

# What's special about a venture capital SPAC?

## An analysis of VC-focused special purpose acquisition companies

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### Key Takeaways

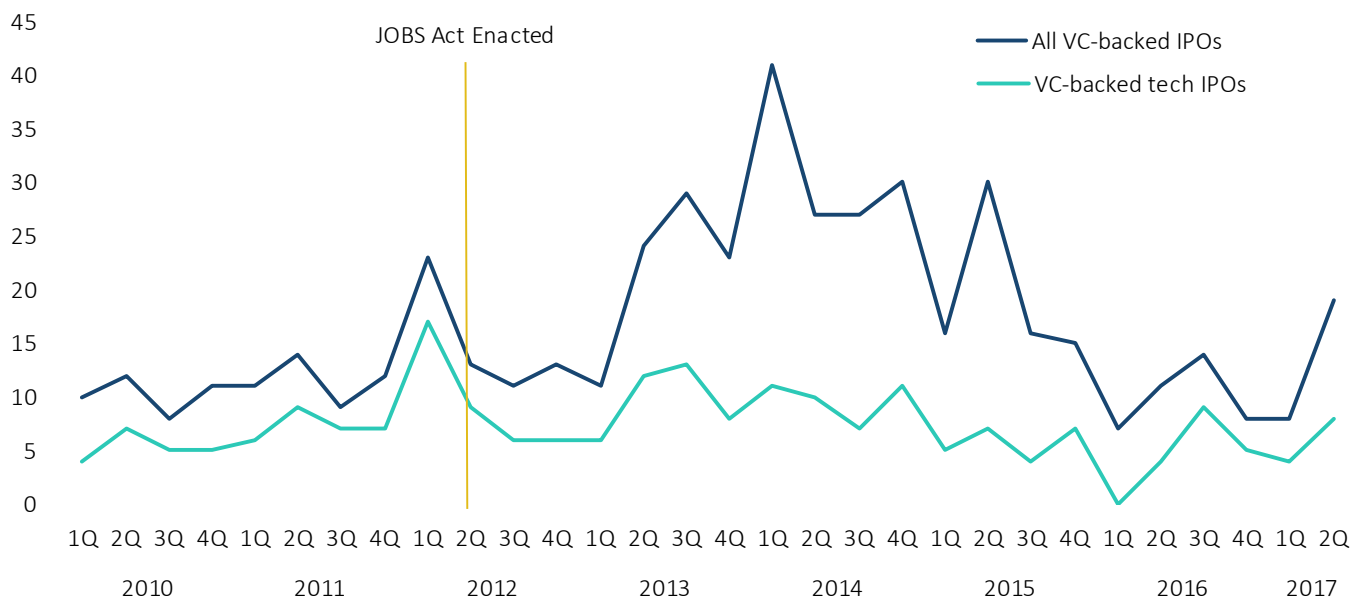
- » Special purpose acquisition companies (SPACs) have been utilized for many years and typically have little media coverage, but Social Capital and Hedosophia's new SPAC ("Social Capital Hedosophia Holdings" or "SCHH") is garnering attention due to its size (\$600 million) and stated intention of acquiring a technology company valued over \$1 billion.
- » Being acquired by SCHH would provide the targeted company with an avenue to go public without many of the hurdles posed by the traditional IPO process. This is the latest in a series of recent innovations and alternatives to traditional exit options as hold times for VC-backed companies have risen.
- » While being acquired by a SPAC can reduce the costs related to an IPO for the company, it doesn't solve any of the reporting, transparency or other problems of operating as a publicly traded firm. The SPAC management also retains a 20% finder's fee.
- » Several risks are inherent in SPAC structure, most notably investors' redemption rights if they do not approve of the proposed acquisition—essentially giving investors a money-back guarantee

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The venture capital industry continues to search for alternative exit routes to meet the liquidity needs of the employees and investors. Even as the route to a traditional IPO has become less costly in recent years thanks to developments such as the enactment of the JOBS Act, we have yet to see a sustained increase in new listings. Venture-backed offerings have been especially tepid since the spike in IPO activity observed in 2014. One driver of this development is that VC fundraising has been robust and dry powder has surpassed pre-crisis levels, so VCs have greater latitude to complete follow-on financings to help companies operate and expand without accessing public markets. This phenomenon has permitted venture-backed firms that would historically have been IPO candidates to avoid the scrutiny, transparency and costs of being a publicly-traded firm.

US VC-backed IPO activity



Source: PitchBook  
\*As of 6/30/2017

The recent dearth of IPOs may have been further exacerbated by poor performance of high-profile technology unicorn IPOs in 2017, such as Snap and Blue Apron. However, on average, US technology IPOs from 2015, 2016 and 2017 YTD have all recorded considerable returns in the market after IPO, and 2017 IPO counts are on the rise. In other words, the IPO route is still a viable exit option but certain headwinds persist, mainly for unicorns. Given some of the challenges inherent in executing an IPO, venture capitalists have been exploring other ways to ease the process of introducing companies to public markets. A special purpose acquisition company is the most recent idea that has been floated as a way to provide an expedited and alternative path to the public markets for venture-backed companies.

