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Special Purpose Acquisition Companies—A Blank Check for Success?

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Special purpose acquisition companies (SPACs) have been around for decades, but in the spring of 2020, they became an extremely popular alternative route for private companies to go public. The subsequent record-breaking surge in SPAC issuance and merger activity that followed was astounding by all measures and led 2020 to be widely dubbed, "the year of the SPAC." By 2022, though, the overabundance led many SPACs to struggle to identify compelling targets within their investment timeframe and dozens had issued warnings they could go bust within the year. With investor sentiment souring, the usefulness of SPACs as a part of a legitimate portfolio investment strategy was called into question.

In our view, investing in SPACs may still provide a differentiated return stream depending on risk–return objectives, and is best accessed through a low-risk, consistent return strategy. However, as with any investment, it's important to understand the key features and complexities before diving in headfirst. In this paper, we break down the basics of the SPAC structure, the reasons behind its sudden rise to prominence and subsequent fall from grace, and review how we believe investors should be thinking about SPACs. First, let's get the lay of the land.

What is a SPAC?

- A SPAC is a "blank check" company that is formed to raise capital in an initial public offering (IPO) with the sole purpose of merging with an unspecified private firm, thereby taking it public. Following the IPO, SPACs have a specified timeframe, typically two years, to find a target firm and—pending majority shareholder approval—consummate a merger or otherwise liquidate and return cash plus accrued interest to investors.
- SPACs have been around since the 1990s as an alternative channel to public markets. However, they were initially viewed as more of a backdoor option for smaller, less established firms, to whom the traditional IPO process was inaccessible. Loosely regulated at first, SPACs were frequently associated with fraudulent activity until a wave of regulatory change helped to legitimize the structure for sponsors, investors, and target companies alike.

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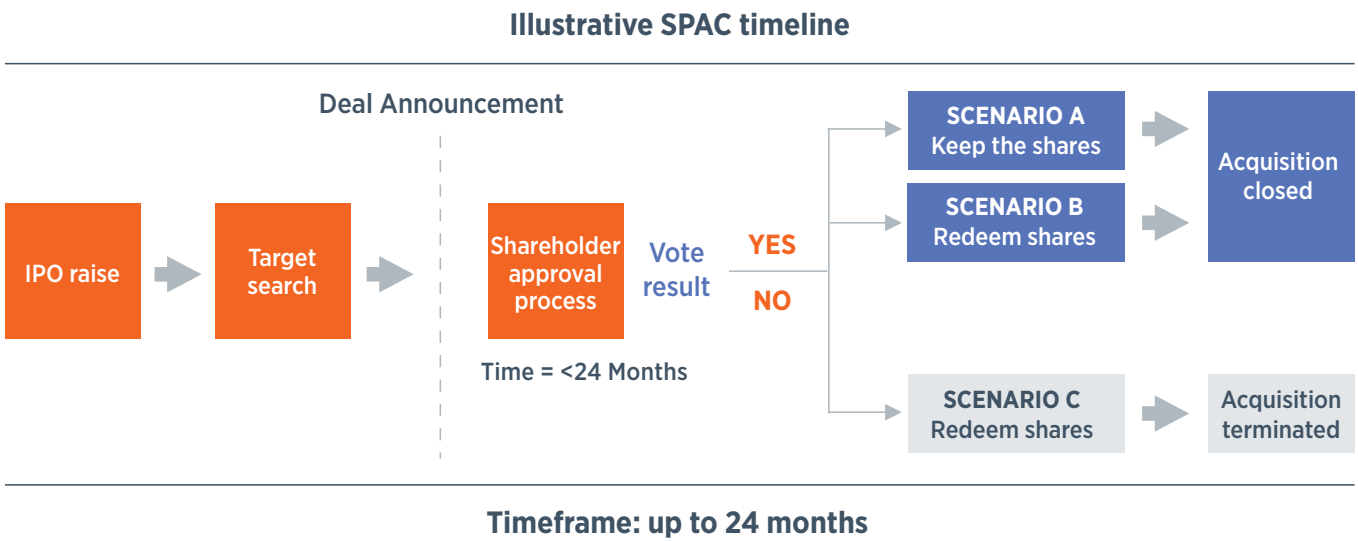
- Even before the pandemic, SPACs had seen an uptick, evidenced by strong IPO activity in January and February of 2020. Soon thereafter, a confluence of factors that began during the market meltdown in March 2020—including a temporary freeze in the IPO market, growing support from high-quality sponsors, and a surge of interest from retail investors—helped usher in a surge of SPAC IPOs and mergers. In 2020, 248 new SPACs came to market, encompassing 53% of all IPOs for the year, and raising a cumulative $83 billion, more than five times the volume of the previous year. Then, in 2021, they hit the high-water mark with 613 SPACs created, raising over $162 billion. By the end of 2021, though, the market had slowed. And as of late June 2022, only 70 SPACs have been created, raising a mere $12 billion.[1] Though this is still slightly above pre-boom levels, it is substantially off highs.

