



## Riding the SPAC Wave

### A webinar hosted by the Harvard Business School Healthcare Alumni Association

On March 17<sup>th</sup>, 2021, the Harvard Business School Healthcare Alumni Association hosted a webinar to discuss one of the hottest financing trends: Special Purpose Acquisition Companies (SPACs). The panelists were **Chris Ehrlich** (CEO of Locust Walk Acquisition Corp. and Senior Managing Director and Head of New Ventures at Locust Walk), **Rekha Hemrajani** (CEO & Director of Jiya Acquisition Corp.), and **Sanjay H. Patel** (Chairman International and Senior Partner of Private Equity of Apollo Management). Josh Lerner of Harvard Business School and the Private Capital Research Institute (PCRI) served as the moderator. The HBS Private Capital Project and the Private Capital Research Institute are distributing this summary due to interest in the discussion.

For decades, initial public offerings (IPOs) have served as the go-to route for growth companies to raise capital and attract investors, but recently SPACs have given IPOs a run for their money. As the Financial Industry Regulatory Authority recently noted, “an unprecedented number of companies are pursuing an alternative path to entering the public market using a SPAC.”<sup>1</sup> In fact, in 2020, 248 SPACs raised \$75.3 billion (before including overallotment option shares), a sum greater than both the volume of traditional IPOs in 2020 and the sum of all capital raised in the entire history of SPACs through 2019.<sup>2</sup> By mid-March 2021, the 2020 record had already been broken.<sup>3</sup> With early wins and losses, there is heightened interest in the longevity of SPACs.

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<sup>1</sup> FINRA. *Investing in a SPAC*. 29 Mar. 2021, <http://yahoo.com/news/investing-spac-160000227.html>.

<sup>2</sup> Minmo Gahng, Jay R. Ritter, and Donghang Zhang, “SPACs,” Unpublished working paper, Warrington College of Business, University of Florida, 2021, <https://site.warrington.ufl.edu/ritter/files/SPACs.pdf>.

<sup>3</sup> “Riding the SPAC Wave.” *HBS Healthcare Alumni Association*, 2021,

At the outset of the discussion, Lerner reminded everyone that even though SPACs are currently hot commodities, they are not new inventions. The first SPACs were created in the early 1990s. Since then, we have seen three waves of SPAC activity. The first wave included SPACs that raised very little capital in offerings often underwritten by little-known banks, and subsequently traded in over-the-counter markets. The second wave occurred after the 2007-2008 financial crisis. During this period, SPAC activity became more institutional and larger, as SPACs primarily focused on buyout activities. In the current wave, SPAC activity has more of a venture-like flavor. The technology and healthcare industries are among the many sectors where we are seeing this phenomenon.

### *The SPAC Perspective*

The panel began by sharing their perspectives on what characteristics make a target attractive to a SPAC. As a precursor to answering that question, panelists noted that over the past 20 years, the number of U.S. public companies has shrunk from about 8,000 to 6,000.<sup>4</sup> This fact may be attributable in part to the obstacles of going public.

As SPACs transactions are more expeditious than traditional IPOs, SPACs are seen as a less cumbersome and faster route to public markets. However, investors may fear that SPACs could result in companies going public earlier than they should. As a result, many investors feel the lengthy nature of the traditional IPO is a “blessing in disguise.” The prolonged IPO process gives a company, whether young or later-stage, time to get prepared to enter the public market domain, especially with respect to corporate governance, the management team, research relationships, and the like. Therefore, the panelists emphasized the importance of identifying whether a target is ready to go public. For instance, a business should be able to deliver on their promises to investors on a quarterly basis. Companies should also have a highly skilled team, especially a sophisticated investor relations teams and

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[www.hbshealthalumni.org/s/1738/cc/index2.aspx?sid=1738&gid=11&pgid=71051&content\\_id=99958](http://www.hbshealthalumni.org/s/1738/cc/index2.aspx?sid=1738&gid=11&pgid=71051&content_id=99958).

<sup>4</sup> Israel, Spencer. “The Number of Companies Publicly Traded in the U.S. Is Shrinking—Or Is It?” *MarketWatch*, October 30, 2020, [www.marketwatch.com/story/the-number-of-companies-publicly-traded-in-the-us-is-shrinking-or-is-it-2020-10-30?mod=investing](http://www.marketwatch.com/story/the-number-of-companies-publicly-traded-in-the-us-is-shrinking-or-is-it-2020-10-30?mod=investing).

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the right CEO and chief financial officer. At the same time, SPAC sponsors are also looking for companies with the same tremendous upside potential as the typical IPO.

### *The Entrepreneurial Perspective*

Next, the conversation shifted to the entrepreneurs' perspective: why should entrepreneurs choose to take their companies public through a SPAC?

The panelists mentioned that in some cases, the SPAC sponsors need to educate CEOs and boards that a SPAC is not just a "poor man's substitute" for an IPO. Instead, they highlight to boards and entrepreneurs that SPACs have attributes that make them a more attractive alternative to an IPO, such as their speed and valuation certainty. Moreover, SPACs allow for a target company to negotiate with essentially one party. Thus, they do not have to communicate with 20, 30, or even more potential investors to get to their buy in on the valuation or the desirability of investing in the first place.