## Special purpose acquisition company definition

The blank check company is an entity formed by financial sponsors for the sole purpose of purchasing one or multiple companies. A SPAC within the context of the venture capital industry would focus on acquiring a controlling stake in a private company as a method to take the target company public. The SPAC first follows the traditional IPO process, registering with the SEC, filing prospectuses and running investor roadshows. This entity then prices the IPO and raises the funds that will subsequently be deployed to acquire the target business. At this point, the SPAC is a publicly traded shell company and has assumed much of the costs and time commitments usually borne by the target company. The IPOs of SPACs are structured as sales of units that include one share and either a full or partial warrant. Warrants, similar to options but issued by the company itself, give the holder the right—but not the obligation—to buy one share at a set strike price.

The SPAC management, which usually retains 20% of the equity in the SPAC, has enjoyed more favorable terms in recent years when compared to their predecessors, especially relating to the warrants offered. SPACs formed prior to the financial crisis typically included one in-the-money warrant per share purchased, while most SPACs are now offered with either one-half or one-third of an out-of-the-money warrant with each share. This recent change in terms is substantial because partial warrants cannot be exercised or sold. Furthermore, now that the warrants are issued with a strike price higher than the offering price, there is added incentive on both sides for the acquisition to be accretive. The change to units with out-of-the-money warrants should also serve to encourage investment by long-term focused shareholders, as the warrants may take time to become valuable.

All the proceeds from the IPO are then deposited in a trust to be used only for the potential acquisition; the SPAC management team has a specified amount of time (usually 24 months) from the IPO to source and close an acquisition. If no deal is completed within the timeframe, the SPAC is dissolved and the money from the trust is returned pro rata to the investors, with the SPAC management forfeiting their original investment.

When an acquisition is identified, the SPAC management team only needs shareholder approval if that stipulation is explicitly guaranteed in the SPAC's S-1, or when it is required under applicable law or stock exchange rules. However, shareholders are given a tender offer that affords them the right to redeem their investment if they are displeased with the acquisition target. After receipt of the tender offer, investors in the SPAC have a 20-day window during which they may redeem their shares for their pro rata share of the trust account. The risk the SPAC management bears is that a significant percentage of investors redeem and leave the proposed deal with a large financing gap that must be bridged via further investment by the sponsor or outside financing. This has the potential to distract the SPAC management and could result in the transaction being withdrawn if a large enough portion of shareholders choose to redeem.

Once all of this is settled, the acquisition can be closed and the target business becomes a publicly traded entity. The acquired company would then be afforded all the benefits of being publicly traded: increased company/brand awareness, easier access to capital, and more liquid equity to allow for employee exits and executing acquisitions. Conversely, companies must also grapple with the normal requirements of being public, such as more robust quarterly reporting, increased transparency and heightened public scrutiny.

## Social Capital Hedosophia



**Chamath Palihapitiya**  
*CEO of SCHH; Founder and CEO of Social Capital; former VP of User Growth at Facebook*

On August 23, 2017, Social Capital Hedosophia Holdings Corp. (SCHH) filed an S-1 for an IPO of a SPAC, with the stated goal of acquiring a large private technology company. While SPAC/blank-check companies have been utilized for many years, up to this point they have not usually targeted venture-backed businesses. The SCHH vehicle is also set apart by its relatively large size of \$600 million and its stated focus on technology companies valued over \$1 billion. According to its filing, SCHH believes the current IPO process is fundamentally broken, which has discouraged many technology companies from entering public markets. Specifically, they contend that the current IPO process is a dysfunctional price discovery mechanism that engenders an investor base overly focused on the short term and distracts the management of the company from driving growth and enhancing operations.



**Ian Osborne**  
*Co-founder and CEO of Hedosophia; Founder and Chairman of Osborne & Partners*

In its filing, SCHH states that the short-term mindset of many investors in traditional IPOs (and specifically technology IPOs) leads to initial mispricing that can result in long-term ramifications, such as high shareholder turnover and heightened price volatility. SCHH argues that investors in its SPAC will have less short-term bias relative to a traditional IPO because the target company is not known during the SPAC's IPO process. As such, SCHH's offering should attract an investor base that has endorsed the SPAC management team, which has expressed a long-term, value-oriented mindset. The management team and their track record is a primary selling point in a SPAC offering, as the investors are buying blindly into an operating company that is yet to be determined.

One potential benefit of the SPAC model is that SCHH management can provide the target company with certain terms and incentives, such as earnouts, which may not be accessible in a traditional IPO. The anticipated structure of the acquisition would give SCHH a controlling share of the target, which would enable SCHH's seasoned management team to be more hands-on than VC investors (who usually have a minority stake) when guiding the business through the public markets. The SCHH management team has extensive experience with large venture-backed technology companies, especially those that have operated as public, which they have marketed as a key selling point for this active management model with higher operational involvement.

