Constellations Podcast

Episode 106 – SPACs, Space Bubbles, and Who's Investing

Speaker: Chris Quilty, Partner, Quilty Analytics – 22 minutes

John Gilroy: Welcome to Constellations, the podcast from Kratos. My name is John Gilroy, and I'll be your moderator. Our guest today is Chris Quilty, partner of Quilty Analytics. Today we will talk about a brand-new acronym for most listeners, S-P-A-C, which stands for Special Purpose Acquisition Company. SPACs have taken the space industry by storm. A SPAC is defined as a shell corporation listed on a stock exchange with the purpose of acquiring a private company, which makes the company public without having to go through the traditional initial public offering or IPO process. Virgin Galactic announced in 2019 that it was going public through a merger with the SPAC Social Capital Hedosophia. Since that time, seven companies within the space industry have revealed their plans to take their companies public through SPACs in 2021, with more on the way.

Joining me today is Chris Quilty. He is a partner of Quilty Analytics, an independent research and consulting firm within the satellite and space industry. They have been following the SPAC trend very carefully and we're going to open up the world of SPAC to you right now. Chris, so what type of work does Quilty Analytics focus on and what about SPACs are of interest to your firm at all?

Chris Quilty: Thanks. So Quilty Analytics is a financial services firm. We're 100% focused on the satellite and space industry. We really provide three lines of service, the first being research, which includes both company-specific and general industry research on topics ranging as widely from flat panel antennas and optical crosslinks to any of the applications like in-flight connectivity or LEO broadband. The second line of business is investment banking, which includes the sort of traditional mergers and acquisition advisory work, raising capital. The third line, as you mentioned, is strategic consulting, which we mostly do on an inbound basis for a range of actors from government agencies to telecom providers, and of course, companies within the satellite and space industry.

So why are SPACs of interest to us? Since I write research on public companies, I guess I'm interested in all of them. To the degree they eventually make it public, they're companies that we may choose to follow and write on. I'll note, we actually had the honor, going back to 2009, of doing the very first ever space SPAC, which was Iridium, which went public through a Greenhill listed SPAC back when I was at Raymond James. Back in those days, SPACs were very different than they are today in terms of how they're structured and the types of companies that are going public. Back then, Iridium was an ongoing concern. They were generating revenues and cash flow. Those are still SPAC candidates, but you're seeing a lot more early-stage companies. I think as we all know, that SPAC transaction, it had its ups and downs for Iridium, but it definitely worked out for them in the long run.

John Gilroy: So SPACs have been around a while, is that right? Back when you got your MBA, did you study it or was this something you learned on your own?

Chris Quilty: No, I would say back in the '90s, sure, there may have been a handful of SPACs that had transacted, but they were sort of in the dark pools of the industry, they weren't very high profile. It was pretty much standard IPO route with big banks taking it down a traditional IPO process. So there was this period back prior to the first procession where we had what I would term, a SPAC 1.0 phase, where the number of transactions picked up. It never hit a peak that even approached anything near what we're seeing nowadays. After the recession, they sort of went into recession or rescission for a while. It was quiet until the last year and a half or so where we've seen SPACs come back with a vengeance.

John Gilroy: Yeah, they certainly have. In fact, there's a surge in the space industry, as you know, but the question is why? Of course, this is a tough question. So why are they looking at a SPAC rather than the traditional IPO approach?

Chris Quilty: So it's a good question, right? If you do a Google search, you can find plenty of articles and reports that outline the relative advantages and disadvantages of a SPAC versus a traditional IPO, including the time to market, perhaps the valuation, looser regulations regarding forward estimates. But if you really had to boil it down to two reasons, I think it comes to, number one, the speed to market. Since a SPAC is technically already a public company, they've done all the heavy lifting of the IPO process. The de-SPACing transaction, where the SPAC merges with a private company, is technically just an M&A transaction. So, it has a very different set of rules around it and what you see is it provides a very fast path to getting public relative to a traditional IPO.

