CLIFFWATER LLC

## SPACs as a Replacement for Private Equity: An Analysis

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*Cliffwater views SPACs as a weak alternative to private equity given the lack of alignment of interest amongst stakeholders, as well as the exposure to changes in market sentiment. SPAC vehicles do not possess the positive long-term characteristics of private equity funds. However, SPAC vehicles may continue to serve as an attractive exit option for private equity and venture capital -backed companies, accelerating company access to a frothy public market.*

### Background

The formation of special purpose acquisition companies ("SPACs") has dramatically accelerated over the past five years, growing from an underground or typically ignored investment structure to a highly active market force, raising record levels of capital in 2020. More than 219 SPACs have been formed in 2020, outpacing traditional IPOs[1]. The rapid growth of SPAC IPO activity has generated a highly active and accretive exit option for private equity funds, particularly venture-backed technology companies, as an accelerated alternative option to a traditional IPO. However, although these investment structures have become increasingly accepted as a viable alternative to a traditional IPO, Cliffwater believes that the SPAC structure is not a viable investor alternative to private equity and venture capital.

### Concerns

*(-) Fee Structure Concerns and Lack of Alignment Relative to Private Equity*

A significant concern regarding SPACs as an alternative to private equity is the lack of alignment between SPAC management teams and investors. SPAC compensation structure varies; however, under a typical structure, SPAC founders will receive a 20% stake in the outstanding shares of a SPAC following the completion of an IPO.[2] This structure enables the founding management team of a SPAC to earn an effective 20% payout of the total equity of a deal, which is paid out independent of the performance of the SPAC. For example, a SPAC management team will still be compensated 20% of total equity in a situation in which SPAC equity investors lose money. This compensation further impacts performance for SPAC equity investors, creating a large 'fee spread.' In comparison, private equity funds typically utilize a carried interest incentive structure which is subject to a preferred return or hurdle. Cliffwater believes that the typical private equity structure provides investors with superior investor protections and alignment given that a private equity sponsor will only earn performance compensation in a scenario in which a private equity fund has generated a positive return (and typically when a fund has generated a return greater than the preferred return or hurdle).

*(-) Investor Base Alignment and Fragmentation*

Alignment is a concern between SPAC equity investors and pre-IPO SPAC investors, such as hedge funds, which are often able to invest in SPAC warrants prior to a SPAC IPO, earning profits at the expense of post-IPO investors. Hedge funds have been a very active funder of SPAC formation[3]; however, these funds often have no intention of remaining invested in a SPAC post-merger. A lack of long-term consistency in the investor base has created perverse incentives in

[1] Business Insider (https://markets.businessinsider.com/news/stocks/spacs-raised-73-billion-more-than-traditional-ipos-blank-checks-2020-12-1029906693)
[2] Corporate Finance Institute (https://corporatefinanceinstitute.com/resources/knowledge/strategy/special-purpose-acquisition-company-spac/#:~:text=SPAC%20Capital%20Structure&text=The%20capital%20is%20sourced%20from,stock%20at%20a%20later%20date.)
[3] Bloomberg (https://www.bloomberg.com/opinion/articles/2020-12-09/hedge-funds-love-spacs-but-retail-investors-should-watch-out)

which SPAC management teams and hedge funds investing in pre-merger SPACs may economically benefit from SPAC mergers (as long as a transaction is consummated) but are not aligned with long-term equity investors in a post-merger SPAC. Hedge fund funding of SPACs has accelerated over the past decade due to an SEC regulatory change completed in 2010, in which SPAC acquisition approval votes are now decoupled from redemption votes. By decoupling the decision to redeem from the decision to complete an acquisition, SPAC equity holders, such as hedge funds, benefit from a potential arbitrage trade in which a hedge fund may vote in favor of a merger (the SPAC acquisition of a target), elect to redeem their interest in the SPAC, and earn a return of capital plus interest and warrants.[4] These types of trading strategies may be profitable for institutional investors such as hedge funds, but create significant alignment issues for investors seeking to remain invested in a SPAC post-acquisition.

