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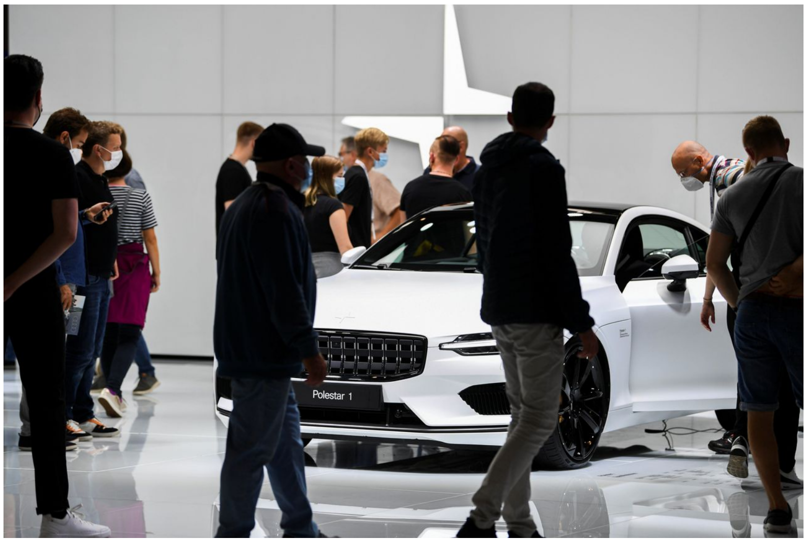
MARKETS

Some Investors Find Stability in SPACs

Mania for blank-check companies and subsequent selloff has created what some see as an alternative to short-term bonds



Shares of SPAC Gores Guggenheim traded below $10 but climbed above that level after the company announced a deal last month to merge with electric-vehicle maker Polestar.

PHOTO: ANDREAS GEBERT/REUTERS

By Sam Goldfarb Follow
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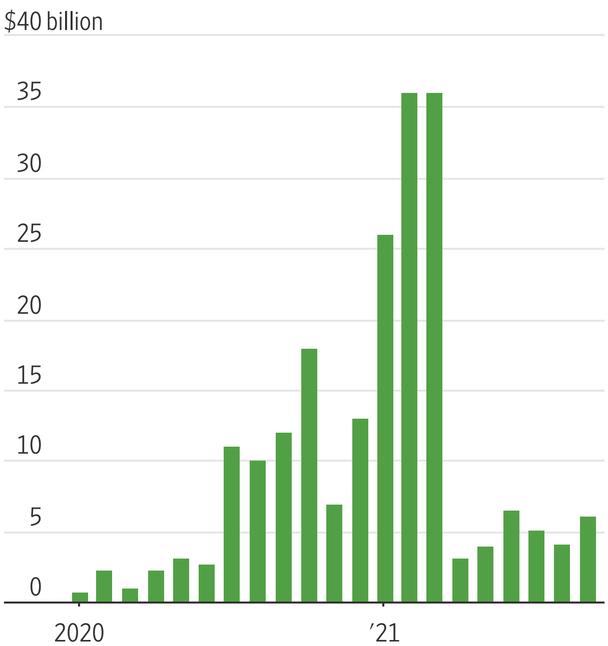
Shares of special-purpose acquisition companies have lost their luster for those who recently saw them as a ticket to fast riches. That is good news for a different group of investors, who treat them as an alternative to bonds.

Known on Wall Street as SPAC arbitrage, the trade has become turbocharged of late—thanks in equal parts to the day-trader-fueled craze for special-purpose acquisition companies that materialized late last year and the more-recent slump in SPAC demand.

While the mania helped increase the number of SPACs to 6 ½ times what it was in the early days of the Covid-19 pandemic, this year's rout has driven down share prices. That has created what some describe as a near risk-free opportunity that offers an attractive return compared with alternatives like short-term U.S. Treasurys.

Money raised by new SPACs, monthly



Source: Dealogic (through August 2021) and SPAC Research (September 2021)

David Sherman, president and portfolio manager at CrossingBridge Advisors, is among those who have piled into the trade recently, creating an exchange-traded fund for it in September and allocating 15% to 20% to the strategy across the fixed-income mutual funds that he manages.

