BETTER MARKETS

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Cutting Through the Hype On SPACS

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Introduction

Special purpose acquisition companies, or SPACs, have been in the news quite frequently over the last year. SPACs, as further explained below, are essentially public shell companies that exist to seek out a private company and merge with it, taking the target company public in the process. These investment vehicles have become suddenly trendy. In part this has resulted from high-profile celebrity involvement, with the likes of current NBA superstar Stephen Curry, retired NBA superstar Shaquille O'Neal, and singer Ciara assuming public roles with SPACs as executives or board members. In addition, SPACs have been involved in taking high profile companies public, including Richard Branson's space tourism company Virgin Galactic and daily fantasy and gambling website DraftKings. And now, even former President Donald Trump is reportedly planning to use a SPAC to bring his recently announced new social media platform public. At the same time, SPACs have generated their share of controversy, including a lawsuit against a high-profile SPAC, which itself generated an extraordinary response, as nearly 50 large, high profile law firms issued a letter condemning the lawsuit as baseless and more broadly defending SPACs.

SPACs proponents often claim that SPACs help "democratize finance" by allowing so-called ordinary, "mom and pop," retail investors to get around the regulations preventing them from investing in private companies, allowing them to play in the lucrative world of private equity (in fact, SPACs have often been referred to by the not-quite-PC term "poor man's private equity"). Also according to proponents, SPACs have also been hyped as a way to fix the ailing public markets by offering a more efficient, less burdensome way for a private company to go public.

Do these claims regarding the benefits of SPACs hold up to scrutiny? Suffice it to say, the facts about SPACs are quite a bit more complicated than the hype. As explained in more detail below, SPACs in fact contribute very little to the so-called "democratization" of finance, as SPAC investments are generally dominated by a few institutional investors (colloquially known as the SPAC Mafia). Moreover, when retail investors do invest in SPACs, they are investing in an inherently risky, speculative venture, which typically underperforms the broader market, and in which they can lose a significant amount of money (especially if they hold their SPAC shares through the merger). Similarly, as it turns out, SPACs are not a particularly efficient way of bringing private companies public. Due to the nature and structure of SPACs, the promoters drain significant value out of the entity prior to the merger, meaning SPACs can only deliver a fraction of the cash raised to the target company, to the detriment of the SPAC's shareholders and the target company.

How SPACS Work

SPACs are not operating companies. They are public shell companies set up for the sole purpose of acquiring a private operating company, with the end result that the acquisition target becomes public. While the SPAC may be focused on a particular industry, its acquisition targets are generally unknown and unidentified at the time the SPAC is formed and goes public. The entity that sets up a SPAC is called a sponsor and typically receives 20% of the shares of the SPAC for a nominal price, which is the sponsor's "promote," essentially their compensation for getting the SPAC up and running, identifying a target company, and successfully completing a merger. The sponsor then goes through the process of registering the securities to be offered to the public. Typically, SPACs offer "units" that include a share in the SPAC and a warrant to purchase additional shares upon an acquisition. Units are typically sold at an initial price of $10 each (while the shares and warrants in a unit are offered together initially, typically they will trade separately shortly after the IPO). The proceeds of the IPO are deposited in an escrow account to ensure that the money is available for a business acquisition or, failing that, for return to investors (less taxes but plus interest). Following the SPAC's IPO, the typical process for identifying a target and completing a merger is as follows:

- Once it goes public, a SPAC typically has two years to find an acquisition target.
  - If it fails to complete an acquisition, the money raised by the IPO is returned to the shareholders at the initial price, *i.e.* $10, less taxes but plus interest.
  - In the event of such a failure, the sponsor's promote is forfeited.
- If the SPAC identifies a target for acquisition, it will attempt to negotiate a merger agreement with the target. Public shareholders have the right to redeem their shares ahead of the consummation of the merger for their pro-rata share of what's in the escrow account, which in almost all cases will be the initial unit price of $10 (plus interest, but less any applicable taxes).[1]
- As a result of this redemption right, sponsors often have to make additional arrangements for financing in order to ensure that there is sufficient cash to deliver to the target when the merger is completed, including contributing cash itself or trying to raise money through one or more private placement transactions. Sponsors also sometimes make side payments to one or more larger public shareholders to induce them not to redeem their shares.
- Once the SPAC has navigated all of this and successfully completed a merger, the result is a publicly-traded, operating company.

