a₹tha

E - JOURNAL OF FRTL @ IIM CALCUTTA

April 2022, Volume 8, Issue 1

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

FRTl

Financial Research & Trading Laboratory

SPAC: Winners, Losers, Robbers?

Arvind Ashta
Dinos Constantinou

1. Introduction

When private firms want to increase liquidity for their shareholders, they list in public stock exchanges. If they do not want to raise equity, they could do a direct listing, like Spotify, Slack, and Coinbase Global did in the last few years. However, if they do want to raise equity capital at the same time, they may opt for an Initial Public Offering (IPO) or merge with a Special Purpose Acquisition Company (SPAC). The usual route has been through IPOs, but ever since COVID started, there has been an increased interest in SPACs. In this article, we explain SPACs to the uninitiated before analyzing the actors' performance and indicating, by a simple financial model, the potential for collusion.

SPACs were created to prevent firms from merging with shell companies with hidden liabilities. Therefore the regulator allowed investors to create new companies with no hidden liabilities. SPACs raise money in an IPO and then hunt for a private operating business to acquire. Therefore, the SPAC is a public company registered on some stock exchanges. A SPAC is a blank-cheque vehicle, i.e., people who put their money in a SPAC do not know what the sponsors who initiated the SPAC will buy. Thus, there needs to be a lot of trust in the sponsor for retail investors to place their money. Often, Sponsors are financial market experts used to conducting deals or alternative investment managers such as hedge funds (Berger 2008). The sponsoring team may also include celebrities whom the public knows, such as Jennifer Lopez and Alex Rodriguez (Kruppa & Aliaj, 2021). SPACs led by able managers may succeed better than those just trying to make a quick buck (Sagayam and Shanks 2008).

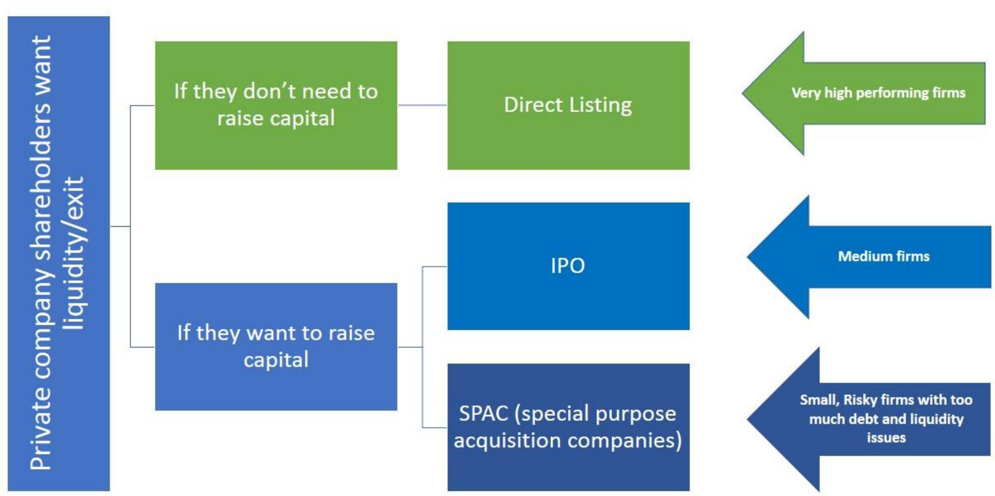
The SPAC starts with its own IPO. However, this IPO is quick and straightforward since very little due diligence is required (Matlin 2006). The money obtained by the SPAC is placed in a trust or escrow account and invested in government securities till a merger is found (Maiden 2006). The second step is to find a private firm to merge with. Once the SPAC finds a suitable target, it proposes to merge the SPAC with the private company. A regulatory body must approve this merger. The merger is also known as a de-SPAC. If the SPAC cannot acquire a suitable target, representing at least 80% of the proceeds, within a specified period (usually, eighteen months to two years in the USA), it must return the money to the investors at par value with interest (Maiden 2006). The percentage of proceeds that need to be invested and the time allowed to complete a merger may differ from country to country. For example, in Malaysia, it is 75% and three years, respectively (Chin 2009). In the

Netherlands, there is an additional requirement that if the SPAC shareholders are allotted more than 30% of the shares in the target firm, they have to make a public bid for the rest of the shares (Sachse and Cuperus 2010).