The big reasons, he said: "One, the market grew. And then, the prices became attractive."

Here is how it works. A SPAC is a shell company that raises money in a public stock offering and trades on an exchange with the sole intent of merging with a private company and taking it public. Investors who buy stock in a SPAC before it merges with another business can always claim a proportional share of its cash holdings when the SPAC seeks approval of its merger. They can do the same if it liquidates, having failed to strike a deal within a specified time period—usually two years or less.

In a typical SPAC initial public offering, investors pay $10 to buy a so-called unit, consisting of one common share and a fraction of a warrant that gives them the right to buy more shares at a specific price in the future. That $10 is put into a trust, where it is invested in Treasury bills.

Investors at that point are pretty much guaranteed at least the return offered by the Treasury bills for their $10. But to entice investors, SPAC sponsors sometimes put extra money into the company's trust—for example, 20 cents for every $10 unit, promising an additional 2% cumulative return.

Common shares also often trade for a discount before the SPAC announces a merger, so investors who buy them at those prices can lock in gains that way as well.

Shares then sometimes rise above $10 when a deal is announced, at which point investors can sell to make some extra profit. Shares of Gores Guggenheim Inc. , for example, once traded as low as $9.70 but climbed as high as $10.45 after the blank-check company announced a deal last month to merge with the Swedish electric-vehicle maker Polestar. Investors can also add to their returns by selling warrants if they hold them.

Taken together, these factors make premerger SPAC shares similar to short-term bonds, investors said, with the liquidation date functioning as the maturity date and a yield determined by the shares' discount to trust value.

SPAC arbitrage has been practiced on a small scale for years, investors said. The basic strategy was nearly impossible during the height of the SPAC frenzy, when the average premerger SPACs traded well above their trust value. But it has now rebounded to new heights, drawing a range of investors including hedge funds, individual investors and even some fixed-income mutual funds like the ones managed by Mr. Sherman.

As of Friday, the common shares of 452 of 469 SPACs looking for a target traded below their trust value, according to SPAC Informer, an analytics site started by Mr. Sherman. Among all SPACs looking for a target, the combined trust value of $135 billion, the weighted average yield to liquidation was 1.71% and the weighted average maturity was 1.3 years. Just over a hundred SPACs offered a yield of at least 2.25%.

By comparison, the two-year U.S. Treasury note yielded around 0.32%, while a Bloomberg index of short-term corporate bonds was yielding 0.68%.

“If you're looking for cash alternatives, it's 10 times better than what's out there,” said Evan Ratner, president of Levin Capital Strategies, which runs a fund dedicated to SPAC arbitrage.

There are drawbacks to the strategy. Premerger SPACs are more volatile than Treasury bills, creating the risk of mark-to-market losses even if investors can

SPAC arbitrage effective yield, two-week rolling average

Note: Encompasses SPACs seeking a target and those that have announced but not completed mergers.
Source: Accelerate Financial Technologies

eventually get their money back.

They also trade less often, making them an imperfect cash substitute. And there is what Mr. Sherman sees as a "one in a million" chance that a SPAC could file for bankruptcy for some reason—possibly after being sued by a service provider owed fees—resulting in a fight over assets.

The biggest question, though, might be how long the strategy can last. SPAC yields are already down from their highs in the summer as demand from investors has stabilized. The volume of SPACs could also fall sharply, given that monthly new issuance is currently just a fraction of what it was earlier in the year.

Still, investors are hopeful that the SPAC market can reach a healthy equilibrium, with demand strong enough to support more issuance than existed before the pandemic but not so strong that premerger SPACs will again trade at a premium to their trust value.

—Amrith Ramkumar contributed to this article.

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Corrections & Amplifications
A Bloomberg index of short-term corporate bonds was recently yielding 0.68%. An earlier version of this article incorrectly referred to the index by its older brand, which was updated in August. (Corrected on Oct. 15.)

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