Basic structural features for investors:

- **Units:** In the primary offering, a SPAC raises capital by selling units to participants, typically a mix of hedge funds and other institutional investors. The units are usually composed of one common share and some amount of fractional "warrants," which give an investor the right to purchase common stock of the newly public target firm after the business combination. Following the IPO, units can be purchased by retail investors on the secondary market, until roughly 50–60 days thereafter, when shares and warrants begin to trade separately.
- **Redeemable common shares:** Typically priced at $10/share, each share represents $10 of cash deposited in a blind trust and invested in securities that are considered secure, e.g., short-term Treasury or money markets securities, to be allocated toward a merger if consummated. Shareholders have the option to redeem shares for the initial $10 plus interest at the time of the merger, and they can also sell shares in the open market at any point. If the sponsor team fails to secure a business combination in the specified timeframe, shareholders receive their pro rata share of cash from the trust account, plus interest accrued.

Figure 1
Timeline of SPAC process from IPO to post merger



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While running a SPAC can ultimately yield a lofty payout, it is by no means a free lunch.

- **Detachable warrants:** Usually warrants give the holder the option to purchase shares at a value 15% above the IPO price ($11.50) by a specified maturity date, typically a few years in the future. Unitholders can keep the warrants even if they sell the common shares.

The hub among the spokes

SPAC sponsor

- **Role:** The leadership team that sets up a SPAC raises funds and is responsible for its success or failure in acquiring a target. SPAC sponsor teams are typically led by former CEOs, private equity or venture capital executives, or prominent investment bankers, with significant expertise in a particular industry or a strong history of deal making. Sponsors contribute "risk capital" to the transaction, which is typically 2% of the IPO size to cover the bank fees, plus an additional $2 to $4 million to cover operating expenses. For this risk capital, sponsor teams typically receive private warrants with similar terms to those issued to unitholders.
- I**ncentives:** In the common SPAC structure, the sponsor receives "founder shares" (otherwise known as a "promote"), equal to 20% of the common shares issued in the IPO. These shares will convert to common shares on the completion of a successful merger.
- **Risks:** While running a SPAC can ultimately yield a potentially lofty payout, it is by no means a free lunch. The sponsor needs to find and win over a target that shareholders will feel comfortable voting for and faces the loss of the contributed risk capital and potential reputational damage if they fail to do so. Founder shares retire worthless if the sponsor fails to close a deal.

Who are the primary investors in SPACs, and what are their incentives and key risks?

Public shareholders

- **Role:** Shareholders provide the sponsor with the necessary capital to take the SPAC public. Mostly institutional investors take part in the IPO and public investors can buy in via the secondary market. Holders of shares vote on whether to approve or reject a merger with the target company.
- **Incentives:** Investors face the potential of muted returns while the sponsor seeks out a private company merger target. To compensate for the associated opportunity cost (versus investing in equities or bonds that may generate higher returns), investors typically receive fractional warrants as a sweetener, enhancing potential upside if the merger is a success. Additionally, prior to the merger, investors have the option of redeeming their shares, which seeks to provide downside protection.

  Investors can also capture meaningful upside if the market is receptive to the target company. The sudden share price elevation ("pop") associated with a traditional IPO is usually only for the benefit of select institutional investors chosen to participate by the company or its bankers. However, anyone can invest in a SPAC that is searching for a company, typically for roughly the IPO price. Then, once the merger is announced, all existing shareholders would benefit from any notable price increase. In 2020, investors were well compensated from the pop in shares seen after the merger announcement, with an average price gain of 13.6% on the day of announcement compared to only 2.5% in past years, according to Barclays Research.[2]

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Before announcement, investors have little visibility of the company they may eventually own and are putting their faith in the sponsor to execute. In that sense, there is no fair value to estimate for an unknown eventual target.