Investors could also ask for their money to be returned at any time before the merger if they wish. This creates a risk for the sponsors, who start the SPAC and have used their money to pay for the legal formalities. Sponsors usually take discounted shares in the SPAC or warrants on SPAC shares to offset this risk. As an example, a sponsor of a SPAC could take 20% of the SPAC's shares (worth $ 50 million) by paying only $10 million. Warrants are call options issued by the firm (in this case, the SPAC) rather than by a trader. Evidently, the sponsors will make higher returns than the retail investors.

If the target firm wants to raise more capital than the SPAC has, it may also seek wealthy or institutional investors to place their money. This placement is termed private investment in public equity (PIPE). PIPEs accompany more than 60% of SPAC mergers. The PIPE investment is also helpful if the shareholders of the SPAC decide to redeem their shares, thus reducing the capital available with the SPAC (Pinedo and Brown 2021). Private firms prefer merging with a SPAC instead of conducting their own IPO because mergers are completed faster than an IPO and are usually less expensive (Matlin 2006). However, in some regulated industries (such as utilities), mergers take a long time to be accepted by the approving authority, and so such industries do not seek SPACs (Matlin 2006). Companies that consider merging with SPACs often require a significant recapitalization because they are over-indebted, operate in a niche sector, or have no strategic buyers because they are already too concentrated in the market (Berger 2008). The SPAC target firms are smaller than those making an IPO, have less liquidity, and have fewer growth opportunities (Datar, Emm, and Ince 2012). The operational performance of SPAC firms is generally inferior to those that make an IPO (Datar, Emm, and Ince 2012). Figure 1 captures the major elements in choosing between direct listing, IPOs, and SPACs.

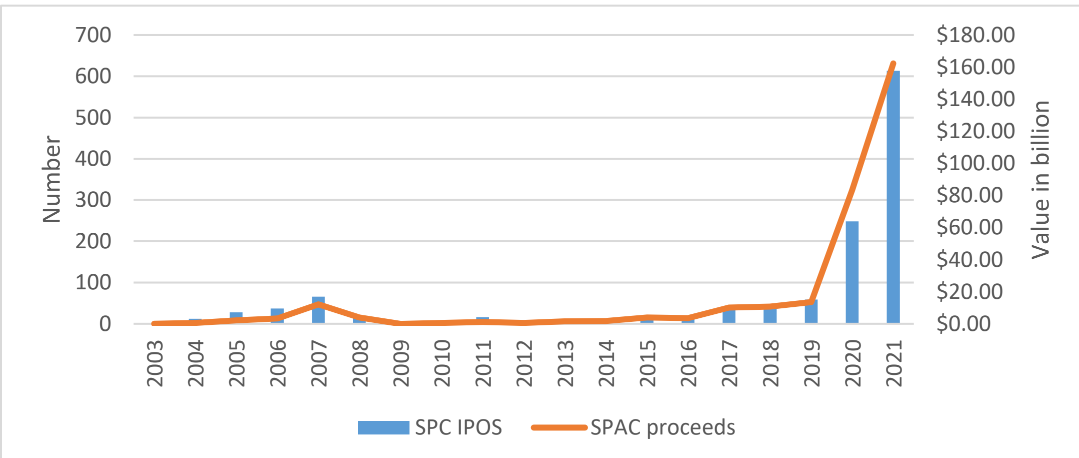
Figure 1: Three usual ways of making stock public