The second element that I think is most attractive is, quite honestly, it's the size or the amount of capital that can be raised. I don't have the exact numbers at my disposal, but intuitively what I can tell you is if you looked at the median amount of capital raised by a SPAC versus a traditional IPO, it's probably on the order of two to three times or more capital raised in those transactions, and for the space industry, as we all know, it's a capital intensive industry. So it's a pretty attractive path for space-related companies.

John Gilroy: You know, Chris, when I've read about IPO's, there's this phrase that pops up that’s called due diligence. So is this a step that's just being skipped here with a SPAC?

Chris Quilty: No, there is due diligence associated with it and a lot of that due diligence is happening behind the scenes. There is a second phase of the SPAC which is called a PIPE transaction, it's a private investment in public equity. What you have are institutional investors that are called into the process once the SPAC transaction has been announced and they will do their own diligence on the transaction. They may argue somewhat about price and valuation. Those are really the anchor investors in the transaction that were brought in to get it across the line. Now, all this time, the SPAC is public and it's trading. Any retail investor can buy and trade the stock. They don't unfortunately have the same visibility that PIPE investors do to the level of diligence that's going on in the background.

John Gilroy: Just to go back to the IPO, kind of the traditional way to do things, when companies go the IPO route, the market sets the price. So how is the price set when a company takes this SPAC route instead?

Chris Quilty: Yeah, it's a good point. I mean, for those of you who have never been involved in an IPO transaction, which is most, it's an auction. I mean, that's really what it is. The price that Amazon closes every day on the market is the last transaction that traded hands between a buyer and seller. In an IPO process, the company and their underwriters will position the company as best they can. They will sort of set terms or an IPO range, we think the company should go public in a range of 14 to 16.

But when push comes to shove at the end of the day after the 4 o'clock bell closes and it's time to go ahead and price the IPO, what happens is investors will put in their orders. The orders will have prices attached and the underwriter will sort through all the orders and pricing and determine how best they can fill the book and still leave excess demand on the table because you want to see aftermarket buying. So they may announce a certain range that they're targeting, but as you see in the headlines, sometimes they price below the range, they price above the range, and the stock trades afterwards the way it's going to trade.

The SPAC transaction is different because that price is set by the PIPE investors that I talked to previously and the company, in terms of what the value of the company is going to be. It's the value that then apportions what the ownership structure is between the management, the SPAC, and the PIPE investors. But the price is the price, it's $10, which is the nominal price that the SPACs are all set at, and it's only after the stock trades that investors get to determine whether that was a fair valuation or not.

John Gilroy: Well, that's interesting. I thought that you were either a SPAC or you were a PIPE and nothing in between, but it's a combination of that. That's interesting. A few years back, there was an Olympic team that got together, it was called the

Dream Team. When I read about several of these SPACs, it seems like there's a reputation that the management team has too, that has impact on the value here. So it may not be the Dream Team, but it might be a set of astute individuals that can pull this off. Is that part and parcel of someone deciding to go with a SPAC, is this management team they have being the superstars or something?

Chris Quilty: Yes and no. It depends on the circumstance. Certainly, there are SPACs out there that have been structured with a management team that is focused on a certain industry. They have experience in Retail or in Aerospace and Defense and they're trying to pitch their credentials, their access to the market and the customers, as an advantage in a SPAC transaction. Because what is often happening nowadays, we've got a little bit of a supply-demand imbalance, right? There's so much SPAC activity that has happened and tens of billions of capital that's trying to find a home, they've got typically two years or less to invest that capital and if they don't, they turn into Cinderella's pumpkin and have to give the money back. So in some ways, the companies are sitting in the advantage position. They've got multiple SPACs coming to them, arguing that they should be the bride. One of the things that companies, the SPACs themselves, will use as their wedge is the fact that they can bring management expertise to the transaction and credibility.

Now, the reality is, again, I don't know the exact numbers, but I think I saw more than 70% of SPACs are, surprise, surprise, led by finance types. Folks that come out of the venture capital or private equity markets, out of the institutional capital markets, not specifically packaged management teams. Also, be aware, just because you've got an Aerospace and Defense team doesn't mean they have to buy an Aerospace Defense company. All you need to do is look at Momentus and Stable Road Acquisition Corp. It was a SPAC supposedly formed to target a cannabis company and ended up merging with Momentus.

