FINANCIALLY SAVVY

The curious case of SPACs

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Spectacular success stories like Virgin Galactic's 150% price jump several months after its acquisition boosted the popularity of SPACs

The Covid-19 pandemic has triggered massive uncertainty in global markets and the US Federal Reserve responded by cutting interests rate to 0.25%. As investors started chasing higher-yielding investment opportunities, the somewhat–obscure concept of a Special Purpose Acquisition Company (SPAC) came back into the spotlight. In 2020 alone, roughly 250 SPAC IPOs raised US$83 billion ($110 billion) — roughly equal to funds raised by conventional IPOs. Moreover, SPAC IPOs in this banner year raised more capital than all previous SPAC IPOs combined. Even 2021 started with a bang, raising roughly US$8 billion in first two weeks and is on track to double the record of capital raised in 2020.

Recently, Asian investors started jumping on the SPAC bandwagon too. For instance, SPACs sponsored by Asia–based Antony Leung, Richard Li, CITIC Capital, Maso Capital, and Malacca Straits have raised more than US$2.5 billion while Singapore–based Vickers Venture Partners, Japan–based **Softbank** and Hong Kong–based Provident Acquisition recently filed to raise almost US$1 billion via SPAC IPOs. The **Singapore Exchange** is even considering allowing SPACs to list due to their popularity.

Furthermore, more than a dozen SPACs are holding talks with Southeast Asia's startups about potential mergers. For instance, Bridgetown Holdings approached Tokopedia — Southeast Asia's largest e-commerce platform, while Traveloka — Southeast Asia's largest online travel app — announced that it is going public with a SPAC as a possible option. Moreover, reports revealed that other Asian unicorns such as Grab, Gojek, and Bukalapak have all been recently approached by SPACs.

While **Goldman Sachs** declared that SPACs in 2021 could even exceed capital raised in 2020 and *Reuters* reported that SPACs are arming up for an Asian unicorn hunt, investors are just getting reacquainted with these alternative financial vehicles.

SPACs 101

Known as a "blank cheque company" with no business operations, a SPAC is formed to raise funds via an IPO with the intention of acquiring a promising private company within two years. When a private company is acquired by a public firm, it automatically becomes public. Hence, SPACs provide the public easy access to mature private equity (PE) investments, while being more transparent than PE, but less transparent than conventional IPOs.

Since investors do not know the eventual acquisition target at the time of raising capital, SPAC resembles a flipped IPO process from the demand–supply perspective. In a traditional IPO process, investment (company going public) is known and underwriters are looking for investors. However, in SPACs, lead sponsors find investors first and then search for investment (company to go public).

After raising capital, SPAC sponsors promise to identify an acquisition target within two years. If they fail to find a target within two years, most SPACs return the money to investors. Even if they find an acquisition target, SPAC shareholders have the flexibility to opt out and redeem their shares before the acquisition.

Also known as De-SPACing, the acquisition by a SPAC automatically makes a private company public and thus resembles a flipped RTO or reverse takeover from the private–public perspective. While RTO represents the process of a private company acquiring a public company, SPAC achieves the same outcome via the process of a public company acquiring a private company.

On the other side of the equation, the acquisition target has to negotiate with only one party (SPAC). This is unlike a typical IPO company that have to deal with multiple parties including underwriters, lawyers and auditors.

SPAC IPOs vs conventional IPOs

How did SPAC IPOs manage to make such dramatic inroads into the well–established world of conventional IPOs?

SPAC proponents claim that the phenomenon of pricing a typical IPO below their market price — so-called IPO underpricing — incurs an unnecessary (opportunity) cost for the company going public. This is also known as "money left on the table". IPO underpricing averaged over 20% this year.

In extreme cases, IPOs leave even more money on the table as in recent cases of **DoorDash** and **Airbnb** which soared 86% and 113% respectively on the first day of trading, thus leaving billions of dollars on the table.

They also argue that SPACs enable investors to avoid IPO underwriting fees that typically go as high as 7%.

Other factors include reduced underwriters' ability to conduct traditional IPO roadshows during the Covid-19 pandemic. Since SPACs are established by reputable sponsors who then search for additional investors through personal networks, there is no need to conduct traditional IPO roadshows.

Meanwhile, the quality and reputation of SPAC sponsors have drastically improved over the years and institutional heavyweights such as Goldman Sachs, **Citigroup**, and **Deutsche Bank** have jumped onto the SPAC bandwagon. Thus, an improvement in the quality of sponsors, institutions and their networks also greatly contributed to the SPAC boom.

Additionally, many view SPAC as an accelerated IPO without the strict regulatory scrutiny that accompanies the typical IPO regulatory process. SPAC accelerates the process of capital-raising as there are no operations, assets or financial data. The entire process can be completed in several weeks, instead of several months. This efficiency reduces completion risk, especially in volatile markets.

Finally, some spectacular success stories also boosted the popularity of SPACs and attracted even more investors. For instance, after merging with SPACs, **DraftKings**' valuation quadrupled while **Virgin Galactic**'s price jumped 150%.

Shortcomings of SPACs

In contrast, the shortcomings and hidden costs of SPACs are numerous.

A recent research study documented that the median SPAC held only US$6.67 per share by the time of the merger — down from US$10 at the IPO stage. This drop was mostly due to dilution of SPAC shares as sponsors were rewarded with 20% of the acquired company — akin to a "finder's fee".

Another research study documented that the average SPAC IPO in the first decade of 2000s lost roughly half of its value over four years, while higher ownership by SPAC sponsors was associated with worse performance. Similarly, the operational performance of SPACs was inferior to industry peers and conventional IPOs.

Finally, research found that SPAC–acquired firms were traditionally small and levered firms with low growth opportunities, consistent with the notion that SPAC acquisitions attracted firms to go public in difficult times.

Former SEC chairman Arthur Levitt said, "I have never found any [SPAC] attractive. No matter what the reputation or what the sponsor might be. They are the ultimate in terms of lack of transparency."

Notwithstanding 2020 being a banner year for SPACs, opponents warn that SPAC is inherently an inferior capital–raising method. A potential reversal in market enthusiasm may come from increased opposition of target companies, the opaque nature of the SPAC deal, or inferior post-IPO performance.

SPAC sponsors try to convince investors that the above-mentioned statistics were derived from older SPACs while new SPACs are bigger, better and of higher quality. Whatever the argument, investors should do their own due diligence and not rely on promises made by sponsors. After all, the incentives and motivation for SPAC sponsors are very different from that of investors. E

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