An Introduction to SPACs

-Safehouse Team

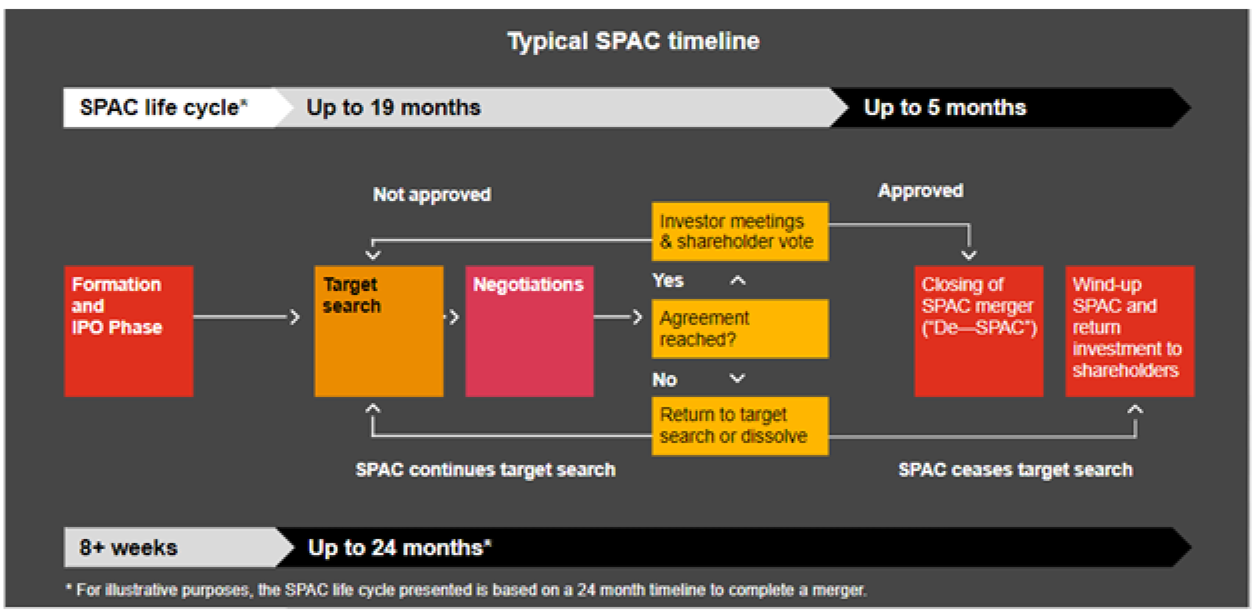
If you've been following the stock market in the past twelve months, you've probably heard the term Special Purpose Acquisition Company, Blank Check Company or SPAC quite often. While SPACs have been around for a while, the recent acceleration and the "rise of SPACs" has frequented headlines in 2020. Below we do our best to simplify the most important elements required to understand SPACs.

An Introduction to SPACs

A Special Purpose Acquisition Company (SPAC) is a shell company that lists on the stock market with the goal of acquiring or merging with a private company. By acquiring/merging with a private company, that private company (or target) in turn becomes a publicly traded company. Like an Initial Public Offering (IPO) or direct listing, this is a method for private companies to go public or list on the stock market.

So how is a SPAC formed and when does a deal happen?

Typically, a renowned investor (the Sponsor) raises money from a group of investors and pools the funds into one vehicle (forming the SPAC). A prospectus is issued once the SPAC lists on the market. Most SPACs list at a "par" value of USD 10 per unit to make the math easy. So, if you know a SPAC is raising USD 100mn at USD 10 a unit, then you know there will be 10 million units issued. Once the money is raised, the sponsor usually has up to 2 years to acquire a stake in a private company. In the meantime, the money sits in the bank generating a nominal yield until a deal happens.



Source: PwC

It is important to understand that the timeline of a deal happening is uncertain, it may take anywhere from 1 month to up to 24 months to happen. The objective is to give the sponsor enough time to hunt for a great deal. If no transaction takes place, the money (with interest but net of listing expenses) is returned to investors. Once an offer is made and accepted, shares of the private company roll into the SPAC (usually within 30 days) in return for the cash investment from the SPAC. The merged companies are now a single publicly traded company.

