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Attack of the SPACs

The advantages – and potential pitfalls – of this newly popular alternative to the traditional IPO

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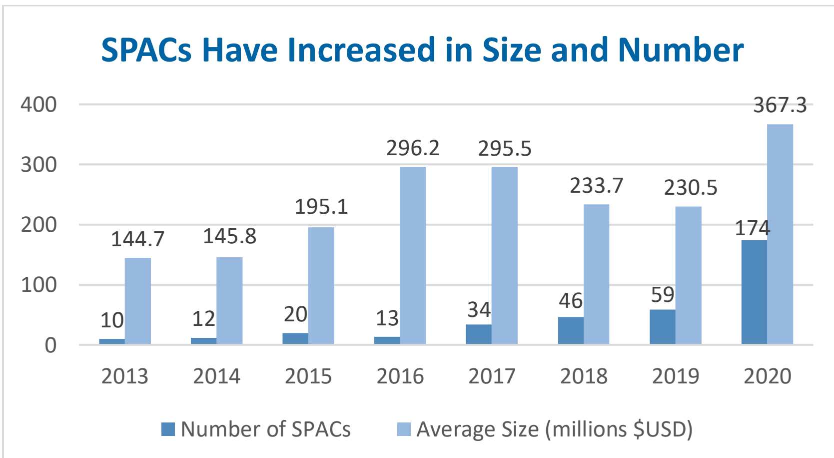
SPACs (special purpose acquisition companies or "blank check" companies) are blind pools of capital designed to take private companies public without going through the traditional IPO process.

SPACs hit the headlines with the highly successful public offering of online gaming and fantasy sports company **DraftKings Inc. (DKNG)** in April. Since then, SPACs have exploded in popularity. There has been more money raised in SPAC IPOs in the past two years than in the prior 16 years combined. More than 40% of 2020's IPOs by volume have been SPACs.



Source: SPACresearch.com

The convergence of two trends is driving the surge. The long-running boom in private equity and venture capital has resulted in a crop of private companies that their investors are now looking to cash in on. The extreme market volatility at the onset of the COVID-19 pandemic in March accelerated interest in SPACs, which can provide greater confidence than a traditional IPO that a deal can be made at a given valuation without being subject to the vagaries of a volatile market. The fast-track nature of SPACs, which do not involve the time- and resource-consuming regulatory requirements and roadshows of the traditional IPO process, is also appealing in an environment rife with macro uncertainties.

The quality and attractiveness of the SPAC pool has also improved. Although they have been around for decades, until a few years ago, SPACs were more of a curiosity in which modest amounts of money were raised to buy small companies and the sponsor economics resulted in significant dilution. Now, prominent and respected sponsors with highly reputable management teams and investment firms are raising large pools of money, acquiring high-quality businesses, and offering investors palatable terms.

SPACs are not without risks. Once a deal is finalized, the share price can fall below the deal price as easily as any other stock. Case in point: **Nikola Corporation (NKLA)**, an electric vehicle company that went public in June through a SPAC for about $34 per share and is now trading at $18 per share amid allegations of fraud and the resignation of its founder. The ever-increasing number of SPACs is resulting in lower-quality sponsors without the same breath of experience and skills needed to find and acquire high-quality companies.

So how do we gain the confidence that we are putting our assets toward the DraftKings while steering clear of the Nikolas?

We have been investing in SPACs for a few years now. Because of our focus and presence anchoring deals and our reputation as long-term institutional investors in high-quality companies, we are regularly sought out by SPAC sponsors and investment bankers as potential participants. We like investing in SPACs and associated PIPEs, which are additional financings done to close the transactions, for lots of reasons.

However, we also take steps to mitigate risk. We do not invest until a target company is in hand, since we are looking for a business that fits our investment criteria, not a blind pool. Once the target is identified and we put the SPAC on our restricted list, we gain access to the management of the company to be acquired, the impressions of the sponsor and seller, and customers and industry players. This access gives us the chance to perform our own extensive due diligence and decide if we would like to invest based on our own investment criteria rather than relying on the reputation of the sponsor.

If we decide it’s a go, we have the opportunity to invest significant amounts of capital up front at a designated price. Typically, just a handful of investors are offered the chance to invest before the company goes public.

In contrast, in the IPO process, you basically have a week to look at the company, which is not really enough time to understand what it does. You are also one of a million people looking at the company because there’s a global road show. And in a hot IPO, your allotment can be de minimus, after which you are forced to chase the deal in the aftermarket.

Three examples of SPACs we like

Vertiv Holdings, LLC (VRT) Vertiv, which provides infrastructure solutions for data centers, went public in February via Goldman Sachs’ first SPAC. The story is fresh and exciting -- a leading niche business in a growing industry that had been neglected inside a bigger entity (Emerson Electric) and is now on its own and led by a very accomplished management team, including former Honeywell CEO David Cote, who serves as Executive Chairman. Vertiv’s plan calls for strong organic growth, margin improvement, deleveraging, and growth through acquisition, which should all be levers for share appreciation.

UTZ Brands, Inc. (UTZ) This 100-year-old family business with a strong portfolio of beloved salty-snack brands had its IPO in August via a SPAC called Collier Creek Holdings. The company is backed by exceptional leadership, including former Pinnacle Foods Chairman Roger Deromedi, who is seeking to replicate his proven operating playbook with UTZ. Currently the fourth largest snack company in the U.S., UTZ is aiming to leverage its access to public markets to acquire smaller brands in a fragmented market and expand its geographic reach outside the Northeast and Northwest regions to the rest of the country.

Repay Holdings Corporation (RPAY) Repay, an electronic payment processor for lenders and debt repayment companies, went public last year through a SPAC called Thunderbridge. Cash has long been falling out of favor as consumers increasingly shift to digital payments, but some industries, like the ones Repay services, have been holdouts. The COVID-19 pandemic has made it more difficult to use traditional payment systems, driving many of these businesses to switch to electronic payments. Repay has reaped the benefit of this trend, growing card payment volume and revenue by more than 40% over the past year. The company also doesn't have a lot of competition in its space, so we think there is plenty of runway for growth.

To conclude, we think SPACs are a great way to invest in promising small companies, but it's important to do your homework. As bottom-up, fundamental, long-term investors, we conduct the same level of due diligence with a SPAC investment as with any of our other investments. Of the 200 or so SPACs in the pipeline right now, at the end of the day, we will likely invest in only a handful of what we believe to be the best of the bunch.

Portfolio holdings as a percentage of net assets as of September 30, 2020 for securities mentioned are as follows: DraftKings, Inc. – Baron Small Cap Fund (1.3%), Baron Discovery Fund (0.5%); **Vertiv Holdings, LLC –** Baron Small Cap Fund (2.8%); **UTZ Brands, Inc. –** Baron Small Cap Fund (1.6%), Baron Discovery Fund (2.4%); **Repay Holdings Corporation –** Baron Small Cap Fund (2.0%), Baron Discovery Fund (1.3%), Baron FinTech Fund (2.4%).

No Baron Fund held **Nikola Corporation** or **Emerson Electric** as of September 30, 2020.