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Earning the premium: A recipe for long-term SPAC success

Special-purpose acquisition companies are having a moment. But not all are thriving. One key to success: leaders with an operational edge.

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Special-purpose acquisition companies (SPACs) have raised funds at substantial rates, attracting more and more high-profile investors. We reviewed the performance of recent SPACs—a mixed track record—and found a strategy that has produced success: SPACs that are led or co-led by operators rather than solely by investors tend to outperform throughout the deal cycle. One year after taking a target public, operator-led SPACs traded about 10 percent higher than their sector index and much better than other SPACs (a premium of about 40 percent). In this article, we review the changes that have placed SPACs at center stage, and we offer practical suggestions for sponsors that seek to deploy the operator's edge.

Same SPACs, new tricks

After some scandals in the 1990s and regulatory reforms in the 2000s, SPACs had a few moments of popularity. However, they generally remained small and developed a reputation as capital sources of last resort.

In the past five years, however, SPACs have reemerged. In 2020, they have attracted unprecedented, market-shifting sums of capital: as of August 2020, SPACs that were actively seeking business combinations held about $60 billion of capital (across more than 100 SPACs) and made up 81 out of 111 US IPOs.[1] In one month in 2020, SPACs raised more than they had in all of 2019. While private equity (PE) firms still hold vastly more capital, with an estimated $1.4 trillion in dry powder, many PE firms (or their alums) have also decided to raise SPACs.

SPACs, at their core, have remained consistent throughout their history. They have a single objective: merge with a company and take it public ("de-SPAC"). SPAC sponsors file with the US Securities and Exchange Commission (SEC) just like any other IPO does, raise capital and place it in a trust, and publicly list their shares. The SPAC model affords sponsors great flexibility, with few constraints on the choice of target (thus SPACs are commonly called "blank check" companies). Sponsors also have relatively few responsibilities after the close: the SPAC sponsor typically takes a minority stake in the merged company (or combination) and may also take a board seat.

So, what changed? Starting in 2015, SPACs appeared to become better-organized, more serious investment vehicles, with three notable differences from previous years:

— *More closes, fewer liquidations.* More than 90 percent of recent SPACs have successfully consummated mergers (Exhibit 1). Prior to 2015, at least 20 percent of SPACs had to liquidate and return capital to investors.

— *Increased size.* The average trust size of SPACs has increased more than fivefold in the past decade, as the average leapt to more than $200 million in 2016 and $400 million in 2020.

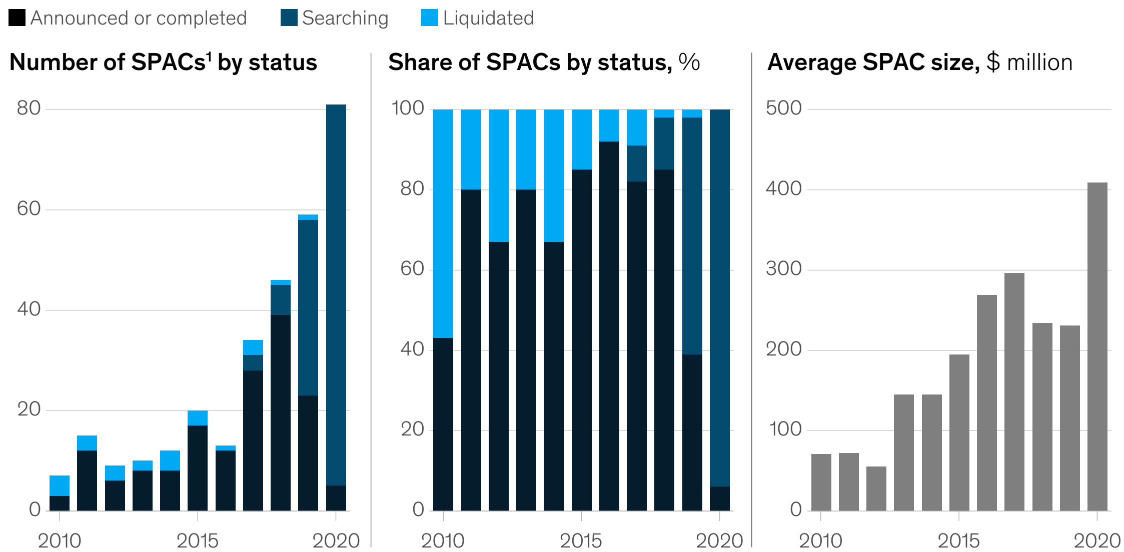
— *More well-known participants.* SPACS entered the mainstream by increasing their number of high-profile investors and recruiting executives from high-profile companies.