2. Synthesis of Recent News

As shown in figure 2, SPACs have boomed in the COVID period both in the number of SPACs and the total value collected. In 2021, 613 SPAC-IPOs constituted 63% of all IPOs in the USA. The value collected from SPAC-IPOs was $162 billion, i.e., 49% of all IPOs. The average SPAC size, i.e., capital raised in the IPO, has remained about $250 million during the last six years. This figure is not very different from the size in 2008 (Berger 2008), but the average SPAC size has been less than $100 billion in the years in between. In the last two years, some outstandingly large SPACs have raised over a billion dollars, such as Lucid Group ($2.07 billion), Ginkgo Bioworks Holdings, Inc. ($1.72 billion), and Alight, Inc. ($1.03 billion) (Patel 2021). Nevertheless, the average size of a non-SPAC IPO remains significantly larger than that of a SPAC IPO.

Figure 2: The number and value of SPACs in the United States.



Source: Based on data from spacanalytics.com downloaded on 19/01/2022.

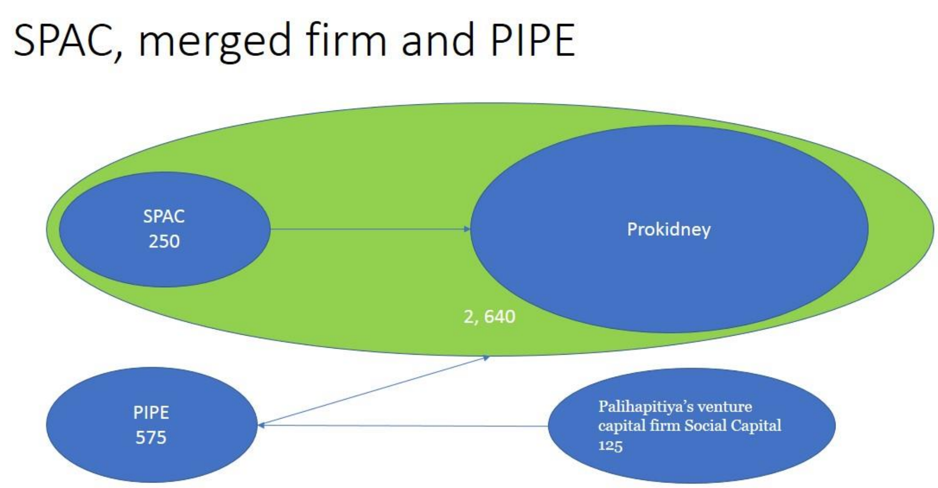
Much of the boom, notably in late 2020 and early 2021, may have arisen from enormous savings generated by generous COVID-related handouts to unemployed people who then had the time and money to try our risky ways to make their money grow. This speculative interest has led to very high values of financial markets, which are now subsiding.

Most news items on SPACs provide a few summary details such as the value of the SPAC, the PIPE investment accompanying it, and the value of the proposed merger deal. For example, a recent news item discusses the merger deal between Social Capital Suvretta III SPAC and ProKidney, a therapeutics company. It indicates that the SPAC would provide $250 million, PIPE investments would provide $575 million, and the value of the merged firm would be about $2.64bn (Asgari 2022). Thus, the SPAC shareholders would own less than 10% of the value of the merged firm. The PIPE investors may oblige the sponsor to place some of its money in the PIPE fund, as shown in Figure 3.

Even a large fund such as Softbank creates SPACs of about the same size. For example, its SVF SPAC raised $320 million and will participate in a merger with Symbiotic, an artificial intelligence company. PIPE investors, including Walmart that uses Symbiotic's technology, would provide $205 million. The deal offers an enterprise value of $4.8 billion (Asgari 2021), and, once again, we see that the SPAC owners would own less than 10% of the merged firm.

One of the largest deals is with Singapore's Grab. The SPAC provided $ 0.5 billion here, and PIPE investors offered $4 billion. Grab had equity of $34.5 billion, and the combined merger value was estimated at $39 billion (Grab.com 2021). Grab was finally listed on the Nasdaq in December 2021. Since then, market capitalization has almost halved to $22 billion (as of January 21, 2022, finance.yahoo.com). The projections in April 2021 are no longer valid, perhaps because of the lockdown.

