The Role of Special Purpose Acquisition Corporations (SPACs) in Institutional Investment Portfolios

SPACs (Special Purpose Acquisition Corporations) were a once small and neglected area of the market that have become increasingly popular over the last two years. Publicly, SPACs have been called a "get-rich-quick scheme that benefits the sponsor[1]," summarizing them as foolish investments made for retail investors in which the sponsor of the SPAC wins while investors lose. There is a lot of research that supports some of those accusations and is hard to dispute.

However, a sweeping denouncement of SPACs could fail to realize there are unique structural aspects to them which could benefit a variety of participants involved. Additionally, there have been recent structural changes to SPACs that could make them more appealing to certain investors. The purpose of this paper is to provide details about SPACs, explain why they have continued to gain recent popularity and experience rapid growth and outline how they could fit into institutional investor portfolios.

What is a SPAC?

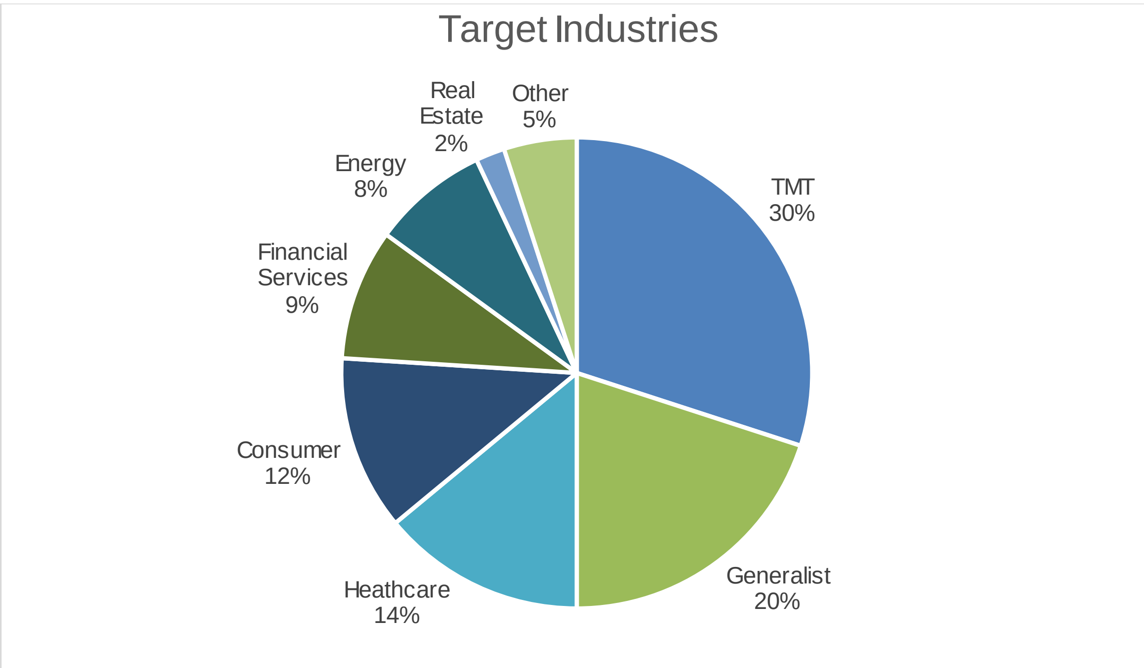
Essentially, a SPAC is a "blank-check company" through which the sponsor of the SPAC raises money from investors through an initial public offering (IPO) and uses the proceeds to purchase, (or technically "merge" with) a private company. SPACs are typically issued at $10 per unit and IPO investors also receive a certain amount of warrants which can usually be exercised at $11.50 per unit. IPO proceeds can range anywhere from $100 million to the largest raise to date (Pershing Square Tontine) which was $4 billion[2]. Upon completing its IPO, the SPAC parks the proceeds raised into short-term Treasuries and trades as a public equity. The sponsor of the SPAC typically ends up receiving 20% of a company the SPAC merges with as a potential return on their investment, also known as a "promote." The sponsor also typically funds the SPAC with the necessary proceeds to pay for expenses as the SPAC looks for a company to merge with by way of purchasing additional warrants of the SPAC. Upon announcing its intended purchase of a private company, the SPAC requires a shareholder vote to approve the purchase (this article will later address why historically the approval rates were low but recently have been very high). Assuming the purchase is approved, the SPAC shares "merge" with the private company purchased so that the private company has now become a publicly traded company. If the merger is not approved, SPAC investors receive their proceeds and interest back in the form of cash. Regardless of the vote outcome, and the way they voted, once an