*(-) Lack of Value Creation or Differentiation*

The time horizon of a SPAC is short-lived, as SPACs typically have a short period of time to complete an acquisition. SPACs typically have two years to complete an acquisition, compared to investment periods of five to six years and a fund term of 10 to 12 years for private equity. Additionally, SPAC equity is publicly traded at the time of an acquisition. As a result, the ability to utilize an active investment strategy, including value creation initiatives such as investment in growth may be limited given the public nature of the assets. As a result of structural limitations, SPACs are often more focused on public-private value arbitrage relative to private equity strategies, which are often focused on a range of value creation initiatives. As a short-lived intermediate or accelerated step to a public listing, many SPACs lack the range of investment strategies which are possible under private equity fund structures, such as diversified stage venture capital, growth equity, turnaround buyout, growth buyout, and other strategies. Cliffwater believes that the typical strategy utilized by a SPAC is analogous to passive "stock-picking" rather than private equity value creation or active asset management. Additionally, the short total time period for SPACs to complete an acquisition, paired with a perverse incentive for a SPAC sponsor to complete an acquisition at any cost, has also resulted in an environment in which SPACs often pay above-market prices for assets.

*(-) Market Environment and Historical Return Concerns*

SPAC activity has been buoyed by a unique market environment during 2020 in which companies, particularly high-growth tech businesses, are trading at record equity valuations and are appreciating significantly from their IPO valuations. For example, the Renaissance IPO Index, which tracks a set of recently publicly listed companies, has generated a 68.7% return YTD as of September 30$^{th}$, 2020, well above the 5.6% YTD return of the S&P 500 and the 16.8% 10-year return of the Renaissance IPO Index[5]. SPACs are attempting to capitalize on a private – public arbitrage opportunity in the current market environment by accelerating the timeline for a public listing of a given business. However, given structural concerns for SPACs, including their high fee structure, alignment issues, and adverse selection concerns, equity returns for SPAC investors have been mediocre to date. Studies have shown that for a large majority of SPACs, post-merger share prices have fallen, and that these price drops are highly correlated with dilution, implying that SPAC investors are effectively bearing the cost of dilution and subsidizing the companies that they bring public.[6]

## Conclusion

SPAC activity continues to hit and eclipse record highs, resulting in significant investor interest in the investment structure as a potential alternative to private equity. Although share sales to SPACs have become an increasingly utilized and accepted alternative to a traditional IPO, Cliffwater believes that the attractiveness of SPAC equity as an alternative to private equity is limited. SPAC activity has helped to provide significant liquidity and exit optionality for private equity and venture

[4] Institutional Investor (https://www.institutionalinvestor.com/article/b1ngx7vttq33kh/Egregious-Founder-Shares-Free-Money-for-Hedge-Funds-A-Cluster-k-of-Competing-Interests-Welcome-to-the-Great-2020-SPAC-Boom)
[5] Renaissance Capital (https://www.renaissancecapital.com/Docs/Renaissance-US-IPO-Index-Report.pdf)
[6] Michael Klausner, Stanford Law, "A Sober Look at SPACs"

capital funds and has helped to accelerate the path to the public markets for many high-momentum private companies; however, problematic alignment concerns and compensation, limitations of strategy and ability to add value are significant concerns for investors of SPACs. The current market environment of significant public market froth, particularly for high-growth technology companies, has created a public-private arbitrage in which recently publicly-listed companies are observing record equity returns. SPAC formation activity has accelerated in order to capitalize on this market opportunity; however, Cliffwater believes that private equity asset classes such as venture capital and growth equity can provide investors with higher-quality exposure to high-growth companies that benefit from innovation, long-term value creation, and the public-private valuation arbitrage opportunity of the current environment.

Will Dornbrook
310-448-5046
wdornbrook@cliffwater.com

***Disclosures***

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