Figure 3: Relationship between SPAC, merged firm, and PIPE investors, illustrated using a recent example



To add spice to this article, we can mention that ex-President of the USA, Donald Trump, is also getting into this action. Digital World Acquisition Corp, a blank-cheque company, seeks to merge with Donald Trump's social media start-up Trump Media & Technology Group. The critics point out that the projected value of the firm is based on the hope that 80 million users will subscribe to its service by 2026. This projection is benchmarked optimistically with Netflix and Disney-plus, which already have more than 100 million subscribers each. However, this forecast may not be easy to achieve if we consider that Fox News only has 1.2 million subscribers (The Economist 2021, Palma, Fontanella-Khan, and Nicolaou 2021).

Indeed, many other SPACs have been blamed for buying targets at high values based on flimsy valuations (Kruppa and Aliaj 2021). Many targets give wild projections before the deal and reduce these projections to a fraction after the merger. For example, App Harvest forecast sales of $20 to $25 million for 2021 before the merger and reduced this forecast to \$7 to \$8 million after the merger, leading to a 20% fall in share price (Powell 2021a). Similarly, Microvast's forecast revenue of \$230 million for 2021 before the merger and reduced this forecast to about \$ 150 million after the merger (Powell 2021b). Regulatory bodies are therefore examining such issues for fraud.

Moreover, a media review shows that SPAC rules and regulations are being rediscovered with each experiment. For example, there is a rule that when a SPAC is formed, it should not have any specific target in mind (Maiden 2006). This rule is being investigated in the Digital World Acquisition Corp case. The Securities Exchange Commission (SEC) is investigating if the sponsor of this SPAC had already contacted the Trump Media & Technology Group before the SPAC was formed (The Economist 2021). Suspicions were raised because the merger was agreed upon a few weeks after the SPAC was formed. Most SPACs take over a year to find a suitable target (Jenkinson and Sousa 2011). Some do not find one and return money to the investors.

Multi-billionaire Bill Ackman learned that a SPAC could not buy a public company or a part of a public company. His \$4 billion Pershing Square SPAC attempted to purchase Universal Music Group from Vivendi (Brower 2021, Aliaj 2021).

3. Critical analysis: winners and losers

Firms may be tempted to merge with SPACs because it is less cumbersome and costly than an IPO. Secondly, with many SPACs chasing a limited number of promising targets, firms can get a high value for their existing shareholders rather than the shareholders of the SPACs (Crabb 2021). Even the PIPE investors get a better offering since they are more astute. Thirdly, the target management is aware that time is running out for the SPAC and the SPAC sponsors need to close the merger, even at an unfavorable price (Sagayam and Shanks 2008). SPACs, therefore, are useful for small, underperforming firms with high debt but low liquidity to find both capital and liquidity (Datar, Emm, and Ince 2012).

Of course, if the deal comes through, the most exciting rewards go to the sponsors of SPACs who have obtained shares of the SPAC at lower prices or warrants in the SPAC, often representing 20% of the shares (Jenkinson and Sousa 2011). For example, Michael Klein made \$690 million, while Palihapitiya made \$408 million from their sponsored SPAC deals (Asgari, Mathurin, and Campbell 2022). The losers are usually the retail investors. Box A below indicates that there is a potential for collusion between sponsors and the owners of private firms.

Box: Modelling a possibility for collusion: An example

The table below uses a fictive example to illustrate how the dynamics of collusion work. We assume that a SPAC raises 250 million Euros. The sponsors invest 10 million Euros but get 20% of the shares if they find a suitable target. The other 240 million Euros are raised by retail investors. Since the SPAC has 250 million Euros in cash, the sponsors would get 50 million Euros at the time of merger (a profit of 40 million Euros) and the retail investors would lose this 40 million Euros. Therefore, retail investors need to recoup this 40 million Euros if they are agree to a merger.