John Gilroy: Yeah, that brings me to my next question, is the number of companies in the space industry that have looked at this path. Just in 2021, companies have announced SPACs, including what you just mentioned, Momentus, AST SpaceMobile, Astra, BlackSky, Spire Global, and Rocket Lab. Now, do you think these companies made the right decision to go public through a SPAC?

Chris Quilty: Well, you forgot Redwire and there's stories out there that Virgin Orbit is on the cusp, and there's more behind that. So, let me say the decision to SPAC or not to SPAC is really a company-specific decision and I'm really a no position to second guess the decisions of the management teams and the investors in these companies. What I would note is the common thread for all of the companies that you mentioned is that they were VC, venture capital backed, and in essence, they opted to go a SPAC route instead of raising another VC round. What motivated that decision? It could have been the fact that they could get a higher valuation by going SPAC than doing their C round or D round or it could be the fact that SPACs raise much larger pools of capital and it gives you the ability to compress what would have been multiple VC funding rounds into a single SPAC transaction. I mean, let's be honest, the funding window for SPACs is open and investors have demonstrated a pretty large appetite for this type of investment vehicle. Sometimes you jump on an opportunity when it presents itself, not on your pre-conceived timeline, and with the window open, I think we're seeing companies taking advantage of it.

John Gilroy: You know, Chris, thousands of people from all over the world have listened to this podcast, go to Google and type in "Constellations Podcast" to get to our show notes page. Here, you can get transcripts for all 100-plus interviews. Also, you can sign up for free email notifications for future episodes. You know, Chris, I don't want to paint too glossy a picture of this, but there obviously are companies in the space industry that may not want to explore the SPAC route, isn't that right?

Chris Quilty: Absolutely. I mean, if you look, there's some notable companies in the space industry that have not gone the SPAC route. Relativity just raised another venture round rather than a SPAC that presumably would be open to them. Firefly has also talked about raising another venture round, and probably one of the earliest and most established companies in the, "new space industries", Planet, has yet to jump on that ship. It's not to say that these companies may not go that route, but what we have seen is a very diverse group of companies, from pre-revenue, like AST and Momentus, to at the other end of the spectrum, Redwire, a private equity roll up of very older, larger established companies with a revenue and profit EBITDA profile. So the market has the ability to ingest and price all of these different types of companies.

John Gilroy: Now, Chris, you appeared in a webinar with SpaceNews called SPACs in Space. I love that phrase, it's a new frontier in investment. I think this was back in March, it focused on exploring the developments in the space industry that have led to this surge we're talking about here. So has anything happened just in the last four months that might've changed any of the insight you gave in this presentation?

Chris Quilty: Yeah, absolutely. So probably through the April and May timeframe, we saw a pretty wholesale pause in the overall SPAC market. Not just space, but the SPAC market in general and it reflected two issues. One, was the fact that the SEC issued new regulations on how companies must account for their warrants. The SEC's move there, I think, was widely viewed by folks in the industry as an attempt by the SEC to put a little bit of a pause or tap the brakes on what had become a red hot SPAC market.

The second item I would note is the PIPE investors that we talked about, they went on strike. Again, it's a little bit behind the scenes, but talking to folks running these transactions, what we heard was that whether it was the SEC's action or the market in general, the PIPE investors really sort of were entrenched and started to take a second look at some of their investments. Along with that, I think we've seen a little bit of a subtle shift in the risk tolerance of the PIPE investors and they're shifting away from more of the early-stage companies towards more established companies that can show revenue, profitability, and a proven business model.

John Gilroy: Now, Chris, there are listeners that are familiar with the terminology and some aren't, and you just dropped in that word warrant and that maybe shocked a few people. Maybe you can define the term warrant with respect to SPAC for our listeners, please?