[1] Huebescher, R. (2020, December 12) *How SPACs Destroy Investor Wealth.* Advisor Perspectives. https://www.advisorperspectives.com/articles/2020/12/21/how-spacs-destroy-investor-wealth

[2] Kilgore, T. (2020, July 22) *Bill Ackman's Pershing Square Tontine raises $4 billion as IPO prices at $20 a share*. https://www.marketwatch.com/story/bill-ackmans-pershing-square-tontine-raises-4-billion-as-ipo-prices-at-20-a-share-2020-07-22

announcement of a merger takes place, shareholders of the SPAC have the right to redeem their shares for cash plus interest earned over the life of the SPAC. Upon consummation of the merger, the SPAC ticker changes to a new ticker representing the public equity ownership of the now publicly traded company. **Figure 1** shows that while private companies targeted by SPACs reside in a wide range of industries, they tend to come from industries experiencing rapid growth like technology.

Figure 1: Industries targeted by SPACs



Source: GP Bullhound, Hyde Capital

Is the Knock on SPACs Accurate?

All you need to do is search the term "SPAC" on Google and you will instantaneously get insight into the overwhelming amount of negative feelings towards these investments. While this negativity holds some merit, separating the economics of a SPAC between the pre-merger and post-merger announcement stage allows for the best understanding of any potential risk.

- **Pre-merger announcement** – Once a SPAC holds an IPO, and prior to it announcing a merger, a SPAC investor essentially owns the economics of short-term Treasuries and accrued interest through a publicly traded vehicle. If they invested in the SPAC via the IPO, they most likely also own warrants, which consist of additional equity ownership in the SPAC at a higher price than the IPO price. Since investors have the right to redeem their shares at the SPAC's net asset value once a merger is announced, this investment is low-risk as long as an investor did not purchase shares when they traded at a premium above the net asset value of the SPAC. In general, historically purchasing pre-merger SPAC shares has been viewed as a strong-risk adjusted investment by most participating investors as a large percentage of them simply redeem their shares post-merger announcement and either purchased shares at a discount to net asset value or received warrants at the time of the IPO. The average pre-merger SPAC has delivered a 9.3% annualized return from 2010-2018 issued SPACs with the worst SPAC producing a 0.5% annualized return[3].

[3] Gahng, Minmo and Ritter, Jay R. and Zhang, Donghang, SPACs (January 29, 2021). Available at SSRN: https://ssrn.com/abstract=3775847 or http://dx.doi.org/10.2139/ssrn.3775847.

- **Post-merger announcement** – At this stage, a merger has been announced by the SPAC, and the investor is in the process of owning publicly traded shares in what was a private business. However, they also temporarily own the economics of what was a "blank-check company" which impacts the valuation of the SPAC. This makes valuing a SPAC at this stage highly complex. The SPAC "gave away" 20% of the economics of the SPAC to the sponsor of the SPAC (the "promote" previously mentioned). It also must pay underwriting fees for the IPO. Depending on how many shareholders redeemed their shares, these two factors can dilute value to shareholders who decide to keep their shares. Additionally, it is common for the SPAC to raise additional capital to finance the merger of its target private business in the form of a private investment in a public equity (PIPE). Investors in the PIPE almost certainly obtain a favorable valuation relative to the shareholders of the SPAC in order to entice that investor base which mostly consists of hedge funds. The SPAC also issued warrants at the time of the IPO, which could further dilute shareholders if the stock price rises by 15% or more over time. (As previously mentioned, SPACs are issued at $10/unit and warrants can be exercised at $11.50/unit). To further complicate things, the SPAC has purchased what was a private business so an investor must assess whether the SPAC paid an attractive price for what is most likely a rapidly growing business with a somewhat limited operating history. The average post-merger SPAC produced a -15.6% return one year following the merger while the value-weighted return returned 8.7% for SPACs executing IPOs from 2010-2018[4]. This implies larger SPACs with prominent sponsors out-perform small SPACs with sponsors not typically as well known.

The post-merger stage of a SPAC has drawn significant criticism. When a SPAC goes public it must file a prospectus with the SEC and disclose the underwriting fees it must pay, warrants it has offered, shares given to the sponsor as a promote, potential fees and dilution risks. However, there is a concern shareholders don't fully understand the impact of how dilutive these items can be if a large percentage of the pre-merger SPAC shareholders redeem shares leaving the non-redeeming shareholders to essentially pay the fee and dilution tabs which were established when the SPAC held the IPO. Often times, the dilution has been very high, causing a SPAC to deliver poor performance to its shareholders who have held on to shares through its merger.