The target private firm that the sponsors find is worth 150 million euros. However, with unrealistic future growth rate assumptions, the value is inflated to 350 million Euros. For example, if earnings in year 1 are expected to be 6 million Euros and cost of capital is 10%, with a realistic growth rate of 6%, the firm is valued at 150 million Euros (E/(k-g)). However, if the expected growth rate is increased from 6% to 8.29%, the value of the firm increases to 350 million Euros. Since the target firm is private, there is little information to verify the assumptions.

If these assumptions are accepted, the combined firm would be worth 600 million Euros. After negotiating with the founders, the sponsors declare that the founders are willing to take a cash discount of 50 million Euros and their shares would be worth only 300 million Euros. The remaining 300 million Euros would be split between the sponsors and the retail investors in the 20:80 ratio or 60 million Euros and 240 million Euros. As a result, in the merged enterprise, the retail investors would not expect to lose money. Indeed as long as the discount agreed by the target firm managers is at least equal to the expected gain of the sponsors, the retail investors would agree to the merger. The bigger the target firm, the less the percentage discount required for the cash deal.

Of course, once the merger takes place, the market will look at the realistic value of the enterprise based on realistic growth expectations. The value of the post-merger enterprise would fall back to 400 million Euros (250 +150). The sponsors would still make a profit of 30 million Euros on their 10 million Euros invested (which is a 200% return). The target firm shareholders would still make a profit of 50 million Euros since their portion of shares are now worth 200 million Euros rather than a realistic 150 million Euros. This 80 million Euros profit of sponsors and target firm managers is at the cost of the retail investors.

(All figures in Millions of Euros)	Invested	Profit/Loss	Comment
SPAC			
Sponsors	10	40	20% of SPAC value =50
Retail investors	240	-40	80% of SPAC Value (250-50)
	250	0	
Target firm (private)			
Realistic value	150		6/(.1-.06)
Optimistic value	350		6(.1-.0829)
Agree to a cash discount	300		
Pre-merged firms (250+350)			
Sponsors	60	50	10% ownership
Target company shareholders	300	-50	50% ownership
Retail investors	240	0	40% ownership
Total	600	0	100%
Post-merger value (250+150)			
Sponsors share	40	30	(40-10)
Target company shareholders	200	50	(200-150)
Retail investors	160	-80	(160-240)
	400	0	

Indeed, the data shows that most SPACs hardly break even. Since they perform worse than IPOs, some have wondered if the behavior of retail investors buying shares in SPAC is rational (Datar, Emm, and Ince 2012). We consider that people get attracted by a small percentage of SPACs showing high returns. According to Spacanalytics.com, about 20 SPACs have given returns from 100% to 1050%. However, by the time we reach the 30th, returns are down to 23%. With a population of 613 SPACs in the USA, these top 30 only represent 5% of the SPACs. Even if we compare with 199 completed SPAC mergers, 90% of the merged firms are trading below the opening price, and the average loss to investors has been 40% (Asgari, Mathurin, and Campbell 2022).

Since the media focuses on the magnificent returns of a few deals, retail investors hope to get companies cheap. It gives smaller investors the chance to put money into early-stage ventures because traditional IPOs are often sold initially to institutional investors. However, as we are seeing, the SPAC structure carries high fees and risks, and larger participants get much better deals than retail investors. It is commonly known that most mergers are value-destroying. Therefore, it is ironic that public investors vote to go into a merger even after the market informs them that the merger will be value-destroying by lowering the price of the shares in the SPAC below book value (Jenkinson and Sousa 2011). A simple strategy for the public would be to redeem their shares at book value (plus interest) if the market price of the shares in the SPAC falls in the week after the announcement. If the market price of the shares in the SPAC rises after the announcement, the optimal strategy would be to sell the shares in the SPAC the day before the merger decision is taken (Jenkinson and Sousa 2011).