Sponsors and investors have also begun seeing SPACs as compelling and perhaps even better alternatives to traditional IPOs. From our discussions with SPAC leaders, bankers, and lawyers, we discovered three consistent themes. First, SPACs offer a simpler IPO process that saves time and energy for all parties and gives sponsors more flexibility to set their targets' narratives. Second, SPACs offer protections, such as the right of an investor to withdraw capital with interest at the time of a proposed business combination, which essentially creates a riskless "free option." Third, SPACs offer their targets' shareholders greater certainty on valuation. Those shareholders may leave less money on the table than they would in a traditional IPO, when underwriters may set an initial price below the market's actual valuation.[2]

[1] "2020 IPO market stats," Renaissance Capital, August 31, 2020, renaissancecapital.com.
[2] Bill Gurley, "Going public circa 2020; door #3: The SPAC," *Above the Crowd*, August 23, 2020, abovethecrowd.com.

Exhibit 1

From 2015, special-purpose acquisition companies’ liquidation rates declined, even as the average size of fundraising grew.



[1]Special-purpose acquisition companies.
Source: SPACInsider; McKinsey analysis

One timeless factor continues to play a major role in SPACs’ popularity: the substantial compensation (“promote”) awarded to sponsors.

Outperformance matters—especially for sponsors

SPACs keep sponsors motivated mostly with carrots, not sticks. While sponsors may profit from mediocre deals, they can earn more if the combination modestly increases in value. In a typical $300 million SPAC, a 20 percent increase in stock price in the first year after combination can yield a double-digit multiple of up-front capital. Consider the following:

— *A large promote grows larger with outperformance.* Typically, the sponsor receives about 20 percent of the SPAC’s value (inclusive) in equity in the combined company. Those shares will benefit from a rising stock price.

— *Lockups create discipline.* For most SPACs, the sponsor must hold the promote as equity in the combination for one year. Outperformance can end the lockup early, but in any case, the sponsor will need sustained outperformance for months after the combination.

— *Warrants magnify returns.* The sponsor usually receives special warrants that convert to equity if the combination’s stock price exceeds certain thresholds. This structure has a powerful magnifying effect, as it can, in some cases, significantly increase the sponsor’s stake.

— *Reputation can lead to repeats.* The sponsor may want to raise another SPAC and enjoy an additional promote. More generally, established investors will want to guard their records for whatever fundraising may follow. The sponsor will want to secure a good deal—one that outperforms—to build a record for future fundraising.

— *SPACs' investors have a say.* This term functions more like a stick: as with most merger transactions, SPACs' investors must still vote to approve any deals. While rejections are rare, they can happen; sponsors are sensitive to the investors that choose to redeem their capital versus participate in mergers. Good deals secure sponsors' promotes—and their reputations.

Maximizing returns through the operator's edge

Despite explosive growth, and the many incentives sponsors have to succeed, most SPACs have not outperformed. On average, SPACs since 2015 have substantially lagged behind their market indexes one year after the combination.[3]