An added benefit is the private placement in public equity (PIPE) that sponsors frequently orchestrate as the merger of the SPAC with an operating company, providing an injection of liquidity to the firm (also known as a forward purchase agreement). It is commonplace in biotechnology SPACs for the syndicate to invest in a substantial PIPE, given the target company has a significant advantage. Unlike other sectors, many companies in the biotechnology industry need to do a mezzanine or crossover round as a precursor to going public in a traditional IPO. This two-step process can be arduous, and there may be much volatility in the market during the extended process timeframe. Contrastingly, a SPAC transaction is a one-step process, wherein the PIPE and merger transaction are negotiated and finalized. That is to say, the risks of market volatility are greatly dampened with the SPAC transaction.

Lastly, a SPAC deal can lead to a much larger transaction than a traditional IPO. Thus, for some businesses, SPACs can be a valuable tool. But the company must fully understand and be comfortable with the process, and the SPAC tool must serve their own objectives and address their capital needs.

### *The Board Perspective*

Lerner then turned the discussion to address the question from the perspective of potential board members, asking specifically about the characteristics of an ideal SPAC board member. The panelists responded by emphasizing the peculiar nature of SPACs. They are CEO-led companies with minimal expenses, no employees, and no compensation. Thus, the traditional task of nominating, compensation, and governance committees are thus much less relevant here. At the same time, having an active and interested board is appealing. Just as in private capital-backed firms, boards tend to be small. Board members are deeply involved with diligence and sourcing. The right board members can also be attractive for potential merger candidates.

### *The Misalignment Issue*

The panel shifted to the topic of SPACs and their incentives. Lerner began the discussion by referring to a statement made by the interim Chief Investment Officer of CalPERS, at its investment committee meeting on March 15, 2021. Referring to SPACs, Dan Bienvenue was quoted as saying, “...it is an area that’s fraught with potential misalignment, potential governance issues. There are certainly challenges there.”<sup>5</sup>

The panel agreed with the concerns voiced in the statement and then shared insights on how to best address these issues. Discussants noted that there are two primary misalignments. First, SPACs must close a deal in two years or will need to return capital. In some cases, SPACs will pay any price just to get a deal done, especially if the SPAC is approaching the end of its two-year period. Second, whether or not a sponsor truly adds value to the deal can vary. Sponsors that add genuine value to a deal do so through significant capital investments, considerable experience, or a large platform. The panelists stressed that sponsor value addition is especially important in the biotechnology space because there exists the challenge of convincing investors to put capital into young R&D-focused firms.

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<sup>5</sup> Mendoza, Carmela. “CalPERS’ Bienvenue: SPACs Are Fraught with Potential Misalignment.” *Private Equity International*, 16 Mar. 2021, [www.privateequityinternational.com/calpers-bienvenue-spacs-are-fraught-with-potential-misalignment/](http://www.privateequityinternational.com/calpers-bienvenue-spacs-are-fraught-with-potential-misalignment/).

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To align incentives, the discussants touched on several innovations. For instance, a panelist noted that excluding warrants from deals has proven successful because it reduces dilution. Other areas with extensive innovation related to performance compensation—e.g., making payments to the sponsor contingent on stock price performance—and the utilization of large forward purchase agreements. The panelists were optimistic that we would see more efforts to align incentives.

#### *A SPAC Bubble?*

As the SPAC surge continues, the audience asked the panelists about the state of the current environment, specifically questioning whether we are in a SPAC bubble. The panelists noted that during the initial phase, investing in SPAC IPOs is completely logical in a zero-interest-rate world because investors have the option to look at the deal the sponsor is making and, even if they find it unappealing, to receive Treasury-like or higher returns.

However, the panelists did warn of absurdly high valuations associated with some recent SPACs (as well as in the IPO market more generally), and foresaw a shakeout in this industry. In this respect, SPACs are little different than other public market innovations: a lot of people rush in, but after a shakeout, there is an institutionalization process. Consequently, today's crop of SPACs will see both mediocre and good deals done. Sponsors should thus be advised to make smart, thoughtful transactions and be wary of rash decision-making.

#### *A U.S.-Only Innovation?*

The majority of the discussion had focused exclusively on the U.S. market. Some panelists stated that there is potential for considerable opportunities internationally, especially in Europe, Israel, and parts of Asia. Indeed, a number of countries have also seen the emergence of SPACs. It is still unclear whether the bulk of the activity involving non-U.S. firms will be a “coming to America” story, where the companies list in the U.S. capital markets. Panelists pointed to some private European companies that have no interest in moving to the U.S., due to GAAP accounting regulations and other considerations. It still remains unclear how widely and enthusiastically non-U.S. securities regulators will embrace SPACs.

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### *Final Thoughts*

SPACs are gaining traction. The sector is still young and evolving. The panelists likened SPACs to public venture capital. However, they noted that a venture firm can invest in one to two dozen early-stage companies, and it is expected that some will be total losses. A SPAC, on the other hand, does not have that luxury. As a result, SPAC sponsors and investors should be disciplined both in picking assets and assessing firms so that this innovation can successfully evolve and the market can remain healthy.