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Q3 2022 SPAC Market Update

Shifting market cycle puts pressure on the future of SPACs

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

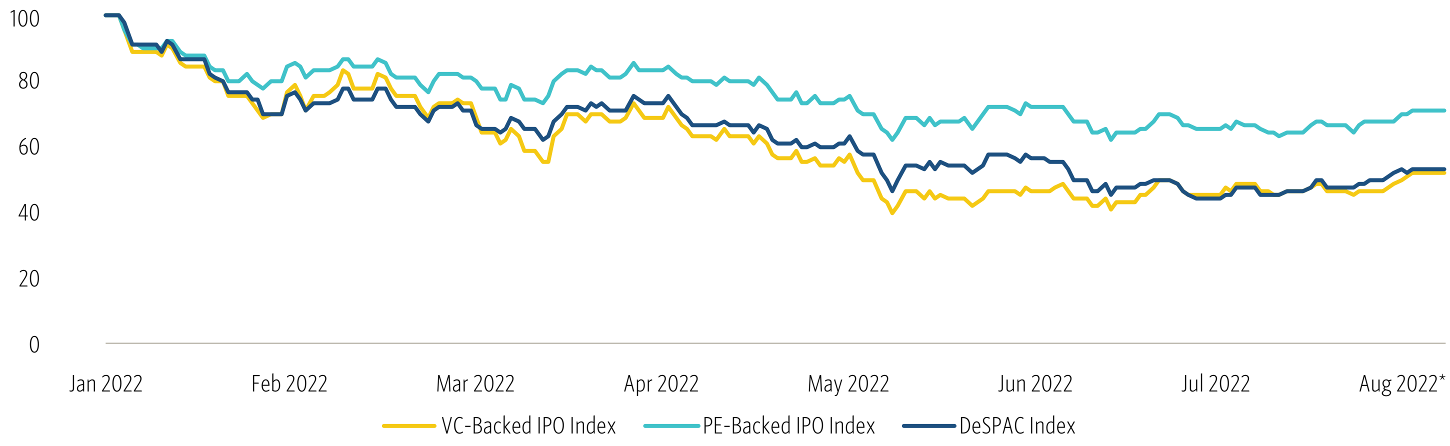
Introduction

2022 has been a terrible year for private companies looking to make the jump to public markets. Public listings have been almost completely shut down due to rising interest rates, which challenged the high-flying valuation multiples of 2020 and 2021. While this has been most noticeable for traditional IPOs, the shifting market conditions have also had an outsized impact on all facets of the SPAC market. SPACs were arguably the largest phenomenon of the public markets in 2021, but they have come to nearly a full stop since the recent correction in asset prices.

While this weakness has influenced the entirety of the market, the most drastic declines over the past nine months have come from newly public companies—particularly the group that are characterized by high growth rates but low profitability—which traded swiftly downward over the first three quarters of the year. This negative shift disincentivized rampant risk-taking in the public markets, which drove the rise of the SPAC in the last two years. Because these modernized versions of the SPAC product skewed toward engaging in deals with businesses in this "growth" category, this concentration has caused the negative performance to hamstring both new SPAC IPO issuance and reverse merger activity. This is another blow to the liquidity markets for private market investors. If sustained, this lack of distributions in 2023 may cause some large ripples throughout the financial markets.