Risks:

- **Pre merger:** In theory, risks for capital loss are relatively low for investors who acquire shares at or near the IPO price during the pre-merger period (which is comparable to a convertible bond in combining bond-like downside with equity upside). The redemption option provides $10/share downside protection and shares typically trade close to that value before the merger is announced. According to Barclays, the median return for SPACs from IPO to acquisition for 2016–2022 was 6.1%.[3]
- **Post merger:** The redemption option concludes at merger completion and post-merger performance has been historically poor, with the DeSPAC Index (which tracks companies that went public via SPAC merger) trailing the S&P 500 index by substantial margins over since its inception in April 2020. Performance for de-SPAC-ed firms is especially notable after the market digests the merger, with the median SPAC returning roughly -30% in the six months post-merger.[4] Relative to other sponsored go-public mechanisms, "the De-SPAC Index" also lags substantially. During the market turmoil seen in the first half of 2022, a number of merger announcements have caused an immediate, sharp drop in share prices, forcing SPAC sponsors to rethink their merger agreements. The post-announcement pop has been muted since late 2021, with certain mergers falling immediately after the deal is publicized as the market moves away from blind enthusiasm for SPACs.
- **Lack of visibility:** Before announcement, investors have little visibility of the company they may eventually own and are putting their faith in the sponsor to execute. In that sense, there is no fair value to estimate for an unknown eventual target.

Private investment in public equity investors

- **Role:** SPACs typically make acquisitions that are two to five times the size of the SPAC IPO. While some of this amount is equity rolled over from the private owners of the company, sponsors often supplement SPAC IPO proceeds with a private investment in public equity (PIPE) to cover the remaining cost. In PIPE transactions, institutional investors receive the SPAC units via a private placement, typically at a price equal to (and sometimes less than) the SPAC IPO price. During this marketing process, prospective PIPE investors receive material non-public information regarding the potential transaction the SPAC is pursuing. PIPE operations in SPACs have evolved and grown in importance; targets and investors often view securing PIPE capital as a vote of confidence in the sponsor and deal, which has been reflected in the performance of the SPAC stock.
- **Incentives:** PIPE investors typically receive their shares at the IPO price or lower, with strong visibility into the merger allowing a detailed underwriting.
- **Risks:** While the shares PIPE investors receive are similar to those issued in the IPO, they are unregistered, have no redemption option, and cannot trade until registered with the Securities and Exchange Commission, which can take weeks or months. Although this is usually well before the SPAC sponsor or the target company can sell shares, PIPE investors are exposed to market movements during that time and often there is a significant drop in price on the day PIPE investors can ultimately sell.

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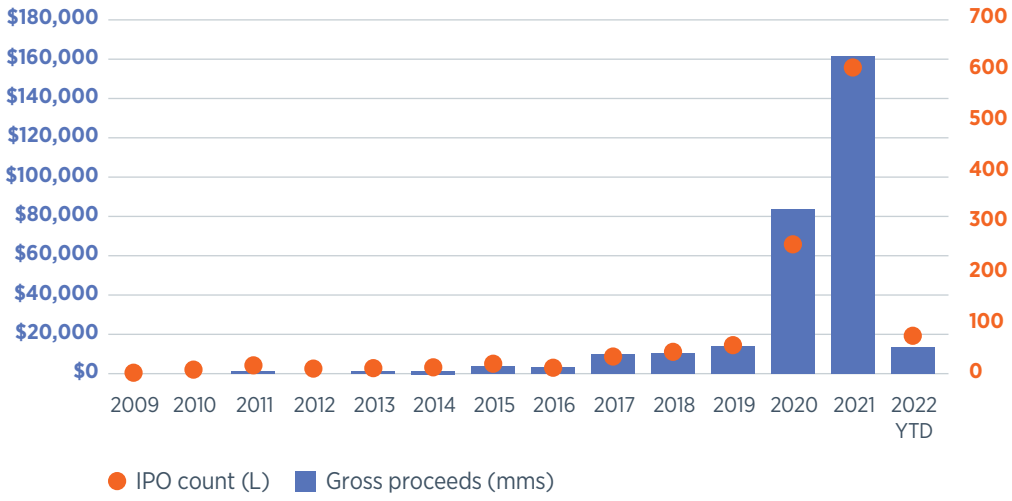
For a private company, what are some of the unique features of going public via SPAC versus the traditional IPO process?

