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Meet the new SPAC circus ringleader: the PIPE investor

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Since late 2019, when the special purpose acquisition corporation, or SPAC, returned to the public markets with a new twist, a circus of activity has breathed new life into the markets for privately-held emerging growth companies, forcing open a large window for public exits not seen in decades.

In this "SPAC 2.0 boom," sponsors of SPAC vehicles first raised large pools of blind capital in the public markets and then struck deals to buy emerging growth companies for ~10x the cash raised plus rollover equity and a second pile of cash in the form of a PIPE.

What is a PIPE, and why is it used for a de-SPAC merger?

"PIPE" stands for "private investment in a public entity," often priced at a discount or containing a "sweetener" for the PIPE investor to make a more significant commitment than it would otherwise in the public market.

The PIPE fundraising process happens after an LOI for a de-SPAC is signed, but before a definitive merger agreement, and is signed and announced concurrently with the latter. Then the SPAC and the target work together to prepare a joint registration statement and proxy filing on Form S-4 and seek SPAC stockholder approval, which requires the U.S. Securities and Exchange Commission to review and clear the de-SPAC transaction.

Once the de-SPAC merger closes, the company files a resale registration statement to register the shares of common stock and warrants underlying the PIPE.

PIPE investors include investment funds, hedge funds, mutual funds, private equity funds, growth equity funds, and other accredited large institutional and qualified institutional buyers of publicly traded stock. The PIPE is well suited to complement the SPAC in a de-SPAC merger because of the speed of execution and because it does not require advance SEC review and approval.

SPACs have tapped PIPEs to bring in additional capital in a shorter amount of time to close de-SPAC mergers. Because of the nature of the SPAC process, there is often uncertainty surrounding the amount of cash that will be on hand following the merger. When combined with the SPAC proceeds in trust, the funds from the PIPE work together to provide liquidity for sellers and post-closing capital for the business to grow.

To be clear, in SPAC 2.0, the enterprise value of the target is so many multiples of the SPAC proceeds in trust that a PIPE has become ubiquitous to bridge the value gap. The Morgan Stanley data showed that on average, PIPE capital almost tripled the purchasing power of the SPAC, and for every $100 million raised through a SPAC, adding a PIPE added another $167 million.

Raising funds via a PIPE deal is comparable in some ways to an IPO roadshow in that there is a pitch to potential investors. However, PIPE deals are only open to accredited individual investors, and the share price is determined by reference to the de-SPAC merger valuation.

When looking for PIPE investors in SPACs, targets look for high profile names whose investment at a specified helps to validate the deal. This investment by well-respected investors can help to mitigate some of the risks that come with SPACs.

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While PIPE deals are seen as an attractive option partly because they avoid many SEC regulations, all the attention SPACs have received, and their incredible spike in popularity has drawn the attention of regulators. This could mean additional regulations are on the horizon for both SPACs and PIPEs. But for now, these two continue to be an attractive combination for those looking to bypass the traditional IPO process.

What is SPAC 2.0 and why is the PIPE investor the ringleader?

SPAC 2.0 was essentially the cash in the SPAC vehicle combined with a new private fundraiser in the form of a PIPE merged into a privately-held emerging growth company.

The resulting party for SPAC IPOs, de-SPAC transactions, and even traditional initial public offerings, or IPOs, continued through the end of the first quarter of 2021, with hardly even a little intermission for the first COVID lockdown.

According to data compiled by Morgan Stanley, in 2020, PIPEs generated $12.4 billion in additional funding for 46 SPAC mergers.

The SPAC 2.0 structure had something for everyone:

- the emerging growth company got a public exit without having to go through a traditional IPO
- the emerging growth company stockholders got a snap spot-valuation based on three-year out financial projections not available in conventional IPOs
- the emerging growth company got a public acquisition currency in the form of listed stock, validation in the public markets via the stock exchange listing, and cash to the balance sheet to power growth
- stockholders in the emerging growth company could negotiate for some amount of immediate liquidity
- stockholders in the emerging growth company got long-term liquidity via the public trading market
- SPAC stockholders and PIPE investors got access to emerging growth companies that weren't otherwise going public
- SPAC sponsors made their "carry" in the form of 20% of the equity in the SPAC (pre-dilution) plus warrants in some cases and a path to liquidity with a short lock-up period
- SPAC sponsors could rent out their names, network, and prestige and get a quick exit

While in SPAC 1.0, the SPAC sponsors would take over the target and operate it like a private equity buyout fund for long-term capital growth, in SPAC 2.0, the SPAC sponsors are like bankers, raising capital and then handing over the keys to management of the emerging growth company in exchange for a commission.

But the lights went out for the SPAC party in April 2021 when President Biden appointed a new chair to lead the Securities and Exchange Commission. Upon taking office, new SEC Chair Gary Gensler effectively closed the market for SPACs by announcing a compliance review, putting long-standing SEC policy and rule interpretations in doubt. Transaction participants reported that SEC staffers reviewing their pending transactions started asking questions, requesting changes, and appeared in no hurry to clear pending "de-SPAC" deals.

The market for new issues froze up, and the demand for de-SPAC transactions ground to a halt. The trading index for recently "de-SPAC'ed" public companies dropped double-digit percentage points. Investors started to lick their wounds.

When the SEC began clearing SPAC mergers again in early summer 2021, it was not as simple as just turning lights back on and taking its foot off the brakes. That is because PIPE investors, who provide fresh capital to the company that is merging with a public SPAC vehicle (commonly referred to as a "de-SPAC transaction"), have taken their place as the new ringleaders at the SPAC circus.

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PIPE investors no longer accept transaction terms as proposed and have started to make new commitments contingent on adjusted valuations, redemptions of SPAC sponsor promote securities, and better alignment to create better after-market trading conditions.

Knowing what PIPE investors want and how much they will pay has become the new ticket to success in the SPAC market. This makes the PIPE investor the new ringleader in the SPAC 3.0 cycle.

About the author

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