Market performance

Select PitchBook indexes YTD performance



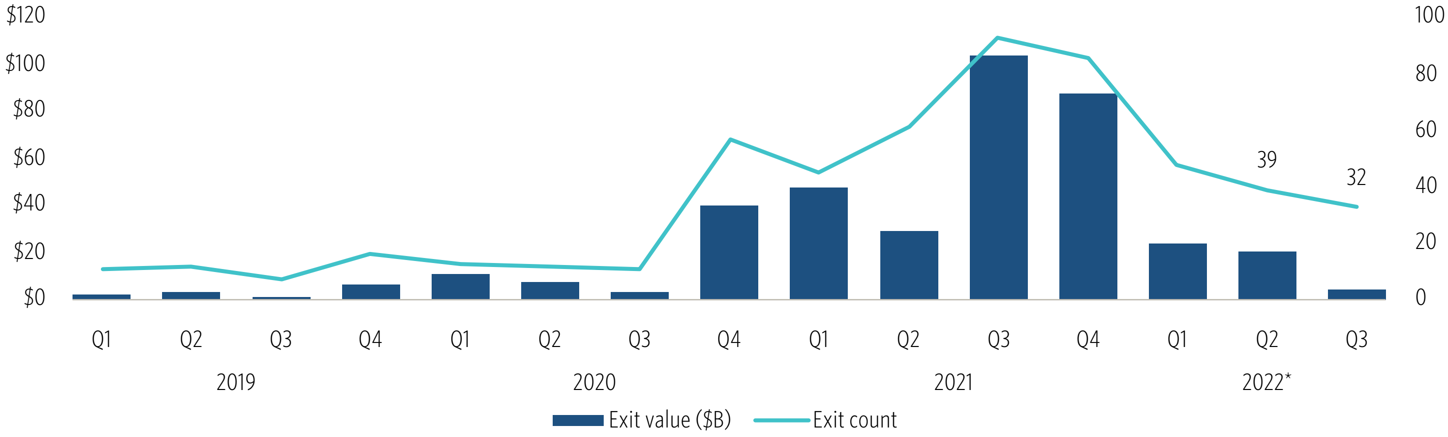
Source: PitchBook | Geography: Global
*As of August 10, 2022

Because public market performance has been a key factor in determining the rest of the market's activity, it seems logical to first examine the aftermarket performance of businesses that have undergone a deSPAC transaction. The growth aspect of public companies' profiles is affecting performance. Both our VC-backed IPO and deSPAC indexes—which are both weighted heavily to growth companies—show performance of -48.5% and -46.9%, respectively, through the early August 2022. The performance of these two indexes throughout the year has been strikingly similar, thus implying a close relationship between the constituents of these indexes—at least in terms of maturity and size. This contrasts with SPACs' history but was a theme of the SPAC phenomenon in 2021, wherein sponsors began to favor companies that were smaller than the average PE- or even VC-backed IPO in an effort to serve a seemingly untapped market. This is also indicative of the post-pandemic bull run, wherein growth investing was outperforming and VC returns were skyrocketing. SPACs were the new market entrants in that environment and seem to have adapted to doing deals in that vein, which has allowed remarkably similar aftermarket outcomes.

While the S&P 500 is not a perfect comparable in terms of risk and return metrics to those two groups of newly public companies, as a broad measuring stick, that market bellwether displays only an approximately 14% decline over the same time period. This discrepancy highlights the outsized impact that the rising interest rates and current economic conditions have had on businesses that are valued primarily on their growth assumptions. The total declines are shocking—at a loss of nearly half of the value from where the year started. However, since mid-June, the public markets been on a much steadier trendline, which implies a bit more market stability than the freefall-like action from earlier in the year. Nonetheless, the sustained inflation led the Federal Reserve (Fed) to enact more aggressive rate hikes, such as the 75-basis-point raise in September, which caused another pullback in growth stock prices.