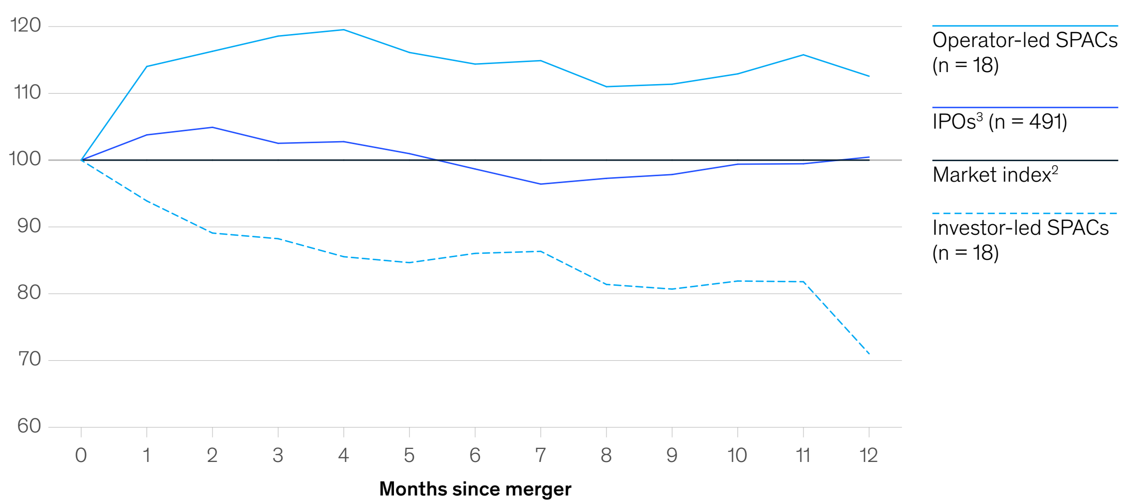
Some SPACs have bucked the trend. We have observed a potential recipe for SPAC success: add the operating edge. We analyzed the 36 SPACs from 2015 to 2019 of at least $200 million with at least 12 months of publicly available trading data. One year after merging, operator-led SPACs outperformed both other SPACs (by about 40 percent) and their sectors (by about 10 percent) (Exhibit 2).[4] "Operator led" means a SPAC whose leadership (chair or CEO) has former C-suite operating experience (versus purely financial or investing experience). The findings, while not statistically significant, strongly suggest that operators make a meaningful difference.

Operator-led SPACs behave differently from other SPACs in two ways: they specialize more effectively, and they take greater responsibility for the combination's success.

Exhibit 2

Special-purpose acquisition companies with operators at the helm outperformed others.

SPAC share-price performance,[1] index (100 = market index[2])



[1]SPACs = special-purpose acquisition companies. Data covers 36 SPACs of ≥$200 million that successfully merged during 2015–2019 and have 12 months of trading history.
[2]Refers to S&P 500 sector indexes (eg, for healthcare or consumer-discretionary sector) matched to IPO's sector. SPACs were compared with S&P 600 midcap-sector indexes to reflect smaller company size.
[3]IPOs were compared with S&P 500 sector indexes and do not include investment funds (eg, SPACs, exchange-traded funds, real-estate investment trusts).
Source: S&P Capital IQ; McKinsey analysis

[3] Yun Li, "Goldman Sachs' guide to the hot SPAC market and why investors should be careful," CNBC, August 3, 2020, cnbc.com.
[4] We studied the 36 special-purpose acquisition companies (SPACs) of $200 million or more that merged from 2015 to 2019 with 12 months or more of performance record. We indexed SPACs' performance to S&P 600 midcap-sector indexes to reflect smaller company sizes.

Operator-led SPACs have a higher tendency to identify an industry focus in their initial SEC filings (Exhibit 3). Unsurprisingly, the operators generally focus on their areas of expertise. Such initial filings typically do not unduly constrain the SPAC; instead, they signal to investors that the SPAC's leaders will focus their resources on the areas they know best. Resources are scarce, so the focus matters; SPACs only have 18 to 24 months to find a deal, with minimal working capital. A narrower, more informed search may yield more effective sourcing, higher-quality diligence, better value-creation plans, and ultimately, better-performing assets.

