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What are SPACs and are they as SPACtacular as they seem?

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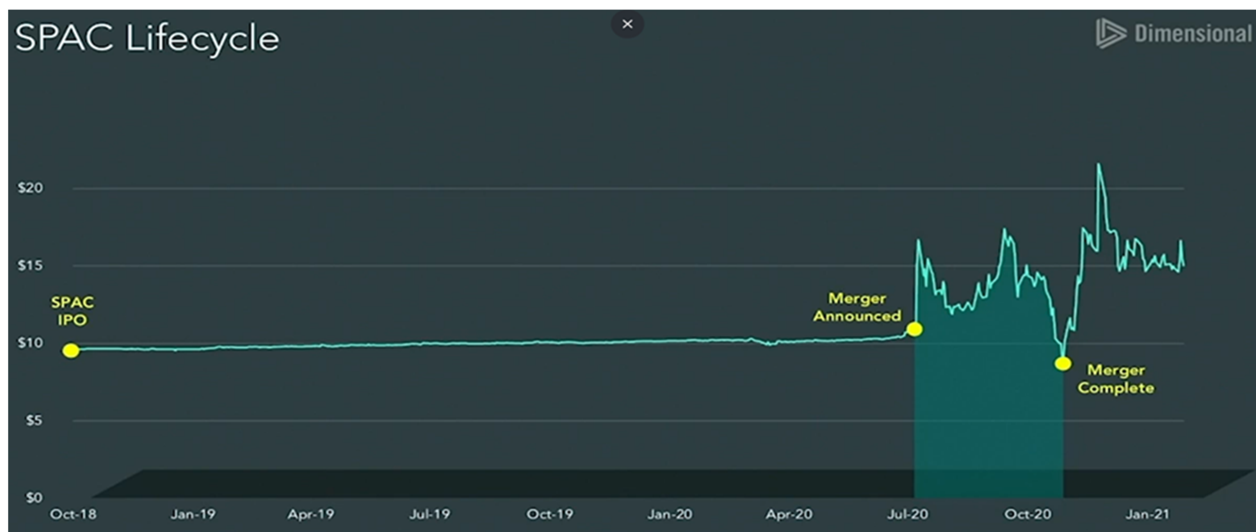
In this brief, I will explain what a Special Purpose Acquisition Company (SPAC) is, discuss the appeal for private companies, the *catches* investors need to be aware of, and explore the investment case. Although they have existed since the 1980s, the recent popularity of SPACs helped them raise ~$80B in 2020 and a whopping ~$95B in the first quarter of 2021. That said, new research that is uncovering a variety of problems associated with the SPAC model and new SEC rules issued in April may disrupt this market segment's rapid growth.

What is a SPAC?

SPACs are also known as blank check companies. A SPAC starts as a non-operating publicly listed company whose **purpose** is to merge with a private company within a maximum two-year timeframe. Private companies may be willing to be acquired by SPACs because the SPAC model can be more flexible and less burdensome than going public through an initial public offering (IPO). SPACs also offer private companies an expedited process to becoming a publicly traded company and the companies often believe they will benefit from the industry expertise of the SPAC's founders.

What else do we need to know?

There are a few important concepts to understand regarding SPACs, the first is the difference between (1) when the SPAC is in its shell company or "blank check" stage and searching for a merger target and (2) at the time of and following the initial business combination (i.e., when the SPAC merges with an operating company).



When the SPAC is in its shell company stage, investors have cash-like exposure. During this stage, the SPAC does not have an established business plan or commercial operations. In *Chart 1* above, which shows the lifecycle of a real SPAC, the cash-like stage lasted nearly 22 months followed by increased volatility after the merger announcement and merger completion.

The exciting part of the SPAC lifecycle is after the merger is announced. At this time, investors are able to learn more about the company being acquired and shareholders are entitled to vote on the proposed merger. A key feature of SPACs is that investors also have the opportunity at that time to redeem their shares for the standard $10 price per share of units sold in the SPAC's IPO, plus interest, and still keep associated warrants and rights. This redemption feature increases the probability that a SPAC may need to raise further cash to meet the target's price.

What's the catch?

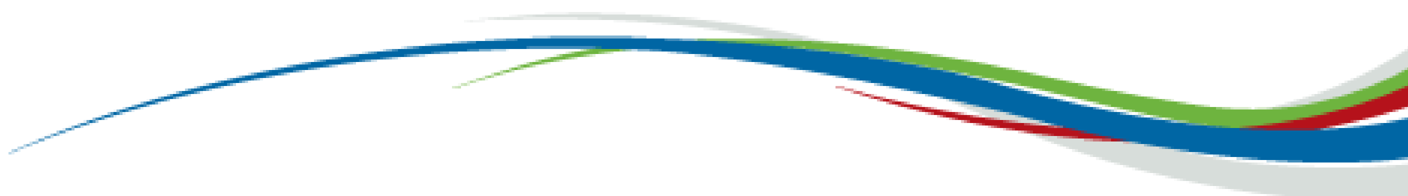
Catch #1: Dilution. The most misunderstood part of investing in SPACs is the various dilutive events.