DeSPAC activity

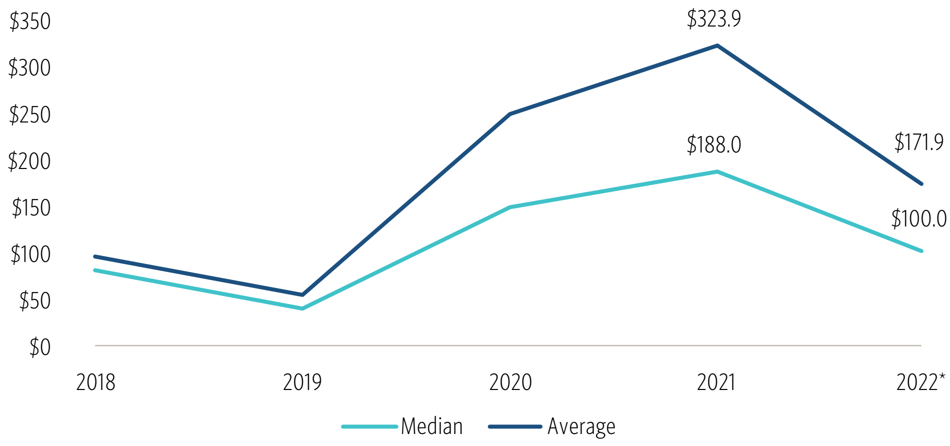
DeSPAC exit activity by quarter



Source: PitchBook | Geography: Global
*As of September 30, 2022

Reverse merger activity has tracked that aftermarket performance and has posted declines in both deal value and count for four consecutive quarters. This trend was especially stark in Q3, with 32 new reverse mergers closing and representing only $4.7 billion of value. Valuations have likely become a sticking point with both announced and new deals. Over the last nine months, the valuation climate has evolved significantly, and the negative direction of this valuation multiple change has brought redemption rights into play—which are one of the key SPAC investor protections. For example, if a SPAC combination was agreed to in late 2021 or early 2022 at a valuation decided in that moment, during the closing process, that agreed-upon valuation would likely have dropped by a material amount. When the deal was put up for a shareholder vote, major concessions would need to be made on the deal valuation, or else no shareholders would approve, as that would mean paying $10 for a share worth much less than that in the current market regime. This phenomenon has cropped up in many of the announced and subsequently canceled SPAC mergers. For example, the SPAC FinTech Acquisition Corp V and online brokerage business eToro mutually ended their bid to pursue the combination, which originally valued the business at around $10 billion. In July, they called the deal off; eToro is now reportedly seeking a new private financing round at a valuation near $5 billion, thus demonstrating the severity of some of these valuation dislocations over the past six months. Situations like these have exacerbated the high redemption rates that arose at the end of 2021, and with PIPE capital becoming scarcer during 2022, a high redemption rate can now kill a deal. Furthermore, this valuation pressure has led to several canceled deals on the basis that the market no longer makes sense to continue the deal in the context of current market conditions.

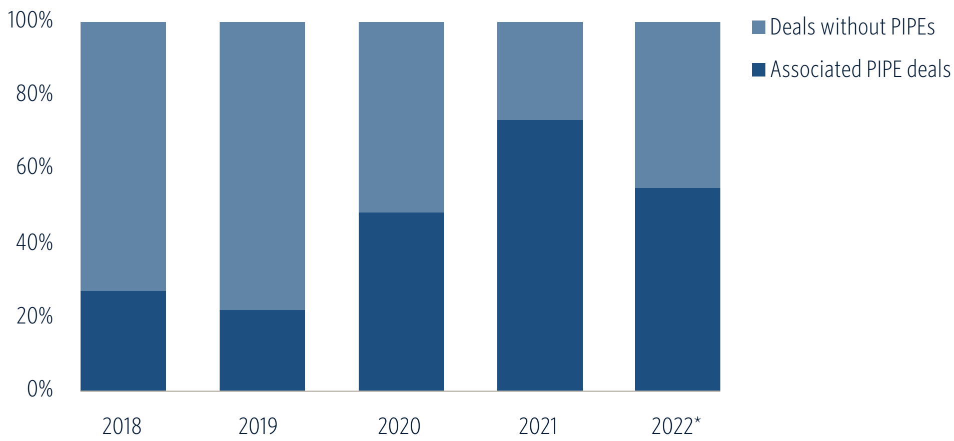
Median and average SPAC PIPE exit value ($M)



Source: PitchBook | Geography: Global
*As of September 30, 2022

As mentioned, PIPE activity has slowed in 2022, with the median PIPE deal size falling to $100.0 million, a 46.8% decline from $188.0 million in 2021. The connectedness of the capital markets comes into play here as institutional investors are de-risking in public equities, so it follows that many of the common PIPE investors would also pull back in new PIPE commitments during this period. While much of this retrenchment of PIPE investment is driven by market weakness rather than a distaste for SPACs in particular, it will undoubtedly put more downward pressure on deSPAC activity.

