KPMG Private Enterprise

SPACs: Here To Stay?

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Erika:
Rajiv, super excited to have you with us today. I've been really itching to do an update podcast, excuse me, on SPACs, and I think you are the perfect person to do it. Your background is tremendous. Without further ado, if you could just give us a brief introduction of yourself, that would be great.

Rajiv:
Thanks, Erika. That's very kind of you to say that. My background is in healthcare investments. I've been a healthcare investor now for nearly two decades doing healthcare investments in one form or the other. Got my big start at Pfizer, where I was at the time of my leaving running global M&A for the R&D division based in New London, Connecticut, and had been involved with about 65 billion in acquisitions during my time at Pfizer. [00:01:00] Was very lucky to be at a terrific company with some great mentors, and really benefited a lot from that experience. Went on from there to private equity, where again, I was focused on healthcare. Did private equity and also ran a healthcare long-short hedge fund at Morgan Stanley, London. And [00:01:30] over the course of my investment career, ended up having over 45 investments, served on 14 boards, had over 65 billion in M&A volume.

So gained a lot of very useful experience. Put some of that experience to work in my first stint as CEO where I was a public company CEO of a company that was not healthcare. It was in the engineering space, but my role there was to restructure the company, recap it and sell it, which I did. Then I was able to use that experience to create my first SPAC, which acquired a very interesting diagnostics company called DermTech based in San Diego. DermTech is a pioneering company in the skin cancer space, although they are focused on other areas besides skin cancer as well. They're getting into inflammatory skin disease [00:02:30] as well. But they have a commercial product on the market, which has reimbursement support from CMS, and they're able to detect melanoma without requiring a biopsy. So it's a noninvasive genomic test with a very high degree of sensitivity and specificity, saves the healthcare system a lot of money, and saves patients from being cut.

Then our second deal was the world's [00:03:00] first RMAT company, a company called Humacyte. They were the first to receive the Regenerative Medicine Advanced Therapy tag, and this is another very interesting company that has massive potential with an extensive pipeline covering many, many areas. They've got vascular products that can be used for dialysis. They've got vascular products that can be used in neonatal cardiac issues where [00:03:30] the transplant grows with the patient. They can also make lungs in the lab, so you can have a whole lung transplant eventually. They can make a biovascular pancreas increase so that if one has type 1 diabetes, you can basically cure that through an outpatient implant. It's a very interesting company. And then I'm running my third SPAC currently, which raised 154 million in July of last year.

[00:04:00] So that's my background. I also have a role as a partner in a company called SPAC Research, which is one of the leaders in the SPAC industry in terms of providing coverage of the industry from a data and analysis perspective.

Erika:
Awesome. So, perfect individual to speak this on topic. Rajiv, I think that the audience have varying degrees of [00:04:30] understanding of what's going on with SPACs currently, and so would really love your perspective, just given how active you are in the space on the SPAC market. And really, how's it going today?

Rajiv:
I'm very data-oriented kind of person, and my view often is that if you rely on media, you tend to get an exaggerated sense of what's really going on.

Erika:
Fair point.

Rajiv:
If you were reading the press last [00:05:00] year, impression one would get is that SPACs are taking over the world. And if you read the press more recently in the last six months, you'd get the sense that SPACs are no longer relevant. The interesting thing is if you look at the data, SPACs accounted for 61 percent of the U.S. IPO market last year, which means that SPACs... Regular IPOs are in the minority, and SPACs [00:05:30] are really the mainstream way of going public, at least as of last year. And by the way, in 2020 as well, they were 53 percent of all IPOs were SPACs.

If one went by the press, you'd think that that number has sharply collapsed from 61 percent down to a much lower figure. Whereas in reality, SPACs now account for 75 percent of the IPO market. And the reason for that is while SPACs [00:06:00] have slowed down and the market is not as healthy as it was, the regular IPO market is in worse shape. And there are even fewer regular IPOs happening, which has led to SPACs increasing their share in the market more so. That's just one data point, IPOs.