Chris Quilty: Yeah, so I don't want to get too much into the financial nitty gritty. A warrant is like an option, which most people are familiar with. It's a financial instrument that gives the holder the ability to buy SPAC stock at a preconditioned or predetermined price at some point in the future.

John Gilroy: That's fine. It's just that there are people listening from all different aspects of this business and as long as they have an idea what that word was. It's kind of a shocking word to some people. So what has been the space industry's overall reaction to the surge of SPAC announcements? Are SPACs good for the industry in general?

Chris Quilty: So look, my view is access to capital has always been one of the primary challenges faced by the space industry and to the degree that SPACs are able to put cash on the balance sheet of young, fast-growing emerging companies, that's a good thing in my view. In the long term, however, these companies have to prove that they're good investments. If a company raises huge sums of capital and fails to deliver on oftentimes lofty promises, the stock's going to correct. These sort of bad high-profile face-plants of companies that raise SPAC money would be bad for the industry in general. Investors can choose to look elsewhere. I mean, the space industry is appropriately considered what are called a frontier investment, which is correct in more ways than one, and we don't want to go back to the old days, bad old days, of companies in this industry going in and out in search for investment capital.

John Gilroy: Do you think that the SPAC surge is fueling the space bubble right now?

Chris Quilty: Well, I don't think so. I think it's fair to say that SPACs have facilitated a compressed wave of financing activity, but the underlying thesis behind space 3.0 or new space or whatever you want to call it, it stands on its own two feet. That's the fundamentals we've seen change in the industry over the last 10 years which are driven by real accomplishments like lower costs, high throughput satellites, the use of commercial electronics, and high-volume manufacturing. Those things, I think, are sustainable, whether SPACs as a long-term vehicle remain the primary way to do it, that's yet to be seen.

One thing that is important to keep in mind with regard to the investment cycle here is most of the funding that has happened for the industry in the past 10 years or so has been led by venture capital and that's new. I mean, prior to this surge of venture funding, most of the startups in the industry were funded by defense primes or government agencies like DARPA, and to a lesser degree, now and then, your billionaire investor. So most of the VC funds have a 10-year investment mandate and most of the capital is deployed within the first couple of years and then they harvest it beginning in years five to seven. So, the fact that we're seeing this surge in exit activity, it's right about on time.

Honestly, it's welcome, because one of the concerns that I've expressed in recent years was that the space industry was at risk of becoming a roach motel. Investors put their money in, and you just didn't see any good exits, and the fact that it's SPACs now, but it could have been a traditional IPO or M&A activity. You want to see those venture investors get their returns and come back to play in the market again.

John Gilroy: We've talked about many aspects of the SPACs here. So do you think SPACs in the space industry is a trend or this is a continued financial strategy for the foreseeable future here?

Chris Quilty: So the markets are all-knowing, infinitely rational, highly efficient, and regularly subject to manipulation, manias, and panics. So yeah, I think it's fair to say that it sure feels like we're in a SPAC bubble. I mean, the numbers are pretty astronomical, but that's probably how brick and mortar companies felt about Amazon back in the early 2000s. So who am I to say that maybe this is the new normal and SPACs continue to overtake traditional IPOs as a way for companies to go public.

We did see, even before SPACs heated up, a move towards things like direct listings, which is a different way to get to public. So hard for me to prognosticate, the market does tend to go in cycles. As I said, this is sort of SPAC 2.0 and we should expect things to cool off here in the near term, but don't be surprised if SPACs come back strong in the back half of the year. I mean, one of the issues with the overall markets and valuation is there's just so much cash flooded into the financial system and it's got to find a home and SPACs turned out to be an interesting vehicle to get there and we will see how eventually these investments play out for companies. That's really the long-term tale of the tape. If we have companies that go public and they're successful, it's all good for the industry, it's all good for the investors.

John Gilroy: You know, Chris, the space industry is replete with specialized vocabulary. Thanks to your explanation, our audience now has a better handle, I think, on some of these new terms for financing space innovation. I'd like to thank our guest, Chris Quilty. He's a partner of Quilty Analytics.