SPAC Attack: everything a founder or investor should know

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15-18 minutes

If you're a founder or investor, you may be wondering what this SPAC thing is that everyone is talking about this week. And it is even more momentous than the press lets on: there is a frenzy of operators and investors within Silicon Valley that are either forming SPACs or investing in them, many of which are still under wraps. Keep your eyes peeled for high-profile venture funds and operators coming out of the SPAC woodwork in the coming months, as the kings of the SPAC game shift from Wall Street bankers to Silicon Valley techies.

Hot takes range from SPACs "disrupting IPOs" to being "a lousy deal for companies going public". There's a philosophical underpinning to the SPAC debate: SPACs let us dream of a world in which companies aren't dependent on stodgy bankers to go public. In theory, this world is fundamentally more decentralized and equitable.

But putting philosophy aside, as a founder going public, choosing the wrong path could cost you and your team millions in cash and equity. I found it surprisingly difficult to find a balanced and accessible introduction to SPACs and their tradeoffs, so I compiled everything you need to know.

What is a SPAC?

A SPAC is a Special Purpose Acquisition Company. In layperson's terms, this means a shell company is formed, raises money from investors, IPOs immediately after, finds a late-stage private company, then merges with them so that the late-stage private company is now public.

From the SPAC sponsor's viewpoint, it's like running a growth or PE fund that can only make one investment. From the late-stage company's viewpoint, it's a quicker and easier alternative to an IPO or corporate M&A process.

Why now?

SPACs have been around since the 1990s – why are they now back in vogue?

Let's not get carried away, SPACs are still relatively niche. There is $25B of SPACs looking for targets right now, which is the equivalent of one large PE firm – pretty small. And only $34.4B across 139 SPAC-driven transactions took place between 2017-2019, compared to $128B across 512 IPOs in the same period.

There are a number of reasons why SPACs are gaining public attention today – and record market volatility and retail investor trading volume have a lot to do with it.

Recent successes: SPACs have historically lost money for the SPAC shareholders, underperforming the market by 3% per year between 2010 and 2017. But there have been some recent high-profile successes in the past couple of years, all generating strong returns within a matter of months:

Robinhood era: IPOs are typically underwritten by old-school bankers, meaning that they target companies with revenue scale and a clear path to profitability. SPACs allow for companies to go public that'd otherwise struggle to IPO in a stable manner via a traditional banking process. In contrast to IPOs, SPACs are empowered to acquire more "exciting" businesses – in industries like space exploration, fantasy sports, or electric vehicles – that may appeal to retail investors (read: Robinhood traders). The recent Fisker SPAC announcement, for example, led to a 67% increase in the SPAC's stock in a matter of days – what Robinhood trader wouldn't want to see Tesla-style gains from a number two player? Another electric vehicle example: a SPAC called VectoIQ had their stock jump 3.4x *pre-merger* on solely the rumor of buying *pre-launch* electric trucking firm Nikola! Retail investors should be aware that these aren't always premium companies.

Volatility: Volatility can make IPOs expensive for companies going public. If your bank is too conservative and encourages you to price your equity at half of its public market value (euphemized as an "IPO pop" or "high coverage"), you're diluting yourself and your team twice as much as you need to. This effect is particularly acute in a year like 2020, when volatility is the highest it has been since 2008. High volatility periods make it preferable to lock in a price if you can – which is exactly what SPACs accomplish.

Institutional credibility: SPAC sponsorship used to be a common fee-generating strategy among tier 2 or 3 PE funds. While the SPAC sponsors made money through guaranteed fees, the investments themselves often lost money, which led to adverse selection on the deals. In the past few years, tier one names like Apollo, Michael Klein, Bill Ackman, and Chamath Palihapitiya have begun sponsoring SPACs, popularizing the process for higher quality companies. Increasingly, there are tech-forward people thinking about SPACs, both as sponsors and investors.

Decreasing structure: SPACs were historically used as an LBO equivalent with heavy deal structure: management changes, earn-outs, secondary sales, debt financing, and other financial engineering tools. Today, SPACs are becoming truer to an IPO-equivalent – fewer management changes, and a greater focus on technology companies with high growth potential.

Shifting access from private to public: In the dot com era, the conventional wisdom was to IPO after six quarters of revenue growth. This left massive gains for public investors – Amazon, Apple, Microsoft all saw 800x gains *after* their IPOs.