The other data point is deals. In terms of SPACS and how it breaks down, there are about [00:06:30] 700 SPACs currently, about a hundred announced deals, and roughly 600 SPACs that are looking for deals. That points to two things. One, that you'll have a lot more deals in the next few months as those 600 SPACs have to get a deal done in the next two years, but also that a lot of those SPACs will not succeed because there aren't enough high-quality target companies for all SPACs to have a happy landing. [00:07:00] So I think you'll see a mix of both trends. You'll see a lot more deals as well as a lot more failures.

Erika:
That's so interesting. And one follow-up question to that. How are the SPACs performing compared to a traditional IPO?

Rajiv:
Yeah. If you look at the IPO index, there's a company called Renaissance Capital that covers the IPO [00:07:30] market and they have some great data that the Nasdaq also uses. There's no question that the regular way IPOs are underperforming. I'm looking at the Renaissance IPO index. They actually publish an IPO index that shows the S&P flattish over the last one year, up, up, low things, but shows the IPO index down 50 percent [00:08:00] over the last year. If you compare that with SPACs, are they broadly down 50 percent from their $10 price? Not quite. They're doing a little bit better than that, but averages don't tell the story. There are some SPACs that are doing a lot worse and some that are doing a lot better. But for the most part, you will see that SPACs are a path to going public. [00:08:30] But once public, the same rules of gravity apply to all public companies, right?

Erika:
Right. Correct.

Rajiv:
So if a newly public company is being dragged down because of whatever macro issues there are, those will apply just the same to recent SPAC deals. And they may be magnified by the shareholder composition, where you might [00:09:00] have more concentration or less concentration, more float, less float, micro cap, small cap wall. All of those factors come into play. But for the most part, companies that have gone public through a SPAC process or this regular way, IPO, are broadly exposed to the same trends. And once they've gone public, nobody remembers—

Erika:
How they got there.

Rajiv:
The company's gone... Yeah, how they've come there.

Erika:
[00:09:30] Sure.

Rajiv:
Yeah

Erika:
That's fair, that's fair. Just in term of the next topic and diving a little bit deeper into the trends, what are your thoughts on the increasing level of SPAC redemptions?

Rajiv:
Yeah. Again, SPAC is the opposite structure of a venture fund or private equity fund, where if you are running a fund, you have commitments and then you call capital [00:10:00] when you have a deal. In a SPAC, it's the reverse. You actually have the capital, and the investors can call it back at the time of deal closing. So it gives you a sense of certainty around how much capital a SPAC might have, but some of that can be redeemed. And that's a very attractive feature of SPACs because it's very rare in the investment world to have a structure where you can get your money back. In private equity or VC, you have to pay [00:10:30] your fees, annual fees, no matter what. And if you decide to ignore a capital call, you lose all your prior investments. There are punitive measures in place, but that doesn't happen with SPACs.

If you look at redemption trends and you look at last year in January, between the start of the year up to say the middle of February, right about this time last year, SPACs [00:11:00] basically had zero redemptions, virtually no redemptions or any redemptions. But if you look at it this year, the redemption rate is very high. On some cases, pretty much all of the capital is being redeemed from some of these SPACs. In other cases, you are seeing deals with 1 percent or no redemption as well, but those are rare. It's much more common to see 60, 70 percent of the capital being redeemed. And the [00:11:30] reason for that, of course, is that fewer people want to belong in this market. You want to reduce risk. You want to take capital off the table. And the reason why investors have to wait till redemption is that the SPAC price might be below 10. So simply by waiting until redemption, they'll get their capital back along with a few pennies of interest.

So it's perfectly reasonable for investors to behave the way they are. [00:12:00] It's completely rational behavior. I believe that once the market begins to look healthier and people want to have exposure to risk and they want to have skin in the game, then again, we'll see SPACs tend to do better as it's a risk on environment. But right now, with the specter of high inflation rates, global wars, pandemic, stuff like these, quite understandable that [00:12:30] investors are being cautious and taking their chips off of the table.

Erika:
That makes sense. So you think that it's really more market-driven versus necessarily a change in the SPAC market?

Rajiv:
Yeah. And I think the structure is less a driver of behavior as opposed to the fundamentals. I think the market fundamentals and the flow of capital explains more things than [00:13:00] a structure, because the structure hasn't changed. SPACs are still structured the same they were last year when we weren't seeing redemptions. It's perfectly understandable. I mean, why are we seeing so few IPOs the regular way? It's because investors simply don't have an appetite to invest.

