BANGOR BUSINESS SCHOOL

SPACs
All that glitters may not be gold

Dr Danial Hemmings explores the risks and opportunities of the pandemic-driven investment surge of special purpose acquisition companies (SPACs). Will SPACs still be making headlines during 2022, and are investors really writing them a blank cheque?

For the unfamiliar, a special purpose acquisition company (SPAC) is a form of 'cash shell' investment vehicle that raises funds from investors at initial public offering (IPO) for the primary purpose of taking over an existing company. Typically, the target company is unlisted, hence merging with a listed SPAC presents opportunities both for the SPAC investors to enter the private equity space, and for the target company to go public without the regulatory hassle of conducting its own IPO.

The target company, however, is usually undetermined, and universally undisclosed at the time of IPO. In essence, investors in a SPAC IPO do so without knowledge of which company they will ultimately be invested in – they are often said to be handing over a 'blank cheque'. For example, at the time of Digital World Acquisition Corp's IPO in August 2021, investors were unaware that the SPAC could become a vehicle to take Donald Trump's Trump Media & Technology Group public, under controversial plans announced just weeks later.

While SPACs are not new, their popularity and prevalence have surged during the pandemic. In 2020 and 2021, respectively, 248 and 613 SPACs were floated on US exchanges, raising a total of $83.4bn and $162.5bn from investors. This compares with 59 SPAC listings during 2019, raising £13.6bn in total – itself a more than decade-long high.[1] I predict that SPACs will continue to make headlines in 2022, not least because, following a slowdown in mid-2021, SPAC activity appears to be gearing up again. In addition, as time begins to run out for SPACs formed at the start of this wave, the value delivered to investors through SPAC deals will attract keen scrutiny.

Safeguards in place

At face value, the SPAC concept is strikingly alike the opportunity described in the following cautionary anecdote. Famously, it is said that an 18th century promoter 'absurdly' and 'preposterously' lured irrationally credulous investors of 1720 London, during the South Sea Bubble period, to invest in "a company for carrying on an undertaking of great advantage, but nobody to know what it is." (Mackay, 1841).

However, reassuringly, modern SPACs feature several safeguards which can, in principle, reduce investors' exposure to downside risk. Above all else, the IPO proceeds are held in a trust account until a merger is conducted. If the SPAC fails to identify a merger target within a pre-defined period (usually two years), it is liquidated, with the balance of the trust account returned to shareholders, normally gross of fees.

Even if a merger opportunity is identified, and a majority of SPAC shareholders vote to approve the transaction, each shareholder still has the chance to redeem their share capital from trust. Alternatively, they can sell their shares at the market price if that is higher. On the flip side, an investor who wishes to remain invested post-merger may gain additional exposure to upside potential through warrants, including those often gifted as 'incentives' during the merger deliberations.

Given this, it may not, on reflection, be entirely fair to say that investors in SPAC IPOs are handing over a 'blank cheque', or at least not one that is signed and ready to cash in. It seems more analogous, in practice, to a refundable deposit. The investment terms at IPO are sufficiently attractive that many hedge funds, colloquially known as the 'SPAC mafia', are heavy investors. With names such as Glazer Capital and Goldman Sachs among those listed by M. Gahng, J.R. Ritter and D. Zhang (2021) as the largest investors in SPACs, one is not necessarily left with an impression of the typical SPAC investor as one that is naïve.

That said, there are still several unguarded risks for the SPAC investor, principally that there is little recourse for those who opt to go along with a merger that winds up being rotten. For all that is said about the SPAC mafia's keenness to invest in IPOs, less often noted is their tendency to exit before the 'de-SPAC', or post-merger, period.

Merger incentives and competition

Two points raised above may become especially prescient during 2022. First, that the amount of capital raised by SPACs surged

[1] *Data from https://spacinsider.com/stats/*

to unprecedented levels from mid-2020. Second, that SPAC managers typically face a two-year deadline to identify and acquire a willing target company, or else the funds are returned to shareholders. Particularly for those who formed SPACs early on in the current wave, the clock is ticking.

Focusing just on the US, there were 861 SPACs listed during 2020 and 2021 combined. At the time of writing (January 2022), less than a quarter (181) had completed deals, although a further 108 had announced potential mergers. The majority of the SPACs formed during the 'boom' period of the past two years are still courting.

Because of the vast amount of SPAC capital now chasing deals, there is a real danger that a shortage of investible companies that are attracted to going public via the SPAC route will drive fierce competition for good-quality targets. This may result in a race to the bottom, reduced standards, and aggressive efforts to persuade and push deals through, even if against shareholder interests.

This is because the sponsors that set up SPACs do not typically charge management fees, but instead are compensated through a 20% stake in the SPAC's shares, coupled with warrants, neither of which pay off in the event of liquidation. The economic incentives of SPAC sponsors are therefore to complete any deal, rather than have no deal at all.

Historically, SPACs that successfully complete mergers have gone on to severely underperform the market, on average, during the post-merger (de-SPAC) period (Dimitrova, 2017), suggesting that this concern is not unsubstantial.

In addition to competition for good-quality merger targets, we may also see SPACs competing more fiercely for new investors willing to buy into the mergers proposed. It is a misnomer to think that SPACs necessarily bring an entirely deal-ready pool of capital (i.e., that 'blank cheque'). Often, substantial numbers of SPAC shareholders choose to pull out at the merger stage, in many cases necessitating new fundraising rounds to make up the shortfall.

SPACs have raised eyebrows over the past two years due to eye-watering amounts of capital raised at IPO. However, that, in many senses, is the easy part. SPAC success is constrained mainly by the availability of good-quality companies to merge with, and investors that are willing to stick around for the de-SPAC period, not by their ability to raise capital at IPO. Thus, high volumes of the latter may give more reason to be wary than impressed. While it suggests that SPAC sponsors feel better able to close good deals now than before the pandemic, much of this fervour remains to be proven. Let us hope that naïve de-SPAC investors do not wind up bearing the costs of excess exuberance. CB