Share of SPAC deals with and without PIPE financing

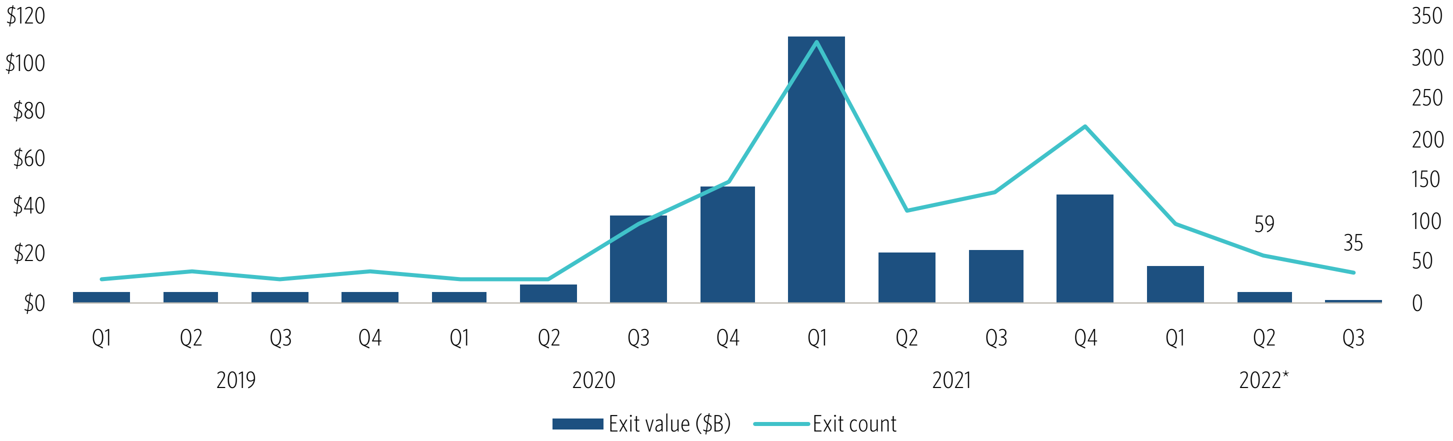


Source: PitchBook | Geography: Global
*As of September 30, 2022

Despite negative sentiment in the market driven by the lackluster price performance of businesses that have completed a deSPAC, the volume of SPACs that are still actively searching for a target will enable some reverse mergers to reach completion over the next few quarters, as sponsors are still heavily incentivized to complete a deal. That said, as mentioned in our 2022 outlooks and reinforced by ample anecdotal evidence, we expect a material portion of SPACs to dissolve and return money to shareholders rather than close on a business combination. Even the major players in the space are experiencing this. Recently, Social Capital Hedosophia announced it will be returning capital on two of its technology-focused SPACs. This is a massive development in the SPAC world, as Social Capital was a pioneer of the new SPAC renaissance and a prolific participant. However, this is just another in a long list of dissolved SPACs that we believe will continue to lengthen as we move into 2023.