The first one is the sponsor's 'promote'. This is the sponsor's compensation for work it does for the SPAC. Prior to the IPO the sponsor acquires 25% of the IPO proceeds (approximately 20% of post-IPO equity), at a nominal price. The sponsor also purchases SPAC warrants as part of their initial allocation.

The second source of dilution are the warrants and rights. A typical SPAC IPO structure consists of a 'unit' which is made up of a Class A common stock share combined with a warrant (typically a fractional share). The warrant gives a holder the right to buy more stock at a fixed price in the future. Some units contain 'rights' as well, and these rights convert into 1/10 of a share at the time of a merger at no cost. The warrants and rights, by their nature, are dilutive and disadvantage later investors. When warrants or rights are exercised, they increase the total number of shares outstanding, thereby reducing the present value for shareholders.

The third source of dilution is the redemption feature at the time of a merger announcement, which increases the likelihood that a SPAC will need to raise more cash to meet the acquisition target's price. As an interesting research paper on the topic noted, 77% of the 47 SPACs that merged between January 2019 and June of 2020 raised additional money at the time of their mergers from a combination of sources. Across all SPACs, the mean amount of funding needed from sponsor and third-party investments at the time of the merger was 40% of the cash a SPAC delivered in its merger.[1]

This high degree of dilution is a little understood trap. It may seem hard to believe target and SPAC shareholders would still agree to a transaction that would be so dilutive to their combined investments. The reality appears to be that many of the sponsors and initial IPO investors do not remain core investors past the merger, instead they use the redemption feature and maintain their upside via the warrants they continue to hold. You can see in



the chart below that on average a SPAC sponsor only keeps a meager 7.7% of the promote (i.e., their original compensation for establishing the SPAC) post-merger. Thus, the sponsor and initial investors have upside if the new company does well, and are incentivized to see the merger through, but they do not share the same downside as other shareholders if it does not.

Catch #2: The Sponsors. There is a significant premium placed on the perceived expertise of the SPAC management team, referred to as sponsors. For one, incentives and compensation for SPAC sponsors are an issue due to the large up-front allocations of founders' shares, rights, and warrants that misalign incentives. Functionally, this incentivizes the sponsors to make a lesser quality acquisition if an ideal one cannot be located due to the typical 24-month time limitation. They have more to gain by a bad, overpriced acquisition than they have to lose in delivering a lower quality one. On a more positive note, the management team is crucial in identifying, acquiring, and providing strategic business advice to the target company so their expertise can be critical. A good sponsor, and the endorsement of a prominent sponsor, can be an important benefit for the target company.

New SEC Rules: In April of this year, the Securities and Exchange Commission announced updated guidelines for SPACs. This new accounting guidance states that most SPAC warrants would have to be classified as liabilities, rather than equity instruments. This is a recent development that is still being digested, but the impact would be to force existing SPACs to recalculate and restate their quarterly financials and may punch a hole in the balance sheets of some SPACs. On top of that, investigations of conflicts of interest may be coming next, as well as stricter rules regarding the often-rosy financial projections that SPAC targets provide in the merger process.

Are SPACs a good investment?

SPACs as designed today are not a good investment unless you can get in on a SPAC pre-IPO (and run to the exit pre-merger). As SPACs cloud news headlines, it is important to keep in mind that while a few SPACs sponsored by high-profile funds or individuals have performed well, most have not due the various sources of dilution which erode the returns of this investment for shareholders. Data from the

Net Promote as % IPO Proceeds	25%
Net Promote as % Post-Merger Equity - No Redemptions	20%
Net Promote as % Post-Merger Equity - Actual (median)	7.7%

[1] Klausner, Michael, Machael Ohlrogge, and Emily Ruan. "A Sober Look at SPACs." European Corporate Government Institute (ECGI), Finance working Paper 746. April 2021.

aforementioned research paper shows that the median SPAC that merged in the first half of 2020 lost one third of its value or more within a year following a merger.

The bottom line:

SPACs are misunderstood, the costs associated are currently outsized, and the returns on average have been disappointing to all but those who sponsor them. Over time, we expect many of these issues to come to light and either changes will be made that improves the upside case for the shareholder or the SPAC craze will die. As designed today, stay away.

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