor.

So what are the benefits to choosing Door #3 and using a SPAC to enter the public market?

1. SPACs have a much lower cost of capital versus a standard IPO. Even before negotiating terms, the SPAC is a cheaper way to go public (because of systematic underpricing). When you are able to improve the terms it becomes a clear no-brainer.
2. SPACs have access to primary capital which is an advantage versus today's version of a Direct Listing.
3. With a SPAC the company has much, much more control. The company negotiates the company value/price directly with the single Sponsor (as well as many other aspects of the transaction). If you like being in control, this is a good way to go. As I mention above, watch out for the PIPE as this has the potential to recreate the oligopoly power of the large institutional investors (and will likely lead to price reduction).
4. SPACS are a much faster way to become a public company. The SPAC door is much faster than an IPO or a Direct Listing, which will both take 6-7 months from beginning to end. With a SPAC you could be public in two-months from when you start the process (assuming you have your house in order). This time window may or may not matter to you.

The bottom line is that SPACs are a very legtimate path to the public markets. They have a lower cost of capital vs a traditional IPO. That cost of capital is falling due to market pressure, whereas it is rising for the IPO. The SPAC has fresh capital whereas the Direct Listing does not (yet), and the SPAC is clearly the fastest path to the public markets (which is a form of risk reduction). I fully expect to see high profile companies walk through Door #3.