But then VCs got greedy. By the Softbank Vision Fund era, the IPO window had shifted massively: conventional wisdom has been to stay private until you simply can't raise any more private capital – which could get you to a $50B+ valuation. This minimizes gains for public investors.

Will the 2020s see a goldilocks IPO window? That's one promise of SPACs – at scale, SPACs should help to shift the IPO window earlier for companies with a more nuanced story. This gives public investors access to great companies early, and unlocks liquidity for early investors, employees, and founders.

SPACs vs. the alternatives

As a founder, does it make sense to take your company public via a SPAC? This is mostly a question of alternatives – corporate M&A, PE buyout, direct listing, or a traditional IPO.

From the founder's perspective, the closest alternative to a SPAC is a bank-led IPO. Existing shareholders get to keep the same upside potential, and the company ends up public either way. Unlike an IPO though, the process for the company is shorter – on the order of 6 months instead of 18 for an IPO. This makes SPACs generally less disruptive and closer to a financing round or M&A process in terms of team overhead.

There are a few key differences from a traditional IPO:

- **The "IPO pop" myth**: SPACs reduce the market volatility inherent in an IPO process, since you're negotiating a fixed price with a single buyer. When you IPO, you don't have a concrete sense for pricing until you run a full roadshow process with bankers – and if pricing changes during your roadshow, it's too late to change banks and too expensive to cancel the process. Recent bank-led IPOs like nCino show how bad of a deal IPOs can be for late-stage companies. As Bill Gurley pointed out, if your IPO is 50x oversubscribed, that probably means the existing shareholders are getting a bad deal. I spoke to Jay Ritter, professor at the UF Warrington College of Business, who shared how egregious IPO pops can be: of the 58 operating company IPOs in the first six months of 2020, the equally weighted average first-day return was 31%, higher than any year since the dot com bubble. This means that $130m in existing shareholder value was left on the table *per IPO!* Admittedly, investors can't pull this money out until their lockup is over and the float is substantive, but the cultural emphasis on the IPO pop is a clear market inefficiency. Bankers are playing an iterated game with IPO investors, but a one-time game with your company. Bankers need to make sure they don't lose money on their IPO underwritings, but don't forget that a post-IPO pop is a direct wealth transfer from existing shareholders to IPO investors.

- **Deal structuring flexibility**: In the SPAC universe, it is more common to have milestone-based compensation for execs, contingent SPAC fees, secondary sales, and other deal structures that can align company and investor incentives. Every facet of SPACs is bespoke, so the sponsor and the company can negotiate management incentives, secondary sales, dilution, debt, lockup periods, or any other bells and whistles they want. While this is theoretically possible via IPOs, they tend to have more rigid deal structures than SPACs.

- **Financial forecasts**: S-1s prohibit companies from including financial forecasts. SPACs, on the other hand, have a private due diligence process which allows companies to present financial forecasts. This opens up SPACs to merge with more vision-driven or high-growth earlier stage companies, where the trailing financial profile is not representative of the company's trajectory.

Will SPACs eat IPOs? Probably not. IPOs still have a lot of benefits for founders:

- **Potentially higher price**: Founders may not want a guaranteed SPAC price if the IPO price could (in theory) be even higher.
- **Fees**: IPO fees can be lower than SPAC fees, depending on the company and deal structure. I expect that over time, the fee structure of SPACs will become more compelling as PIPE:SPAC ratios increase (fees taken primarily as % of SPAC), warrants come down, and more founder-friendly SPAC sponsors come onto the market over the next 2-3 years.
- **Control**: Founders have more control over their press cycle and investor base.
- **Culture**: There is still a big cultural premium on "ringing the bell".

Some businesses are structurally better suited for IPOs today – particularly those with 1) a straightforward growth and margin story, 2) a clear set of comparable public companies, and 3) strong pre-existing investor demand. But as SPACs mature and become increasingly founder friendly in terms of fees and pricing, an increasing percentage of companies may be better off going public via SPACs.

SPAC sponsor timeline

From the SPAC sponsor's perspective, the timeline from SPAC formation to closed transaction can take 24-30 months.