Erika:
Right, not right now. Maybe going back to a point that you had earlier in terms of the number of SPACs that are really looking for a target [00:13:30] company, a lot of our audience, Rajiv, as we've talked about, would be those potential target companies either today or sometime in the future, if they're a high-growth company. And I have to believe that some of what they're considering is, well, what does that company look like, right? What is a SPAC looking for? And maybe you can share what you think the top three things are that SPACs are looking for in a target [00:14:00] company.

Rajiv:
Sure. Look, I think there are lots of unique things that different SPAC sponsors look for, which is often a reflection of our own experience and what has worked well for us in the past and our own approach to life and so on. So for example, I stay away from binary bit type plays, and I like investing in platform companies with multiple shots on goal, where [00:14:30] there is some degree of proof of concept. Whereas, there might be other investors who are perfectly willing to invest in single product companies that have just one product that's in the clinic. And if that works, then it's a huge win. If it doesn't work, then it goes to zero. There might be folks who don't like gene therapy, others who love gene therapy. One might have a preference for CAR T over TCR.

And [00:15:00] so putting all of that aside, there are some broad elements that I think SPAC sponsors care about. One is we are certainly looking at companies that are ready to undergo diligence. And there is often this narrative that SPACs are fast-tracked to the public markets. There are shortcut. If you look at the process, there is no way to shortcut the process. You [00:15:30] have to go through the same process broadly. The only difference is certainty. So in the case of a SPAC process, a private company might have more certainty on the capital, particularly if they have a meaningful pipe, and at the time of deal announcement, they've got a fair sense of what the bare minimum is going to be, and then what it could be on the [00:16:00] upside if they have low redemptions. So in that sense, you get that visibility sooner as a private company, and then you can do all the paperwork subsequently.

But overall, the timelines are roughly the same. It's only a difference of the sequencing. In a regular IPO, you have to go through a huge amounts of documentation with no sense of whether you're going to get the IPO done or not, and how the markets might even look like by the time your S-1 [00:16:30] has been declared effective.

The most important, I think, value of a SPAC is that a SPAC allows for a lot deeper engagement and deeper diligence by investors in these private companies. And I've been a private investor myself. I've been a hedge fund guy, too. The single biggest driver of investor confidence is diligence. If I can do more diligence, I'm going to be more confident [00:17:00] in terms of what I'm doing.

In a regular IPO, you might have three days or five days of road shows. You might have six to eight hours of meetings a day. They might be structured as 45-minute sessions with some breaks in between, but you don't really get much time to talk to investors and they don't get much time to ask you questions. They have to basically rely on the public prospectus. [00:17:30] However, in a SPAC, the investors can ask you many questions. They can have multiple rounds of discussions with you. They get access to a data room as well.

That data room is subsequently cleansed by a proxy filing, but the investor has potentially several weeks of time to review your data. So you have to be ready as a company to be solid in terms of diligence.

The second thing is you must have [00:18:00] a good set of books for a deal to go through. Not to be announced, but to be voted upon. And for the deal to close, you have to file PCAOB, audited financials for two years, sometimes three years. This is not very difficult for biotech companies. It's not very onerous, but that's a box that needs to be checked. And there are some times we see that companies are not ready with these [00:18:30] financials, and that might delay the proxy process, but that's a very important thing that you must have.

And the third is you must have a group of people around the company, if not the management themselves, who are very public market-savvy. So whether it's the management, whether it's the board members, your investors, it really helps to see people who have had prior public market experience. Because what happens is a lot [00:19:00] of these innovative companies, they're absolutely on the cutting edge of science and they're doing stuff that even leading academics would find hard to follow. And they live in a world where they spend all of their time talking to these ultra smart, cutting edge scientists.

When you have to get out of that and talk to regular folk who might be [00:19:30] responsible for investing, you have to be able to convey your business strategy, what your events are likely to be, why what you're doing is impactful. In simple English, you should be investor-friendly. You have to be patient in terms of talking to folks and repeating your story repeatedly. So if you are coming from a academic background, or you might like doing [00:20:00] the science, then we would encourage you to hire folks in your IR function or have a CFO who's adept at speaking with public market investors. Those are very important factors.

