Investor beware when it comes to SPACs

There are inherent risks in a SPAC process that the average retail investor may overlook

By Dexter Tiah

SPECIAL Purpose Acquisition Companies (SPACs) have grown in popularity over the past few years with SPAC initial public offering (IPO) capital in the US increasing from US$3 billion five years ago to US$76 billion in 2020.

This was perhaps buoyed by superior performance of recent SPAC mergers such as Virgin Galactic and DraftKings, which resulted in 53 US SPAC IPOs being launched in the first two weeks of 2021.

In South-east Asia, the US$40 billion valuation for the SPAC merger between Altimeter Growth Corp and Grab this year is a prominent example of a well-known company participating in this relatively new form of financing.

With such fervent interest in SPACs, retail investors may be forgiven for thinking that investing in SPAC IPOs or after SPAC mergers are announced is a sure-fire way to make private equity-like returns. But is it all a bed of roses?

What are SPACs?

SPACs are shell companies with no assets other than cash. The SPACs' sponsor (a middleman company typically comprising private equity professionals and ex-CEOs) writes out a plan to raise funds from equity markets, and thereafter invest in or acquire a private company that fulfils certain criteria.

The SPAC process kicks off with an IPO. The IPO price in the US is usually set at US$10 per share, and the IPO typically raises more than US$200 million. Initial public investors contribute cash in exchange for the right to a fraction of a share, which only becomes valuable (in-the-money) if the stock price is US$11.50/share or higher.

The sponsor typically contributes 2-3 per cent of the IPO funds raised (or at least US$4 million) to fund the SPAC set-up and miscellaneous fees. They earn a "sponsor promote" by doing so. This sponsor promote allows the sponsors to acquire approximately 20 per cent of the total shares of the SPAC via warrants at a very low price, provided that the SPAC price eventually reaches US$18 per share, for example.

Theoretically, there should be no reason for the SPAC to trade above US$10 per share post-IPO. However, the previous track record of a sponsor may give rise to a premium post-IPO.

The proceeds from SPAC issuances are then usually held in interest-earning Treasury securities. And the sponsor is given two or three years to acquire or merge with a private company. Failure to do so results in the funds being returned to initial shareholders (and the sponsor loses its investments of 2-3 per cent of the IPO funds raised).

When the sponsor identifies a private company, a decision must be made to acquire the company or relinquish the opportunity to do so.

This is also known as a de-SPAC transaction. The initial shareholders can either: (1) redeem their initial investment plus accrued interest (in some jurisdictions, initial public investors who redeem are still left with warrants which they can exercise at a later stage); or (2) remain invested.

If initial shareholders redeem, the sponsor has the option to replenish the outflow of funds through private placements (usually at a discount to the current price to entice new private placement investors to subscribe to these shares).

The funds (net of redemptions and new subscriptions) in the SPAC are then used to purchase equity in the target company. Post-merger, the combined company is owned by: (1) remaining initial investors, (2) new investors from private placement (if any), (3) SPAC sponsor, and (4) the original shareholders of the target company.

The bed of roses

Initial public investors can benefit from: (1) being an early investor in a private company, (2) the sponsor's track record and skills in identifying a target company, (3) the sponsor's ability to negotiate an attractive deal with the target company, and (4) the sponsor's ability to value-add post-merger.

Private placement investors participate for similar reasons. All investors are hoping for outsized returns on their investments.

For target companies, they believe they can obtain a higher valuation via a SPAC process compared to a traditional IPO. As for the sponsors, they are eyeing a significant upside via a typical 7-8 per cent ownership of the post-merger company.

While SPACs provide an excellent opportunity to be invested in some of the world's leading private companies, the biggest issue is whether initial public investors can generate the type of private equity returns that some sponsors do.

Investor beware

An initial investor who chooses to remain invested would probably require at least a 20 per cent increase in price of shares to break even. The jump in share price is needed due to (1) dilution arising from sponsor promote via warrants, including other warrants exercised by initial public investors; and (2) lower entry point for private placements.

Secondly, there is considerably less scrutiny in a SPAC process compared to a traditional IPO process. Some are of the opinion that the SPAC route is meant for companies which will not qualify to be listed if traditional IPO criteria were to be used.

With a lower hurdle via SPACs, will SPACs lead to higher incidences of potential misstatement of facts, overvaluation of the private companies or potential fraud?

Given the apprehension, how then have some SPACs rallied interest among public investors? Prominent investors and media personalities such as investor Bill Ackman and basketballer Steph Curry have lent their celebrity status to SPACs in return for advantageous terms as part of the sponsor team. Many retail investors follow the lead of these personalities and subscribe to SPAC IPOs.

Nevertheless, the question remains if leveraging on celebrity status adds value to the sponsor's ability to find, acquire and manage the target company.

Finally, there may be conflicts of interests in the process. The most common example is the sponsor recommending the acquisition of an overvalued or sub-par target company to the detriment of initial public investors who stay invested.

The motivation for doing so is to avoid the sponsor losing their initial investment should the IPO funds be returned to investors if a target is not found within the stipulated two to three years' time frame. How are these conflicts managed or disclosed? Does the average retail investor truly understand the implications?

The popularity of SPACs in the US reflects retail investors' interest in participating in private equity, especially amid the low interest rate environment. In the first quarter of 2021, 298 SPAC issuances raised US$88 billion in the US. BT FILE PHOTO

In summary

The popularity of SPACs in the US reflects retail investors' interest in participating in private equity, especially amid the low interest rate environment. Private companies are also reluctant to leave money on the table, and hence they avoid under-pricing their shares in a traditional IPO exercise.

However, there are inherent risks in a SPAC process that the average retail investor may overlook. Despite the risks, it looks like SPACs are here to stay – 298 SPAC issuances raised US$88 billion in the US in the first quarter of 2021.

Investors with an appetite for SPACs should look for strong alignment of interest, quality sponsors and structures that do not unfairly dilute their interest if they remain invested for the long-term.

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