### Select portfolio companies of Social Capital

Company	Most recent valuation (\$M)
Slack	\$9,000
SurveyMonkey	\$2,000
Clover Health	\$1,200
Flatiron Health	\$1,140
Ipsy	\$800
Wealthfront	\$700

While SCHH features a management team with a long track record, the same can be said about a myriad of VC firms, including many who have run successful IPOs and/or public companies. As such, the VC backers of potential targets may not prefer to cede control to SCHH. To mitigate this potential conflict, SCHH may choose to pursue an existing portfolio company of either of the two sponsor firms, which should result in a smoother transaction because they have preexisting relationships with both the company and other investors. We've included a table listing Social Capital's six most highly valued current portfolio companies that we track, which could be potential targets for acquisition by SCHH.

### Special purpose acquisition company risks

- **Recent legislation reduces SPAC's cost advantage**

Recent amendments to the JOBS Act have expanded its scope to the point that almost all companies are eligible to file for an IPO confidentially, resulting in reduced pre-IPO legal, accounting and regulatory reporting, which diminishes many of the non-underwriting expenses related to an IPO. Despite these improvements, one of the most widely discussed issues about the traditional IPO process remains the cost to the company relative to other exits. An acquisition by a SPAC will likely provide the target company with a more expedient path to the public markets at a lower cost because the SPAC will have assumed the underwriting costs, paying for those fees with a private placement of warrants. But while acquisition by a SPAC may result in a lower total cost to the company relative to a traditional IPO, the achievable level of savings between the two approaches is shrinking.

- **Investor's redemption rights may threaten the acquisition**

As previously mentioned, the SPAC's pre-acquisition investors have the option to redeem their shares as the deal approaches finalization. Redemption is a key shareholder right in a SPAC due to the inherent uncertainty about the acquisition, but it can cause several issues for the SPAC management. Unpredictability of the number of redemptions that will be exercised casts doubt about how much of the cash that has been raised will be available for use on the acquisition. Depending on the percentage of shareholders that redeem, the SPAC can be left with a financing shortfall. Therefore, the SPAC management would be prudent to arrange standby financing in order to avoid a potentially failed deal. This can be done via debt, PIPE or issuing more equity. If more equity is issued, the conversion ratio for the SPAC management's class of shares will adjust to maintain their 20% ownership, while common shareholders would be diluted. If a significant portion of shareholders redeems their stock and the deal is still completed without new equity being issued, it would reduce the number of publicly traded shares. A smaller float could result in thin trading volumes and/or heightened volatility—two issues that the SPAC structure is supposed to address.

- **Are other investors willing to give away upside on promising company?**

Other hurdles the management team at the SPAC must overcome are the negotiations with the target company and their investors. While investors will usually consider acquisition offers that provide an attractive return for their position, late-stage venture funds most likely have experience bringing companies through the IPO process and a vision for the future of their portfolio companies. For instance, they may believe their portfolio company would perform better by remaining private or may see a similar value in bringing their portfolio company to the public markets and don't want to lose out on the upside. Additionally, executing large IPOs can be essential to a VC investor's reputation in the marketplace.

- **Will “founder-friendly” impede the search for a controlling stake?**

In an environment that is currently labeled as “founder-friendly,” one outstanding question is whether the SPAC team will face push back on the control terms or be forced to pay a large premium. Frequently, founders own a substantial portion of the voting rights in venture-backed companies, and there may be other qualitative factors they consider before committing to a full exit or giving up control of a company they founded. A SPAC acquisition can be structured to allow for some retention of existing investors' positions; however, that is usually not a stated goal of a SPAC and could complicate the combined company's capital structure.

- **The SPAC is in a race against the clock**

One other potential headwind is the SPAC's time constraint—24 months from IPO to source and close an acquisition—so the SPAC management must act quickly. There is a possibility that the target company could use this leverage against the SPAC in the negotiation process. Also, this time constraint can incentivize the SPAC management to propose acquisitions with poor economics in an effort to beat the clock. Therefore, the timing of deal sourcing is another factor investors should consider when making their decision on redemption.

## Conclusion

While we are skeptical that SPACs will completely change the venture-backed IPO space, the Social Capital Hedosophia Holdings SPAC is an intriguing alternative. Achieving liquidity for employees and long-term investors remains a prominent theme in the VC market and presenting more venture-backed businesses with the opportunity to be publicly traded should help alleviate some of those issues. For both general partners and limited partners, it is also important to be able to exit at an attractive valuation, especially since decade-high levels of paper gains reside in current VC-backed portfolios. Traditional exit routes will likely remain the primary liquidity option for venture-backed companies, but as hold times continue to increase, we expect to see more innovation in this space.