SPECIAL PURPOSE ACQUISITION COMPANIES 101

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Investment market trading news seems to be coming in leaps and bounds lately—who could miss all the attention paid to cryptocurrency or GameStop traders vs. hedge fund strategist issues on financial cable stations and business pages?

If you've had a sharp eye out, you would also be paying attention to SPACs, or Special Purpose Acquisition Companies, sometimes called blank-check companies.

These are publicly traded vehicles formed for the purpose of merging with (or acquiring) a private company, essentially taking that company public. While SPACs are formed through Initial Public Offerings (IPOs) without knowing the target private company, most of them will have a focus on a particular sector, geography, or purpose.

What's also exciting about SPACs is that they allow investors previously unable to access the private markets or traditional IPO space the opportunity to participate in these investment vehicles.

Private firms may choose to merge with a SPAC for raising capital versus a traditional IPO, since SPAC mergers can be put together much more quickly, don't need extensive financial statement disclosures and offer more predictable pricing.

While there has been an influx of SPAC IPOs recently, accounting for about half of all new IPOs in the period 2019-2020, SPACs have been around since the 1980s and have experienced fluctuations in their popularity and usage over the years. According to JP Morgan, completed SPAC IPOs in the 2019-2020 period were dominated by technology, electric vehicle companies, health care and industrials (specialty chemicals, aerospace, and metals and mining).

The target companies tended to be early-stage firms with negative net income, as with most companies involved in traditional IPOs in 2020, although at least one well-known SPAC merger candidate was a private company with no revenue. Most SPACs formed over the 2019-2020 two-year period have not yet found a target company with whom to merge.

The structure of SPACs can be flexible, although many are organized with the same characteristics. The process is started by a sponsor, which is a management team or entity seeking to raise capital in order to merge with a private company. As part of the SPAC IPO, investors are sold units in the SPAC, typically at $10 each. The units often comprise public shares and warrants, which eventually begin trading separately.

The capital raised is placed in a trust account and invested in short-term Treasuries until needed for an acquisition. The sponsor also typically purchases "founder shares" for a nominal amount that usually equates to 20% of the total shares, which is called the "promote." The promote represents the compensation to the sponsor for its work. The sponsor typically has 18 to 24 months to complete a merger or acquisition. If no transaction takes place by the end of that time period, the SPAC is dissolved, and the capital plus any accrued interest is returned to the investors.

Historically, private companies that choose the SPAC route are companies with little or no operational track record or those for whom the SPAC approach could be a last resort toward becoming public because a traditional IPO process would be unavailable to them. While the profile of the typical company going public through a SPAC is beginning to improve, generally these companies are not the ones that many investors are excited to see go public. However, the quality of the sponsors has improved dramatically, as well-respected private equity and hedge fund managers are beginning to sponsor their own SPACs.

INVESTOR CONSIDERATIONS

Investors seeking to participate in a SPAC should consider many factors when deciding on the merits of the investment. Research has shown that SPACs do not perform well post-merger as a public equity when compared with traditional IPOs or the Russell 2000 Index of small-cap companies.

With the explosion of SPAC IPOs recently, there have been several new players in the industry, including celebrities like baseball executive Billy Beane of *Moneyball* fame, former astronaut Scott Kelly, 15-time NBA All-Star Shaquille O'Neal, and former Speaker of the House Paul Ryan, who are all involved with SPAC companies.[1] Since a SPAC investment is essentially like investing in a one-company private equity fund hoping that the new firm post-merger trades higher, investors should make sure they are comfortable with the sponsor's track record, whether as an executive at a company, hedge fund or private equity manager. Some research has shown that operator-led SPACs whose leadership has former C-suite experience outperform other SPACs.

Another factor to consider is how the "promote" the sponsor receives may affect the outcome of the investment. Since the sponsor typically receives 20% ownership in the entity, the investors' shares in the SPAC will be diluted. When a target acquisition is announced, shareholders have the right to redeem their shares at the full price of $10.00 if they do not like the acquisition. However, research has shown that at the time of a merger, each SPAC unit has only $6.67 of cash, due to fees, sponsor shares and other expenses, instead of the original $10.00 paid by the investor, reflecting the dilution risk to the non-redeeming shareholders. The SPAC generally makes up this funding difference by raising funds through private placements in order to complete the transaction. This introduces another set of investors who will own shares of the completed company after the merger with the private company.

The type of investor in the SPAC and the timing of the investment will play a role in the investment returns. Additionally, a few items should be considered when analyzing the returns that SPACs have provided over the last two years. First, while the average returns look generally attractive on an absolute and relative basis (versus the Russell 2000 Growth Index), the median returns do not. The disparity between the two figures means there are a few big winners driving average returns. Second, the volatility as measured by the standard deviation of these investments is extremely high, which points to the risk of these deals. Last, the sponsors appear to be the biggest winners of the deals. As mentioned previously, the "promote," which gives sponsors an outsized ownership in the SPAC IPO, can play a large part in the returns. The outsized sponsor returns have been likened to a wealth transfer from the SPAC investor to the sponsor.

CONCLUSION

Investors should consider the risks involved with SPACs as with any other investment. While investors do have the right to redeem their shares prior to the private company merger, we consider SPACs to be a speculative investment. Aggressive investors whose risk tolerance can accommodate speculative investments such as SPACs should consider the idea that each SPAC represents a potential merger with a single, as-yet-unknown company that is likely to have negative earnings, as opposed to a private equity fund that will invest in a variety of private companies. Just as with IPO investments or even traditional publicly traded stocks, the investor should carefully consider the size allocation of the SPAC investment in the overall portfolio in order to prevent unintended concentration risk.

The question of whether a SPAC investing strategy is right for you must be evaluated in the context of an individual investor's time horizon and the amount of volatility, and thus risk, that can be tolerated. A Commerce Trust advisor can help you select the right mix of investment strategies to support your long-term financial goals.

[1] https://privatebank.jpmorgan.com/content/dam/jpm-wm aem/documents/en/investing/eotm/Hydraulic-Spacking.pdf; https://www.barrons.com/articles/more-celebrities-are-involved-in-spacs-investors-should-be-wary-51607689813

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