There is no specific statute or SEC regulation governing SPACs. SPACs are similar in form and function to "blank check companies" that proliferated in the 1980s. These companies were often implicated in fraud and abuse, including pump and dump schemes. As a result, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, which directed the SEC to promulgate a rule governing blank check companies—but SPACs are not considered "blank check companies" under that rule because they do not issue penny stock. SPACs also benefit from an "unintentional legal loophole" that allows them to make rosier forward-looking statements, with less fear of legal liability if those statements prove false, than companies engaging in a traditional IPO. As discussed below, this is just one of the risk factors facing investors who put their money into a SPAC. Because of the heightened level of risk surrounding SPAC

[1] Investors also typically have a right to vote on the acquisition. Previously, most SPACs provided that only shareholders who voted against the acquisition could redeem their shares, but now SPACs typically no longer condition redemption rights on voting against the merger, meaning the shareholder vote is typically more pro-forma, as shareholders have less reason to vote against the acquisition.

investments and the gaps in the current regulatory framework, two bills have recently been introduced in the House that would strengthen investor protections in connection with these offerings.[2]

SPACS Are Not Democratizing Finance for Retail Investors

Proponents of SPACs have argued that they are beneficial because they democratize finance by allowing retail investors to play in the highly lucrative world of private equity, finally allowing them to get around the "accredited investor" barrier that prevents them from investing in startups and finding the proverbial unicorn.

As it turns out, however, this purported benefit of SPACs is more imagined than real. First, SPAC shares tend to be overwhelmingly held by institutional investors. Retail investors make up a relatively small portion of the shareholders of the typical SPAC. A recent study found that, post-IPO, large institutional investors that are required to file Form 13F held a median of 85% of shares in SPACs established from January 2019 to June 2020. This number likely underestimates the proportion of SPAC shares held by institutional investors, since some institutional investors who hold SPAC shares may not be required to file Form 13F. This finding caused the study's authors to conclude that "it seems clear that the description of SPACs as a 'poor man's private equity' is off the mark."

Second, SPACs are ill-suited to serve as a "democratizing" investment opportunity for everyday investors because they are uniquely risky, especially for the retail investors who do invest in them. As explained below, SPACs are inherently speculative and in addition, retail investors are not likely to receive the full benefits of the features of SPACs that purport to provide protection.

SPACS Are a Uniquely Risky Investment for Retail Investors

There is no real business to evaluate. Those retail investors that do invest in SPAC are putting their hard-earned money in a uniquely speculative investment. SPACs are not operating companies, with a product or service that investors can judge, or a previous history that investors can analyze, and they are not a part of any sector whose long-term prospects can be reasonably assessed. An investor in a SPAC is making an inherently speculative bet on the sponsor's ability to identify and successfully consummate a merger with an operating company that will return sufficient value to shareholders. This aspect of SPACs—that investors are necessarily investing in the business acumen of individuals rather than the prospects of a company's products and services—becomes especially risky for retail investors when the SPAC is promoted by one or more celebrities, since many investors may conflate a celebrity's carefully crafted public brand for competence, trustworthiness, savvy, and other traits, with the actual business skills necessary to identify and consummate a profitable business transaction.

Conflicts of interest are intense. There is also the reality that the SPAC structure involves at least one blatant conflict between the SPAC sponsor and SPAC investors: Because the sponsor's promote becomes worthless if the SPAC fails to consummate a merger within two years, the sponsor has an incentive to sell and promote a merger, even if it is of dubious value for the SPAC's shareholders.

Exemptions in the law tend to promote hype. This conflict is exacerbated by the ability of SPAC sponsors to make rosier forward-looking statements, with less fear of liability, than a company engaging in a typical IPO would be able to make. This is because of the way the Private Securities Litigation Reform Act of 1995

[2] H.R. 5910 would exclude SPACs from the safe harbor for forward-looking statements currently in place, and H.R. 5913 would prohibit brokers and advisers from recommending the securities of SPACs to unaccredited investors unless the sponsors' fee (the "promote") is capped at 5% or the SPAC complies with disclosure requirements that the SEC may impose.

("PSLRA") operates. The PSLRA provides a safe harbor from liability for forward-looking statements made by an issuer so long as the statements are made in good faith and with appropriate qualifications. IPO filings are specifically excluded from this safe harbor. When a SPAC merges with a private operating company, it is functionally taking that company public, but since the SPAC is already a public company, neither the SPAC nor the target has to make new IPO filings. Instead, the SPAC can make disclosures about the merger in filings for which the PSLRA does grant a safe harbor from liability; if the target company went public through the standard IPO process, it would not get the benefit of the safe harbor (although it is far from clear exactly how beneficial this legal difference is).