Interestingly, this phenomenon has begun to change for two reasons. First, SPACs have been starting to offer more favorable terms, which can better align the sponsor with shareholders who wish to maintain their shares post-merger announcement. The second reason is the recently introduced strategy of SPACs raising capital via PIPEs upon announcement of a merger. The introduction of PIPEs offer a non-dilutive way to SPAC shareholders for the SPAC to raise enough capital to consummate a transaction. Most negative content found via that Google search on "SPACs" does not recognize that these trends could make SPACs more attractive to shareholders who wish to maintain their shares through a merger.

[4] Gahng, Minmo and Ritter, Jay R. and Zhang, Donghang, SPACs (January 29, 2021). Available at SSRN: https://ssrn.com/abstract=3775847 or http://dx.doi.org/10.2139/ssrn.3775847.

Another common criticism of SPACs is that they funnel money to companies which promise unrealistic growth and/or are simply fad ideas intended to draw interest from unknowing retail investors. This is often the case. For example: Google was the fastest company to reach $10 billion in revenue[5]. Five SPACs over the last year have provided pro-forma estimates that indicated they expected to grow revenue *faster* than what Google was able to do. In turn, this drums up investor excitement, especially in the retail investor world. Many SPACs focus on buzz-worthy areas of the market promising high future returns and incredible growth rates. There will inevitably continue to be stories like these in the SPAC market given the large number and range of quality of sponsors which participate. However, perhaps due to the changes to SPAC structures discussed in the preceding paragraph, the last year has brought an overall increase in the quality of companies acting as SPAC sponsors. Many of these sponsors (see sidebar) bring better management teams with a focus on businesses with profitable unit economics and some of them are already profitable.

Examples of more recent SPAC sponsors:

- Fortress Investment Group (large asset manager)
- Lazard, BainCapital (large private equity manager),
- Warburg Pincus (large private equity manager)
- Blackstone Group (large, publicly-traded asset manager)
- Texas Pacific Group (multi-billion dollar private equity manager)
- KKR (multi-billion dollar, publicly traded asset manager)
- Berry Sternlicht (prominent real estate investor)
- Khosla Ventures (prominent venture capital firm)
- Post Holdings (multi-billion dollar publicly traded company)
- Bill Ackman (prominent, multi-billion dollar hedge fund executive)
- Goldman Sachs

What does the SPAC universe look like today?

Since the creation of the first SPAC in 1993, institutional investors cast them off, and for good cause. The issuance of new SPACs was extremely limited and issuance sizes were small. In many instances at least 80% of shareholders had to vote “yes” for a transaction to consummate. Due to the arbitrage opportunity previously discussed, their prime holders were hedge funds who would often vote “no” to a deal, resulting in the vast majority of deals not executing. Due to this dynamic and the poor quality of sponsors involved, reputable organizations publicly cast them aside.

Further adding to the dismissal of SPACs, was that, prior to 2008, the New York Stock Exchange (NYSE) did not list SPACs on their trading exchanges[6]. Beginning in 2017, the issuance of SPACs starting to see significant increases and then dramatically accelerated starting in 2020. As of the writing of this paper (April 2021), SPAC issuance this year has already exceeded last year’s total issuance in terms of the number of IPOs and proceeds raised. As shown in **Figure 2**, SPACs have represented a significantly higher percentage (77%) of all IPOs in 2021 compared to years past.

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[5] Brown, E. (2021, March 15). *Electric-Vehicle Startups Promise Record-Setting Revenue Growth*. Wall Street Journal. https://www.wsj.com/articles/electric-vehicle-startups-promise-record-setting-revenue-growth-11615800602#:~:text=It%20took%20Google%20eight%20years,some%20cases%20by%20several%20years.

[6] Pauta, Gustavo and Hung, David. (June 2008) *The SEC Approves the NYSE’s Proposed Rule Change to Allow Listing of SPACs*. Reed Smith. https://www.reedsmith.com/-/media/files/perspectives/2008/06/the-sec-approves-the-nyses-proposed-rule-change-to/files/bull08090pdf/fileattachment/bull08090.pdf

Figure 2: SPACs as a percentage of all IPOs

Year	# IPOS	SPAC Proceeds ($b)	SPACs as % of IPOS
2021	308	99	77%
2020	248	83	55%
2019	59	14	28%
2018	46	11	20%
2017	34	10	18%
2016	13	3	12%
2015	20	4	12%
2014	12	2	5%
2013	10	1	5%
2012	9	1	6%
2011	15	1	11%

Source: SPAC Analytics as of April 15, 2021

Why have SPACs increased in popularity?