Here's an example:

1. "SPAC A" raises USD 100mn from investors at USD 10 per unit (units will be explained later)
2. "SPAC A" lists on the market with 10mn units
3. "SPAC A" identifies an interesting company "Target" worth USD 1bn
4. "SPAC A" acquires 10% of "Target" for USD 100mn (offering can be primary/secondary)
5. "Target" is now listed on the market and open to any investor to buy shares

SPACs are better than IPOs because:

- Quicker route to public markets
- Company management continues running business and is not distracted by a roadshow
- Company management has more control over the price/valuation
- All investors have the ability to buy shares of a SPAC upon listing
- Lower cost transaction

Is that all you need to know? Most certainly not.

When SPACs first list on the market, they list in "units". Typically, 1 unit is equal to 1 share of common stock + part of a warrant depending on the terms established. Warrants give their owners the right to buy common stock at a predetermined price (strike price). Let's assume units trade at USD 10 and entitle you to 1 share of common stock + 1/3 warrant, and warrants have a strike price of USD 11.5, then a warrant gives you the right to buy shares at USD 11.5. What this also means is that for every 3 shares, 1 new share may be issued if the share price is over USD 11.5 and all the warrants are exercised (the owners of the warrants decide to pay USD 11.5 to buy additional shares). As a result, shareholders that only own common stock may be diluted once the warrants are exercised.

Here's an example:

1. "SPAC A" raises USD 90mn at USD 10 per unit therefore issuing 9mn units
2. Each unit converts to 1 common stock + 1/3 warrant
3. Common stock and warrants are now both tradable (new shareholders can buy either or)
4. "SPAC A" acquires stake in "Target"
5. "Target" becomes a publicly traded company
6. Stock price moves above warrant strike price (assumed for this example)
7. All warrant owners exercise their warrants (3mn new common stock issued)
8. Total capital raised becomes c. USD 125mn (90+3*11.5)
9. Total share count goes from 9mn to 12mn (25% dilution =9/12-1)

If a shareholder does not own warrants and only owns shares, he/she can be diluted by up to 25% in this example. To be conservative, always assume full dilution.

What if you don't like the proposed merger?

It should be noted that before a deal combination occurs, all shareholders are given a chance to redeem shares at the original issue price (with interest and less expenses) ie. c. USD 10 per share. Even though a vote takes place before the deal closes, investors can redeem their shares regardless whether they have voted for/against the combination. This can create an asymmetric risk reward profile for investors who buy shares close to NAV as they are guaranteed a chance to redeem at USD 10 per share (worst case) and therefore downside is limited.

Buying at close to NAV locks in your downside due to redemption rights.

So how does the sponsor make money?

The sponsor, who is being trusted by investors to make a great deal, often has an asymmetric compensation mechanism. For most of the SPACs you read about, the sponsor can pay USD 25,000 for 20% of the SPACs common stock (Founder shares). Let's think about what that means in dollar terms.

"The typical compensation for SPAC sponsors comes in the form of so-called founder shares which entitle the sponsor to 20% of the SPAC's common stock for an investment of $25,000 (this is not a typo!), which the sponsor receives if it completes a transaction. For example, a sponsor that raises a $400 million SPAC will receive 20% of its common stock, initially worth $100 million, if they complete a deal, whether the newly merged company's stock goes up or down when the transaction closes.

In other words, if the stock of the newly merged company in the above example declines by half after the transaction closes, the sponsor's common stock will be worth $50 million, a 2,000 *times multiple of the $25,000 invested by the sponsor, a remarkable return for a failed deal. This value is realized by the sponsor while their shareholders have lost half of their investment. To make matters worse, many sponsors receive additional fees for completing transactions, which can include tens of millions of dollars in advisory fees, often paid to captive "investment banks" that are often 100% owned by the sponsors themselves."*

- **Bill Ackman (Pershing Square Semi-Annual Letter to Shareholders, August 2020)**

The right SPAC = The right Sponsor

At the end of the day the most important factor in determining the risk reward of a SPAC is the Sponsor behind it. The track record, experience and reputation of the sponsor will allow them to raise money quickly, source great deals and price the deal efficiently. With the rise of SPACs today, Sponsors act as the key differentiator for investors who wish to determine which SPAC to invest in.