Short sellers such as hedge funds are also profiting from the market. They know that the SPAC has two years to make a deal. With so many SPACs, there may not be enough targets. The data from spacanalytics.com indicates that at the end of 2021, 588 SPACs with $158 billion were looking for acquisitions. In 2015, Gloo Networks raised £30 million but never made a deal (Asgari, Bradshaw, and Massoudi 2021). Short sellers also know that the public is being taken for a ride and that prices will fall (Aliaj and Kruppa 2021).

At a more macro level, countries are trying to control fraud, but at the same time, they would like to promote their financial markets by introducing more permissive regulations. In the US, the SEC has already warned SPACs about selling themselves with misleading predictions and that it will take a closer look at their accounting. Harsh punishment should follow for those that misbehave. However, other countries are seeking to lure SPACs. For example, the UK changed its rules to enable listings of SPACs in July 2021. But only one SPAC was floated in the UK in 2021 (Elder 2022). Singapore has recently had two SPACs (Daga 2022). India is considering allowing SPACs but is in no hurry to change its laws (Lai 2021).

4. Policy recommendations

Even though the SPAC boom seems to have passed its peak, it still represents significant amounts of new money. Other jurisdictions are getting into the game.

The reality is that the good private firms that need liquidity just go for a direct listing. The merger with SPACs permits valuations based on forecasts that a direct IPO does not allow. These flimsy valuations create risks for retail investors who do not listen to markets by selling their SPAC shares if their value falls below par value when the merger with the target is announced. Therefore, if countries want to open the market for SPACs by introducing regulation on SPAC, they need to be careful to prevent fraud towards retail investors. If retail investors consider the stock market a rigged game with no possibility of winning, it may break the market.

Nevertheless, the process of criminal action and punishment is long. Instead, we need to align the interests of the sponsors and retail investors by ensuring fair valuation and avoiding discounted shares or warrants. The sponsors should only make money over the longer term if the merger is adding value. This means that sponsors will be obliged to ensure due diligence at the time of the valuation of the target and later participate in the governance of the firm.

Countries could also consider giving SPAC investors more time to close deals. This extension would allow them to search patiently for deals where their shareholders can gain.

References

Aliaj, Ortenca. 2021. "Bill Ackman to return $4bn to Spac investors if new vehicle is approved." *Financial Times (Europe)*, August 20. https://www.ft.com/content/e62337cd-65ce-4548-9cbb-7d1056e121dc.

Aliaj, Ortenca, and Miles Kruppa. 2021. "How hedge funds are fuelling the Spac boom." *Financial Times (Europe)*, March 11. https://www.ft.com/content/812b243b-4831-4c65-92b2-f72bfdc6eff6.

Asgari, Nikou. 2021. "SoftBank poised to complete first Spac deal with AI robotics company Symbotic." *Financial Times (Europe)*, December 13. https://www.ft.com/content/e1da7cbc-5c12-4d82-bfc8-de3d80e4475a.

Asgari, Nikou. 2022. "Chamath Palihapitiya Spac deal launches amid Uyghur controversy." *Financial Times (Europe)*, January 19. https://www.ft.com/content/2386c577-7cb6-438f-b708-2aa27c2fd253.

Asgari, Nikou, Tim Bradshaw, and Arash Massoudi. 2021. "British tech groups target Spacs for US listings." *Financial Times (Europe)*, February 28.

Asgari, Nikou, Patrick Mathurin, and Chris Campbell. 2022. "Spac kings lose their touch." *Financial Times (Europe)*, January 21. https://www.ft.com/content/af62d6b2-daad-44a2-9aa2-73f91c744d28.

Berger, Robert. 2008. "SPACs: An Alternative Wav to Access the Public Markets." *Journal of Applied Corporate Finance* 20 (3):68-75. doi: 10.1111/j.1745-6622.2008.00194.x.