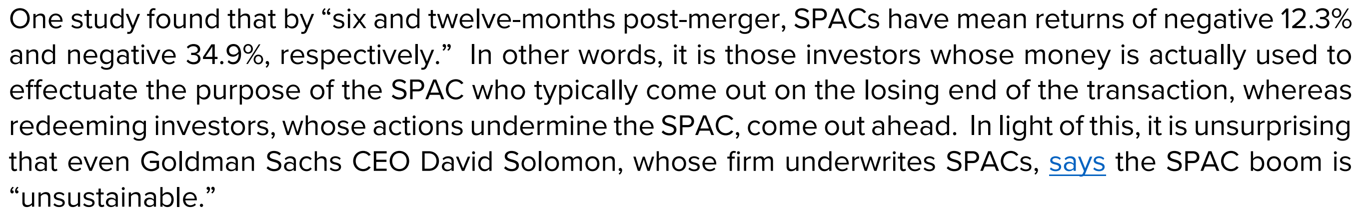
Redemption rights usually don't protect initial investments. While SPACs typically do have some features that purport to provide protection for investors from the speculative nature of the investment and the inherent conflict with sponsors, in reality these features do not provide as much protection for retail investors as it might seem at first blush. For example, as noted above, SPACs have generous redemption rights that allow any shareholder to redeem their shares, for the initial price of $10, ahead of the proposed business combination, which ensures that shareholders who bought in at the initial price will at least be able to recoup their initial investment in full. However, because public shareholders can only buy into the SPAC once it goes public, they are unlikely to have bought their shares at that initial price. For an investor that paid more for their shares than $10, the redemption right does not represent the potential to have their investment returned in full if they do not want to participate in the merger; rather, it represents a potential loss if they do not want to participate in the merger. As one commenter put it, "retail investors will tend to enter a SPAC under conditions perfectly designed to expose them to risk." This may be compounded because of the powerful appeal of the sunk cost fallacy—investors who face a loss if they exercise their redemption rights may instead be tempted to hold onto their investment rather than cut their losses, even if the merger seems likely to be unprofitable. Finally, the right of redemption, especially of warrants, is subject to deadlines and other technical requirements that retail investors may not fully understand or comply with, potentially resulting in loss of the redemption right.

Their track record is dismal. These pitfalls of investing in SPACs are not just hypothetical—empirical studies have shown that SPACs are typically poor investments for retail investors. For example, an analysis by Reuters showed that SPACs' recent performance has trailed the S&P 500 by as much as 15%. Another study determined that "SPACs perform extremely poorly" with the "average four-year buy-and-hold return following the SPAC IPO [of] -51.9%, compared with an average return of 8.5% for all other companies that became public in the year of the SPAC IPO." This is why the SEC has voiced concerns with the recent surge of retail investor interest in SPACs.

SPACs Do Not Efficiently Serve Their Stated Purpose of Bringing Private Companies to the Public Markets

This last point implicates one of the more startling facts about SPACs: Despite the fact that their "special purpose" is to acquire a company to bring public, SPACs are not actually particularly efficient at bringing companies public. The aforementioned study shows that the four-year performance of SPACs (which would ordinarily include at least two post-merger years) is -51.9%, compared to 8.5% for other companies. Another recent study shows that whereas IPOs have a cost of approximately 27% of offering proceeds, the median SPAC had a cost that was more than half—50.5%--of the SPAC's IPO proceeds. In other words, a company going public via an IPO can expect to keep 73% of the proceeds of the IPO, whereas a SPAC typically delivers less than half of its IPO proceeds to the company it eventually takes public.

These findings are exacerbated by the fact that it is primarily SPAC shareholders who hold their shares through the merger who bear these costs (and they are more likely to be retail investors as opposed to the institutional funds that understand the value of redeeming prior to the merger or "de-SPAC" phase).



One study found that by “six and twelve-months post-merger, SPACs have mean returns of negative 12.3% and negative 34.9%, respectively.” In other words, it is those investors whose money is actually used to effectuate the purpose of the SPAC who typically come out on the losing end of the transaction, whereas redeeming investors, whose actions undermine the SPAC, come out ahead. In light of this, it is unsurprising that even Goldman Sachs CEO David Solomon, whose firm underwrites SPACs, says the SPAC boom is “unsustainable.”

The Bottom Line

- SPACs are public blank check companies that exist specifically to identify a private operating company and bring it public by acquiring it.
- While proponents of SPACs claim they “democratize finance” by allowing retail investors to make potentially lucrative investments in private companies, in fact, SPACs are dominated by institutional investors. In addition, they are too inherently risky to serve the needs of most retail investors.
- Retail investors that do invest in SPACs are making a uniquely risky investment. SPAC investing is inherently speculative, there is less accountability for SPACs that make rosy forward-looking statements that turn out to be false, and the elements of the SPAC structure that are supposed to provide protection in fact provide little protection to retail investors. This is why empirical research has shown that SPAC investments typically turn out poorly.
- SPACs are not an efficient or effective means of bringing private companies public, as they supply comparatively little capital to the acquired company while providing investors with poor returns.

By Stephen Hall and Jason Grimes

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