"Since 2015, the 89 SPACs that have completed mergers have an average loss of 18.8 percent (and a median loss of 36.1 percent), compared with the average aftermarket gain of 37.2 percent for other IPOs through July 24, according to Renaissance Capital, which tracks IPOs. Only 29 percent of the SPACs had positive returns." – **Michelle Celarier**[1]

For those of you who want to learn more about SPACs, we suggest you read the following articles:

https://abovethecrowd.com/2020/08/23/going-public-circa-2020-door-3-the-spac/

https://techcrunch.com/2020/08/21/almost-everything-you-need-to-know-about-spacs/

https://corporatefinanceinstitute.com/resources/knowledge/strategy/special-purpose-acquisition-company-spac/

https://www.winston.com/images/content/1/3/v2/135061/Winston-Strawn-SPAC-Basics-Presentation-2018.pdf

https://www.publiclytradedprivateequity.com/portalresource/SPACsOverview.pdf

The best SPAC out there: Pershing Square Tontine Holdings

At Safehouse, we invested in our first SPAC almost a year ago when Chamath Palihapitiya of Social Capital successfully took Virgin Galactic public. He has and continues to be an advocate of companies going public through SPAC mergers, calling it "efficient, timely and transparent" and coining the term "IPO 2.0". This is what really put SPACs on the radar for us and we continued to monitor new issuances in the market. Today, we are invested in what we believe is the best SPAC available to equity investors, Pershing Square Tontine Holdings (PSTH).

[1] https://www.institutionalinvestor.com/article/b1ngx7vttq33kh/Egregious-Founder-Shares-Free-Money-for-Hedge-Funds-A-Cluster-k-of-Competing-Interests-Welcome-to-the-Great-2020-SPAC-Boom

Around three months ago, legendary investor Bill Ackman, raised a USD 4bn SPAC, the largest in history. At USD 20 per share, Ackman raised 200mn shares and is pledging a minimum of USD 1bn and up to USD 3bn of Pershing Square Holdings' capital taking the SPAC size up to USD 7bn. While the size limits the number of candidates PSTH can merge with, it also means the company will have no competition when making a bid and in turn have more bargaining power than the rest of the SPACs out there. In this instance, size matters. Each unit of PSTH is made up of 1 share of common stock, 1/9 redeemable warrant and 2/9 warrants only exercisable above USD 23 (strike for both sets of warrants) once the deal is completed. This encourages investors to hold onto shares until the deal closes, unlike other SPACs where investors can sell their warrants once the unit conversion takes place.

Ackman has been a vocal critic of the 20% sponsor shares that typical SPAC founders receive and instead, Pershing will pay c. USD 68mn for warrants to receive c. 6% of the combined entity only after reaching a 20% hurdle rate (USD 24). They have also agreed to not exercise these warrants for three years after the deal is completed. This ensures that Pershing's incentives are aligned and is not the typical "free" 20% that most Sponsors receive today. We have yet to come across a SPAC with such favorable terms for investors.

Combining the above elements with Bill Ackman's track record makes this an asymmetric risk reward for investors today. Bill Ackman's last SPAC which acquired Restaurant Brands in 2012 compounded at c. 19% per year for the last 8 years[2], we think history can repeat itself. Theoretically, a SPAC should not fall below its cash value as investors can redeem their shares and get their money back at par value. Therefore, until a deal is announced, PSTH acts as a cash proxy which will likely monetize once Bill decides to pull the trigger.

As we mentioned earlier, the sponsor is the most important element in determining the risk reward profile of a SPAC. The risks are that Bill makes a bad deal (and shareholders don't redeem), or that the market rallies 50% and PSTH remains close to cash value, sunken opportunity cost. Yet if the market corrects, this should remain close to cash value and one could argue that market multiples will derate offering Ackman an even better ability to secure a well-priced deal. From where we stand, this is unquestionably one of the best opportunities in the market today.

As always, please don't hesitate to reach out to us at any time.

Regards,

The Safehouse Team

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[2] https://www.institutionalinvestor.com/article/b1ngx7vttq33kh/Egregious-Founder-Shares-Free-Money-for-Hedge-Funds-A-Cluster-k-of-Competing-Interests-Welcome-to-the-Great-2020-SPAC-Boom

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