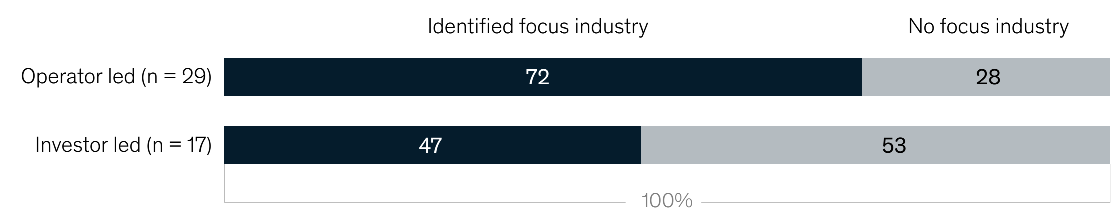
Second, operators have increasingly taken leadership roles on combinations' boards. In almost two-thirds of combinations, operators take chair or vice-chair roles. Those roles allow the operators to put their industry experience to work for the longer term. The operators can provide more influential governance and see plans through to execution. As in PE, operators may prove better collaborators for management—or know when to find new management teams.

In short, operators have helped drive outperformance starting from the SPAC's IPO and continuing throughout the combination's life cycle. An operator's expertise may serve an important role in helping the SPAC narrow and vet its targets, then in exercising influence over the combination's governance.

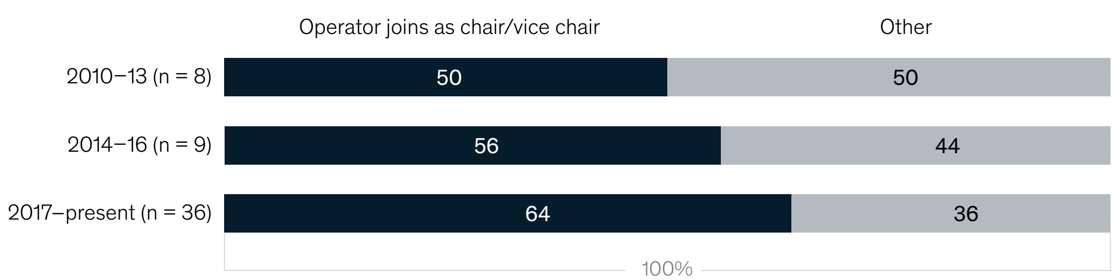
Exhibit 3

Operator-led special-purpose acquisition companies are more focused and better governed.

Focus/target industry of SPACs,[1] % of total



Governance model of SPACs, % of total



[1] Special-purpose acquisition companies.
Source: US Securities and Exchange Commission filings; McKinsey analysis

Sharpening the operating edge: Practical advice

McKinsey has long observed the advantages of the "operating edge" in PE transactions. We can apply similar lessons to SPACs in three phases of their life cycle:

— *IPO and search for a target:*

- *First and foremost, hire the right operators.* Find seasoned executives with clear, proven experience. They serve a dual purpose in providing expertise and in signaling the SPAC's seriousness to investors.

- *Focus the search.* Narrow the SPAC's primary search to the operator's area of expertise. SPACs can declare this intention in their initial filing. Of course, the SPAC can remain opportunistic, but at least the initial intent will help marshal limited resources in the most efficient manner. Operators may also bring in differentiated deal flows through their networks.

— *Due diligence:*

- *Leverage the experts.* Bring the operators into the diligence process, from start to finish. Their experience will help quickly weed out bad deals and pressure-test targets' fundamentals, strategic plans, and management teams.

- *Establish a value-creation plan jointly with target management.* C-suite executives have long spoken with investors about their industries. Build on their knowledge to create credible value-creation plans that will translate into sensible, exciting narratives for the combination. Operators can also help tell these stories in the road shows leading up to de-SPACs.

— *Postclose:*

- *Lead.* Join the board—preferably in a position of leadership, such as a chair or vice chair, to help guide the combination through its value-creation plan.

- *Collaborate with (or replace) management.* At the combination, SPACs dissolve into their individual shareholders. With a leadership role on the board, operators can represent sponsors' interests with management, bolstered by their own credibility as seasoned C-suite leaders.

- *Engage in active governance.* In 2005—a lifetime ago in investing circles—and again in 2008, we showed the benefits of active ownership by operating partners in PE firms. Done well, SPACs combine the best of private and public ownership: the superior rigor of PE-style governance and the lower capital costs of public firms.

As more SPACs raise funds and pursue deals, sponsors may find themselves under increasing pressure to differentiate their approaches and demonstrate returns. Having operators at the front, from the IPO to the combination and beyond, may offer SPACs a path toward better performance.

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