- **Speed to market:** For a target acquired by a SPAC, the process from private to public markets can take as little as five to six months, versus the IPO process, which can take one to two years from start to finish.[5]
- **Certainty of pricing:** For IPOs, the offering is announced months ahead of when the deal comes to market, and prices are highly influenced by market conditions and investor demand. Additionally, newly issued shares often see a tremendous Day One price pop. This benefit goes to the investors lucky enough to receive an allocation of IPO shares at the expense of the company that issued those shares at prices well below what the market would bear. In contrast, terms of the SPAC merger with a target, including price and valuation, are negotiated between the sponsor and target before the transaction is announced.
- **Lower cost:** In a traditional IPO, the fees associated with the offering (underwriting, legal, auditing, etc.) are the responsibility of the company and reduce the proceeds. In a SPAC merger, those costs are typically born by the SPAC shareholders, rather than the company, at the time of the merger.
- **Ability to present projected growth:** For legal reasons, companies don't typically provide forward-looking statements and financial projections when marketing an IPO. SPAC sponsors do not face the same hurdle and can present the target's financial forecasts to potential investors. This feature can be a major selling point for earlier-stage businesses with limited financial history since it allows them to walk investors through both strategic growth plans and how they intend to allocate capital.

Figure 2

SPAC IPO count and gross proceeds raised by year



Source: SPACInsider.

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- **Strategic partnerships:** Beyond providing a path to public markets, SPAC sponsors often join the target company's board as strategic advisors, supporting the new public firm with industry expertise, connections, and credibility. It is hence no surprise that former Fortune 500 CEOs, venture capitalists, and prominent bankers are frequently at the helm of SPAC management teams.

Why did SPAC transactions surge in 2020?

- **A ballooning supply of mature private companies:** With steady inflows into private markets over the past decade and no shortage of financing options, companies have stayed private for longer and private markets expanded relative to public. According to the Milken Institute, up until 2007 there were more publicly listed firms than private companies backed by private equity (PE) in the U.S., but the ratio flipped that year and, by 2018, there were just under 8,000 PE-backed private companies versus roughly 3,400 public companies.[6] All the while, private equity and venture capital firms extended their hold periods, with the median time to exit tripling between 2005–2018. As the pandemic took hold, the IPO market temporarily closed down, PE firms' attention shifted to stabilizing the companies that were already a part of their portfolios, and SPACs provided a convenient and relatively quick way to infuse mature portfolio investments with the opportunity to access liquidity.

- **Broad acceptance of SPACs as a legitimate path to public markets for high-quality companies:** SPACs have historically had a less than pristine reputation as a vehicle that allowed shady financial sponsors to earn returns by bringing low-quality companies public at the expense of unsuspecting retail investors. As a result, companies that could gain liquidity through the IPO market did not view SPACs as a viable option. So, what's changed?

  The quality of SPAC sponsors has improved, and SPAC structures have become more shareholder friendly, making the SPAC route an increasingly viable choice, even for companies that have the option of a traditional IPO. A growing crowd of experienced financiers have entered and lent credibility to the space, which has helped form a positive feedback loop, luring more high-quality sponsors, attractive innovative companies, and in turn, enticing more institutional and retail investment.

  The pandemic made features of SPACs appealing for prospective targets and investors: With unnerving market volatility and an uncertain path forward in the worst of the pandemic, SPACs provided an avenue to public markets with greater certainty of execution and pricing. For investors, the option to redeem shares for their initial cost and additional warrants embedded in SPAC units provided institutional investors with an easy return on investment with minimal downside risk, which became desirable in a highly volatile and low-rate environment. Extremely strong market activity and rising valuations in the second half of the year made the prospect of going public increasingly attractive, and SPACs provided an abbreviated method of doing just that.

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Characteristics that had originally drawn investor capital to SPACs fell out of favor and the macro environment shifted away from riskier assets.

Retail investors: SPACs have become a hit with retail investors. According to Bank of America, 40% of SPAC trading on its platform from July to December 2020 was driven by retail, relative to just 21 % of each S&P 500 and Russell 2000 Index stock trading.[7] In 2020, SPAC targets were highly concentrated in exciting industries popular with the retail crowd, including clean energy, biotech, and space travel. Virgin Galactic, a commercial spacecraft and spaceflight company under the Virgin Group, was one of the first SPAC targets to drum up significant retail interest, following its announced merger with Chamath Palihapitiya's Social Capital Hedosophia in October 2019. Retail investors have typically been shut out of IPO allocations in the primary market, excluding them from participation in the often sizeable first-day pop. In contrast, buying SPACs pre merger provided retail investors with a unique opportunity to capture upside comparable to that of the pros following a merger announcement, when a good portion of SPAC alpha (an investment's excess return vs. that of a benchmark index) is typically generated.

