INVESTMENT BRIEF

Q4 2020

Strategic Investment Group®

SPACs, IPOs, and Froth

In addition to speculative fever and outlandish asset valuations, market booms are also periods in which innovative structures gain currency. These novel structures help sustain the boom and, when sentiment sours, amplify the bust. In the 1920s prior to the Great Crash, investment trusts were all the rage, increasing the demand for shares, boosting leverage, and reducing transparency by creating complex webs of cross holdings. Prior to the GFC, a slew of securitized vehicles proliferated. Championed as novel ways to disentangle and diversify risks, these vehicles ultimately spawned another novelty, the first shadow bank run. We are now witnessing the popularization of yet another vehicle: special purpose acquisition companies (SPACs), "blank check companies" that are fueling high volumes in the IPO market.

Why the "Blank Check" Moniker?

Today's SPACs can be traced to the South Sea Bubble of 18th century England. At the time, one promoter of a SPAC precursor offered shares in a "company carrying on an undertaking of great advantage, but nobody is to know what it is." The SEC's definition of a modern-day SPAC is no less enigmatic: "A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person."

SPACs raise funds through an IPO and typically have two years to deploy the cash raised. The SPAC sponsor manages the SPAC and identifies an attractive private company to take public through the SPAC vehicle. Sponsors are remunerated by a grant of shares, known as the "promote," generally equivalent to 25% of the SPAC IPO proceeds. Investors in the SPAC have the option of approving the acquisition target or withdrawing their invested funds plus interest. The lure to final investors is the possibility of private equity-like returns over a shorter horizon than a typical private equity investment.

SPACs and IPOs Hit Record Levels

Fueled by SPACs, the number and value of IPOs surged in 2020 to levels exceeded only in the tech bubble of 1999 (Exhibit 1). More than half of the 450 U.S. IPOs in 2020 were SPACs, and SPACs accounted for nearly half of the $179 billion raised. Thanks to SPACs, the amount of funds raised by U.S. IPOs in 2020 reached an all-time high (Exhibit 1).

The impetus for this surge in the number and value of SPAC IPOs is purportedly their value in keeping the cost and complexity of going public low. The abundance of global liquidity looking for a home has been another factor. High profile companies – like Nikola, DraftKings, and Virgin Galactic – that have gone public through a SPAC have also whetted the appetite of investors keen to find the next big thing.

EXHIBIT 1:

Record Number of SPACS in U.S. Fuels IPO Boom

Source: Jay Ritter, University of Florida.

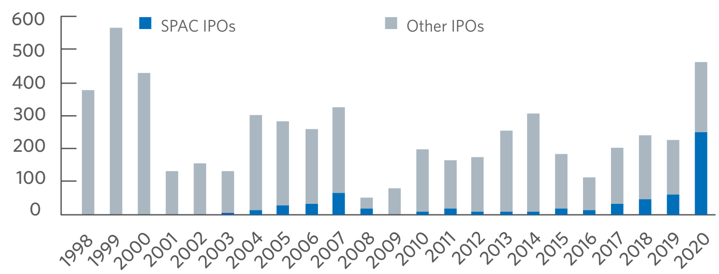
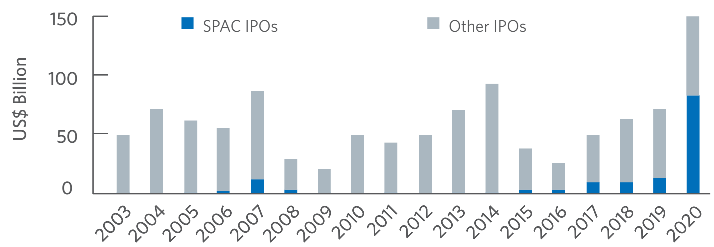


EXHIBIT 2:

Funds Raised by U.S. SPAC IPOs Dwarf Previous Years

Source: SPAC Analytics.



The hype surrounding SPACs and the perennial lure of possibly striking gold may have numbed investors to the risks of SPACS. In addition to the usual risks of investing in a private company, SPACs have the added risk of dilution arising from the sponsor's promote as well as the warrants retained by initial investors who withdraw their funds from the SPAC before an acquisition. Since the sponsor promote only has value if a company is acquired, the sponsor has the incentive to conclude deals, even less attractive ones, creating a potential conflict of interest with the SPAC investors. While there have been some notable success stories, the median SPAC has delivered a strikingly disappointing post-acquisition result.

Another Sign of Froth?

Record flows into blank check companies are another worrying sign of potential froth in financial markets. The liquidity fueling asset price inflation in other markets is one factor driving the current SPAC craze, raising the specter of its South Sea Bubble antecedents. Like other innovations that proliferated in past periods of exuberance, SPACs may deliver a rude awakening to unsophisticated investors afraid of missing out.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

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