SPAC IPO activity

SPAC IPO activity by quarter



Source: PitchBook | Geography: Global
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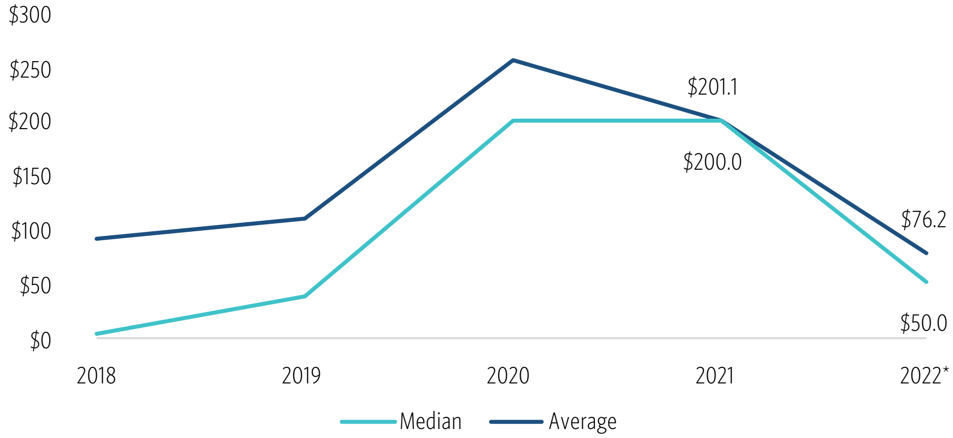
The slowing deSPAC activity and negative short-term outlook in broader equity markets in Q3 halted the flow of new SPAC vehicles listing, with only 35 closing throughout the quarter. Outside of the spike in Q4 2021, this is a continuation of the declining trendline since the end of Q1 2021. However, in the last two quarters, the volume of new SPAC issuance has fallen to a significantly lower level than the rate of approximately 70 new SPACs per quarter that we predicted during 2021. This again shows the effect of the volatile public markets and more bearish economic outlook on something like SPACs, which work best during periods of positive market performance. This performance aspect is key because new SPAC issuance relies on interest from public market investors to buy the newly issued units. Given the incentives for SPAC sponsors to raise new capital, it seems clear with the minuscule volume of new SPACs that the institutional demand is not currently present, which is similar to PIPE activity. In a contrast to how easily capital flowed in 2021, any of these investment conversations between potential SPAC sponsors and institutional investors have likely been met with more skepticism and tepid demand. The new SPAC issuance market is also closely tied with public market performance, so until there is stability and improvement there, we don't expect to see another resurgence of new SPAC IPOs.

Median and average SPAC IPO exit value ($M)



Source: PitchBook | Geography: Global
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What now?

Q3 seems to have marked an inflection point toward a collapse of the financial market's most recent experiment with the SPAC vehicle. While we had previously retained hope for a steady state of SPAC issuance and combination activity, it seems that the turning of the business cycle and the move away from low interest rates has chimed a death knell for the 2020/2021 SPAC renaissance. The breakdown in the speed and certainty of the reverse merger relative to an IPO, which was a main value proposition that the new SPACs offered to private companies, drove the SPAC downfall. Deal security for the companies going forward with SPAC combinations has continued to drop, with increasing redemptions and closing negotiations now averaging upwards of six to seven months, which offers little time savings against a traditional IPO. With the recent flurry of SPACs, the financial sponsors sought to outmaneuver the reliable—but undoubtedly flawed—traditional IPO method. However, it seems that the IPO window closes for a reason, and SPACs could not be an exception, especially during a shifting market cycle.

Despite the large potential target market for sponsors created by the swelling population of private companies, nearly 800 of the 1,288 SPACs raised since 2020 remain without a closed deal. Over the next couple of quarters, we expect few new SPAC IPOs, with only a handful of SPAC business combinations reaching the finish line. The current inflationary period and rising interest rate environment seems to be more long-lasting than the market turmoil of the onset of the COVID-19 pandemic. Current market conditions will likely bring about less investor and private company interest in SPAC vehicles.

Finally, as outlined in our 2022 outlooks, the return of capital to investors from a significant portion of SPACs that failed to make a deal will be a driving theme of the end of 2022 and beginning of 2023. While outside of the opportunity cost, this equates to a wash for the SPAC IPO investors. It will be a financial loss for many sponsors, which may cause reduced future risk-taking and innovation in capital markets. For now, it seems as if the traditional IPO hasn't been disrupted after all.