But look, besides these you have your usual investment logic type factors, right? You want to make sure that the company is valued properly. You don't want to see a company, have a massive jump in valuation [00:20:30] between rounds. You want beware of companies that had not raised money from institution investors before and it's all family office or friends and family type money. Typically, those companies tend to not be well-received by the public markets. We want to see evidence that other smart people before us have bet on this company. SPACs are not ideally suited as a series A or series B type structure. SPACs are really meant for companies and [00:21:00] are public market ready.

Erika:
That makes a lot of sense, Rajiv. And I think one of the things you said at the beginning of that response was really they have to follow the same rules as other public companies. And then you were really speaking to my heart on the audited financial statements. That's just, again, a requirement, right? So really, really important things. Maybe to bring us home Rajiv, what do you think the future holds [00:21:30] for SPACs and the private companies considering being acquired by a SPAC?

Rajiv:
Well, I think with 600 SPACs looking for deals out there, clearly we'll have some very interesting deals that will come to market. We'll see some exciting assets come through. But also, I think, we'll see lots of SPACs not cross the finish line with flying colors. I think we'll see a mix [00:22:00] of interesting assets as well as some failures.

I'm quite happy to see some Darwinian evolution at work. Darwinian evolution is great for making frozen systems evolve over time. I would certainly like to see that happen over time. What's going to happen is there will be some SPAC sponsors who will survive and who will be viewed as being [00:22:30] solid and reliable, and others who will be viewed as tourists who'd come in and gone. I think that's what I would expect to see if these 600 SPACs even each try to raise $100 million PIPE. Think about that number. That's $60 billion of PIPE capital. I'm not sure whether there is enough PIPE support for all of these players, whether there are enough quality targets.

The interesting thing that I do [00:23:00] note is that if you look at the structure of the IPO market, the tech sector and the healthcare sector, biotech, account for roughly 80 percent of the IPO market in terms of number of filings and broadly, in terms of dollars as well. However, tech and healthcare, particularly healthcare biotech, does not account for the same proportion in SPACs. So biotech [00:23:30] is a little underrepresented in SPACs because it's quite hard to do biotech investing if you don't know the sector. Whereas if you're a generalist, you could do consumer, you could do tech, you could do whatevers, finance and fintech and things like that.

So there is certainly a very interesting dynamic here where there are a lot of SPACs out there, but proportionally... Just to make that [00:24:00] even more crystalline, if you look at the biotech SPACs that are in the market currently, and you say, "How many of the SPAC sponsors who are currently in the market have done three SPACs or more?" I think the answer is there is two right now in the market. There's us and Perceptive, that's it. [00:24:30] Some of these broad numbers tend to obscure what's really going on, but if you're a biotech company and you want to go do a SPAC transaction and you're absolutely insistent on working with only the most experienced teams, there aren't too many options in the market currently there.

Erika:
Got it. That's fair. Well, Rajiv, this has been outstanding. [00:25:00] Your knowledge in this space and just your experience and your background is tremendous, and I really hope that our audience enjoys it. I know I sure did, so thank you very much for your time. And any parting words before we wrap up here?

Rajiv:
I'd just be wary of any claims around both the positives and negatives, where folks might say that SPACs confer some advantages over [00:25:30] IPOs in terms of diligence or lack thereof, or speed to market. It's absolutely not correct. There's actually more diligence, and the timeline is broadly the same. The accounting standards are also exactly the same for companies going public, or the doomsdayers and folks who are bemoaning that things are really bad. The reality often [00:26:00] is in the middle. It's a market where one must very carefully select whom you're working with, and focus on the details as opposed to least doing things.

Macro kind of strategies work great when you're at extremes. When things are going really great, you can afford to be approximate and not be precise. Or if things are going really bad, then again, you can afford to be approximate and not precise. But when you're in the middle, you have to [00:26:30] get the details right.

Erika:
Yes.

Rajiv:
I would leave our listeners with that word of caution and say, "Focus on the details."

Erika:
Well, thank you again for your time. We really appreciate it, and we hope to talk to you again soon.

Rajiv:
Thanks for having me on, Erika. I really enjoyed this.

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