Why did the bubble burst?

By mid-2021, the outlook for SPACs had taken a turn for the worse, with continued underperformance through the first half of 2022. Characteristics that had originally drawn investor capital to SPACs fell out of favor and the macro environment shifted away from riskier assets. Some key reasons for this development include:

- **Too much ready cash:** It is estimated that investors poured $162 billion into SPACs in 2021, an increase of 91% relative to 2020.[8] Despite the preponderance of private companies in existence, the level of excess capital that needed to be put to work in a relatively short timeframe far outstripped the number of potential merger targets that viewed going public via SPAC as a compelling option. Of the roughly 600 SPACs still in existence as of early June 2022, nearly 270 have been looking for a target for at least a year.[9]
- **Changing regulations:** A key benefit of SPACs—particularly for higher-growth, early-stage companies—was the ability of companies to go public using growth projections rather than realized historical performance. Regulators are increasingly focused on this provision, with proposed rules that would make it easier for shareholders to sue companies that go public using exaggerated financial projections. The SEC has already opened two dozen investigations involving SPACs since early 2020,[10] leading banks and service providers working on SPAC deals to worry about increased liability.
- **Disappointing returns:** For companies that have gone public via SPAC merger, the majority have experienced discouraging market reception. After interest in SPACs sent pricing sky-high in 2020 and early 2021, shares of companies that went public through SPACs in those years were down 52% on average in 2022 through June, according to PitchBook index data.

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While the market has corrected from its highs, it seems likely that SPACs' positioning as a viable alternative to IPOs for a subset of private companies is here to stay.

As returns have lagged, more premerger investors have redeemed their shares prior to merger completion. Historically, around 54% of shareholders would opt to redeem shares; more recently, as many as 80% of investors have opted to redeem.[11] Higher levels of redemptions mean the merged company can access less of the capital that compelled the target to merge in the first place. As prospects dim, lower-quality companies desperate for cash infusions are more likely to seek out SPAC mergers, while stronger companies may opt to pursue a traditional IPO or delay going public.

What we believe the future holds for SPACs

Competition among SPACs and their weakening relative performance has led to evolution of the structure, to better align the interests of all stakeholders. Certain SPACs do not include founder shares for sponsors—a key source of dilution that allocates asymmetric windfall to SPAC management teams. In a similar vein, Morgan Stanley has developed a new structure, called a "Stakeholder Aligned Initial Listing," which ties compensation directly to post-merger performance, and aims to better align compensation with shareholders and limit post-merger dilution. As regulatory bodies home in on overly rosy projections that disadvantage retail investors, they are also likely to favor arrangements that block financial institutions and SPAC sponsors from benefiting when promoting investments that ultimately generate negative returns for the broader investor base.

With recent headlines highlighting the oversaturation of potential acquirers, the weak performance of target companies once public, and the increased percentage of investors redeeming premerger, it appears that the flood of earlier enthusiasm for SPACs has slowed to a trickle. Despite this, SPACs today still have a far larger presence on Wall Street than they did before the boom. While the market has corrected from its highs, it seems likely that SPACs' positioning as a viable alternative to IPOs for a subset of private companies is here to stay.

Investing in SPACs

The risk–return profile of a SPAC investment can vary widely depending on when in the timeline an investor buys and sells, as well as which security or securities are involved. Participating in the IPO or buying units near the IPO price and selling or redeeming at or before the business combination has historically produced consistent positive returns, up 6.1% from IPO to acquisition from 2016–2020.[12] Given that interest remains in the ability to redeem SPAC units at the IPO price plus interest, there is embedded downside protection up to the merger completion. Holding the stock after the merger has seen more volatile results, where the average company significantly underperforms broad equity markets. While this pattern is similar to that of traditional IPOs, SPACs have historically performed worse on average albeit with certain companies performing well. However, given the increased attention to SPACs and the proposed regulation changes, their future performance may be more positive. As SPACs are required to produce compelling backwards-looking performance to garner investor support, this market may leave its Wild West roots in the past.

Continued

ENDNOTES

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