Brower, Derek. 2021. "Ackman's Spac buys 10% of Universal Music for $4bn." *Financial Times (Europe)*, June 20. https://www.ft.com/content/879952a3-951f-4f4b-a502-b19e13100a91.

Chin, Annie. 2009. "Malaysia." *International Financial Law Review* 27 (8):99-100.

Crabb, John. 2021. "Companies looking to go public have more choices than ever." *International Financial Law Review*:

Daga, Anshuman. 2022. "Pegasus Asia, Tikehau Capital-backed SPAC, debuts in Singapore." *Reuters.com*. https://www.reuters.com/markets/europe/pegasus-asia-tikehau-capital-backed-spac-debuts-singapore-2022-01-21/.

Datar, Vinay, Ekaterina Emm, and Ufuk Ince. 2012. "Going public through the back door: A comparative analysis of SPACs and IPOs." *Banking & Finance Review* 4 (1):17-36.

Elder, Bryce. 2022. "UK Spac market under scrutiny for safety-first approach." *Financial Times (Europe)*, January 7. https://www.ft.com/content/6b2fa289-1558-4bbd-bead-6ebbf440b5f1.

Grab.com. 2021. "Grab, the Leading Superapp for Deliveries, Mobility and Financial Services in Southeast Asia, Plans to Go Public in Partnership with Altimeter." April 13. https://www.grab.com/sg/press/others/grab-go-public-in-partnership-with-altimeter/.

Jenkinson, Tim, and Miguel Sousa. 2011. "Why SPAC Investors Should Listen to the Market." *Journal of Applied Finance* 21 (2):38-57.

Kruppa, Miles, and Ortenca Aliaj. 2021. "A reckoning for Spacs: will regulators deflate the boom?" *Financial Times (Europe)*, May 4. https://www.ft.com/content/99de2333-e53a-4084-8780-2ba9766c70b7.

Lai, Karry. 2021. "Archaic laws stunt SPAC growth in India." *International Financial Law Review*.

Maiden, Ben. 2006. "Return of the blank cheque IPO." *International Financial Law Review* 25 (5):10-12.

Matlin, Robert S. 2006. ""SPACs" Present Advantages to Midsize to Smaller Energy Companies." *Natural Gas & Electricity* 23 (3):14-17.

Palma, Stefania, James Fontanella-Khan, and Anna Nicolaou. 2021. "US regulators probe Donald Trump's social media Spac deal." *Financial Times (Europe)*, December 6. https://www.ft.com/content/c5daa659-7737-457a-be4a-a260c3dd1d0f.

Patel, Kison. 2021. "Biggest SPACs of 2021 and Planned for 2022." *Dearlroom.net*. https://dealroom.net/blog/biggest-spacs.

Pinedo, Anna, and Mayer Brown. 2021. "SPAC PIPE transactions: the market matures." *International Financial Law Review*.

Powell, Jamie. 2021a. "AppHarvest's Spac forecasts go splat." *Financial Times (Europe)*, August 11. https://www.ft.com/content/52b775ce-54bc-4111-85b9-e3c3f29c3ebf.

Powell, Jamie. 2021b. "Microvast's revenue forecast runs out juice." *Financial Times (Europe)*, August 17. https://www.ft.com/content/b74134df-bbd9-4f59-a971-112563e274c5.

Sachse, Hans, and Philip Reeser Cuperus. 2010. "Spac opportunities." *International Financial Law Review* 39 (1):66-67.

Sagayam, Selina, and Eleanor Shanks. 2008. "Too regulated to succeed?" *International Financial Law Review* 27 (10):12-12.

The Economist. 2021. "SPAC-handed: Donald Trump's media SPAC is the zeitgeist wrapped in a complex financial instrument." *The Economist*, December 11. https://www.economist.com/united-states/2021/12/11/donald-trumps-media-spac-is-the-zeitgeist-wrapped-in-a-complex-financial-instrument.

****