The SPAC structure could be beneficial to the following constituents involved which has created demand:

1. **The sponsor** (i.e. creator) of the SPAC contractually gains a significant equity ownership (typically 20%) in the now publicly traded company. The sponsor can often sell that equity quickly (after six months of the merger) on the open market. The sponsor also obtains warrants at IPO, which gives it the right to purchase additional shares at a slight premium to the original IPO price of the SPAC.
2. **The acquired company** gains significant benefits of going public through a SPAC, including the timeframe that is often 75% shorter than a typical IPO process. Unlike an IPO, SPACs have to provide pro-forma estimates of financial results which often extend out approximately five years.
3. **Select investors** are lined-up as additional financing to complete the transaction. This is due to SPACs typically merging with a company that has a transaction value requiring larger financing than the SPAC has raised from its IPO. This financing comes in the form of a PIPE. The sponsor will do a "road show" among select institutional investors (mostly hedge funds) to line up the PIPE financing. The investors participating in the PIPE financing can experience multiple benefits. One is that they typically receive a substantial discount to the transaction valuation. In addition, the investor gains the ability to hedge through shorting or buying puts on similar equities or exchange traded funds. These benefits can result in attractive investment opportunities for the PIPE participants.
4. **Arbitrageurs** can take advantage of an opportunity that exists in SPACs whereby investors can purchase pre-merged SPACs at a discount to their net asset value (as a reminder, there is certainty over what that net asset value is because the asset consists of short-term Treasuries plus accrued interest). By purchasing the SPAC at a discount, investors inherently own "cash" at a discount. An investor receives a "yield" in the form of the discount and interest earned on the SPAC's short-term Treasury holdings because the pre-merged SPACs have a contractually limited life in that the SPAC has a firm timeline in which they have to announce a merger. Returns can improve if the SPAC announces a deal earlier than expected or if the SPAC trades at a premium to net asset value post-merger announcement. Hedge funds use leverage to take

advantage of an arbitrage opportunity with optionality created by owning the SPAC's warrants. Arbitrageur capital creates demand for new SPACs.

5. **Stock exchanges –** The number of public companies has declined by approximately 50% over the last 20 years while the amount of money flowing into public companies has continued to grow. Stock exchanges have an incentive to encourage more SPAC listings.

The significant benefits of the SPAC structure applied to a range of constituents most likely means SPACs will continue to grow in popularity for the foreseeable future.

What investment opportunities do SPACs create for institutional investment portfolios?

SPACs will continue to have an influence on investment portfolios in a number of strategies including:

1. **Private equity and venture capital –** SPACs create a way for private equity and venture capital firms to exit private portfolio companies. By merging a private portfolio company investment with a SPAC, it creates a liquidity event for a private equity/venture capital firm the same way a traditional IPO does. This liquidity event can come partially at the time of the IPO and down the road if the private equity/venture capital firm retains ownership and sells publicly traded shares over time.
2. **Hedge funds –** Hedge funds can take advantage of SPACs through the arbitrage opportunity explained previously and can adjust their investment's risk profile depending on the stage of the SPAC including IPO, PIPE transaction and pre or post-merger announcement.
3. **Traditional equity managers –** Like any company post-IPO, traditional or hedge fund managers gain investment access to what was formerly a private company because they can invest in a SPAC after announcement of a merger or after it is closed.

Conclusion

The pace of SPACs has potentially been disrupted by recent SEC investigations which could result in SPACs having to change the way they account for warrants they issue by treating them as liabilities versus how they currently treat them as equity. Further changes to SPACs caused by future SEC and investor requirements are not expected. As SPAC issuance increases, the sponsors will likely have to make the terms more attractive to the companies they are targeting to merge with and potential SPAC investors. These changes should be an overall positive for the SPAC market's growth. Expectations are that the participants previously mentioned (sponsors, acquisition targets, pre-merger arbitrageurs, PIPE investors, traditional equity funds looking for new investments, stock exchanges) will take advantage of the unique features of SPACs. SPACs should continue to enter the mainstream and continue to play a prominent role in the market, although there will inevitably be hiccups due to supply and demand. Investors are well-served to understand the market and be aware of the risks and opportunities which SPACs represent.

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