💰 **Raise SPAC, IPO (2+ months)**: This can take anywhere from 2 months to much longer, where the key bottleneck is your ability to raise a few hundred million dollars for a blank check. SPAC investors are buying into your ability to find a great late-stage acquisition target, with no certainty as to what that company may be. This period involves auditor engagement, SPAC incorporation, S-1 preparation, SEC filing, a roadshow, and closing / funding the IPO. The average SPAC size was $230m in 2019 across 59 deals. The convention is to price SPAC equity at $10 per share, and the shares trade within a narrow band around $10 until an acquisition target is found. Pre-merger SPAC shares may trade at a slight premium if investors are confident in the SPAC sponsor – e.g. Hedosophia II, run by Chamath Palihapitiya, was trading around $13/share at the time of this article despite still searching for an acquisition target. There are currently 99 active SPACs seeking acquisition targets.

🔍 **Find acquisition target (6-18 months)**: SPAC agreements typically allow for a 24 month window to find and acquire a company. During this period, the SPAC is a public company with nearly blank financial statements. Given the merger itself takes 4-6 months, the SPAC sponsor must find their target in the first 18 months in the SPAC's lifespan.

The SPAC sponsor typically comes up with a list of target late-stage companies, and engages each one to better understand their business and financing needs.

🤝 **Execute transaction (4-6 months)**: The execution of the acquisition takes 4-6 months, requiring due diligence, preliminary tender offer documents, and 8-K filings. SPAC investors must then approve the transaction – if they reject the transaction, it means deal renegotiation or back to the search process. During the tail end of this process, the SPAC sponsor will coordinate a second group of investors who invest into the company alongside the SPAC via a PIPE (private investment in public equity).

PIPE investments typically accompany the de-SPAC transaction, which essentially adds more equity leverage to the SPAC. SPAC sponsors coordinate the PIPE capital raise from hedge funds and PE firms, who are tagging along for the ride. The ratio of PIPE to SPAC money is typically between 2:1 and 3:1. This means that a $400M SPAC could effectively generate a total transaction size of $1.2-1.6B.

There will be fees of around 20% of the size of the original SPAC (excluding the PIPE amount), which goes to the SPAC sponsor in the form of equity – this effectively means a blended fee of 5-6% for the company as a percentage of total capital raised, fairly similar to the 5-7% for a traditional IPO. SPAC fees are mostly equity-based to align the SPAC sponsor and the company, in contrast to the primarily cash-driven fees for IPO bankers. SPAC fees can also be performance-triggered to incentivize fair pricing, such that a portion of the fees will be withheld unless the stock price crosses a certain threshold. Some SPACs use outside bankers to execute the de-SPAC process, which can add some cash fee overhead.

🕴 **Manage investment**: After the acquisition, the SPAC sponsor looks like a large investor, where they can take a board seat or two. For more PE-style SPACs, this could involve active management and control by the SPAC sponsor. I expect the SPACs of the 2020s, run increasingly by techies, to adopt the founder-friendliness ethos that defines Silicon Valley.

SPACs often incorporate warrants and earn-outs to further align sponsor and company incentives. This gives the SPAC investors the right to purchase additional stock post-merger, unlocking asymmetric upside for them. These equity and milestone-driven compensation structures tend to align investors and companies more than the historical SPAC structures that were focused on squeezing out fees.

Future of SPACs

Between direct listings and SPACs, banks will no longer be the sole gatekeepers of what goes public. And the SPAC sponsors may shift from structure-oriented PE firms to tech-forward VCs – there are natural synergies given late-stage VCs' synergies with their existing portfolio companies and access to the best companies. I view this as an inevitability as VC firms build out an array of products to support companies throughout their entire lifecycle – a critical leap towards building Sand Hill Sachs.

As SPAC fees compress and founder-first SPAC sponsors enter the market over the coming months, they'll become an increasingly compelling option for founders to take their companies public.

Bankers that lean into SPACs will get to capture more company upside and sell their services earlier in the company lifecycle. Those that don't should be nervous: SPACs may be another step in the startup value creation process that slips out of their hands, and into the hands of private investors.

SPACs won't disrupt IPOs entirely. But they give us hope of a future where companies can go public independent of the archaic and conservative banking institutions that have misaligned incentives on valuation and fees. I think this hope is well-founded. The SPAC model is more decentralized and ad hoc than the bank-led IPO model, which should be good for founders and investors alike. SPACs aren't for every company, but every founder should consider them as an alternative path to going public.

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