Does the current structure of Special Purpose Acquisition Companies expose financial markets to excessive risk?

David Sera

Special Purpose Acquisition Companies (SPACs) have shifted the IPO landscape in the past two decades. The structure of SPACs changed in 2010 to address issues related to distasteful investor practices, the length of time to close deals, and high warrant overhand. However, these changes also shifted the incentives of the SPAC stakeholders. Namely, SPAC investors who previously had an incentive to vote against a merger with an unattractive company, now have an incentive to vote for that merger. The sponsor also has an incentive to follow through with a merger, to avoid losing their investment. I hypothesize that these incentives result in an environment where sponsors and investors care more about the completion of a merger than the actual quality of company that they merge. I propose to analyze the financials of companies that went public prior to 2010, and after 2010. I intend to show that the current structure results in a deterioration of the size and maturity of the companies that are being identified as targets for acquisition by SPACs. If validated, my hypothesis suggests that the public markets are exposed to excessive risk. This exposure warrants a response from a legislative body or the underwrites of SPACs to address the misaligned incentives present in the current structure.

Background and Proposed Question of Study

Going public is one of the most important financing and strategic decision of a company and is an important component of the health of the financial markets (Jain and Kini, 1999). However, the number of US public companies has declined considerably in the past two decades, which can be mostly attributed to changes in listing rules due to the dot-com bubble and increased regulation because of Sarbanes-Oxley Act of 2002 (SOX). As a result, there are fewer offerings now, with larger companies that are more stable and are raising more capital and smaller companies turning toward private capital (Brown et al 2017). The need for private capital has been supported by a growth in hedge funds and private equity firms. They offer unique investing opportunities to wealthy investors with the possibility of diversified and excess returns. Access to these opportunities have been in demand by the public as well. This demand is what drives the creation of less-suitable, publicly available investments like Specified Purpose Acquisition Companies (SPACs) that mimic the characteristic of hedge funds or private equity (Davidoff 2008).

SPACs are a formed by a sponsor and it is a publicly traded company with no commercial operations. Their sole purpose is to acquire a suitable private company and thereby make the private company publicly traded. In this sense, SPACs provide an alternative way for private companies to access the public markets. Although market conditions played a central role in the decline of SPACs in 2008 and 2009, there were issues in the traditional SPAC structure that also contributed significantly. (Wittlin and Ferris 2010) argues that since the vote to approve the merger and redemption of shares were combined, investors had a lot of power over the completion of the deal. This led to distasteful investor practices, such as the use of forward contracts. As a result, the structure of SPACs changed in 2010 to alleviate concerns of distasteful investor practices, the length of time to close deals, and high warrant overhang. These changes facilitated a revival in SPACs and by 2020 248 SPAC IPOs raised $75.3billion (Ghang et al 2021).

However, the current structure is far from perfect as it has substantial costs, misaligned incentives, and losses for investors who own shares at the time SPAC mergers (Klausner et al 2020). This is an important finding, but I believe the real issue lies in how the decoupling changed the incentives for investors, as noted by (Ghang et al 2021). Prior to decoupling, investors had an incentive to vote down a merger with an unattractive company so that they could redeem their shares and protect their investment. After the decoupling, public shareholders now have an incentive to approve a merger even if it's with a bad company or a poorly structured deal, redeem their shares and hold onto their warrants. I hypothesize that the current structure of SPACs creates an environment where sponsors and investors care more about the completion of the deal over the quality of the company. Thus, the quality and maturity of companies that have been acquired by a SPAC should be deteriorating and expose the public financial markets to excessive risk.

Literature Review

The academic literature on SPACs have mainly described their legal structure, motives and incentives of stakeholders, and post-merger stock performance.

The existing legal literature on the structural aspects of SPACs focuses on the ways that the SPAC structure implements and combines features from “blank check companies”, private equity firms, and a traditional Initial Public Offering (IPO). (Heyman 2007) discusses how SPACs are a type of blank check company that were developed by creative lawyers to work around limitations of the Penny Stock Reform Act of 1990 and SEC Rule 419. By including provisions of these regulations in the SPAC IPO terms, SPACs can avoid the limitations related to these regulations without defeating their purpose of investor protection. (Rodrigues and Stegemoller 2013) note that the SPACs borrow from features from the private equity “playbook“ and translate them to the public markets. Most notably, both private equity firms and SPACs make a contractual agreement with the target company, but SPACs are traded as one-shot deals and thus SPAC sponsors are awarded for the mere acquisition. On the other hand, private equity relies on delicately calibrated private relationship and managers receive money upon realization of profit generated by the company. (Reimer 2007) argues that SPACs fill a void in the US IPO market, due to regulatory environment created by SOX, which has made it more difficult for smaller companies to raise funds in the public markets. In contrast to the existing research, which has focused on comparing the legal structure of these types of companies, my proposed research focuses on how this legal structure creates incentives amongst stakeholders and how those incentives affect the type of companies they bring public.

The incentives of the main stakeholders in SPACs, i.e., the sponsors, investors, and the target private company, has been studied as well. (Nilsson 2018) studies the incentives of the SPAC sponsors and investors. Sponsors receive a 20% equity of the SPAC for a nominal price, which creates a strong incentive to find a target and complete a business combination. If the merger does not complete, the sponsor loses their initial investment, because it is used to cover operational costs incurred during the target search. SPAC investors are incentivized through shares, warrants, and sometimes rights to bonus shares, which are sold as unit offering during a SPAC IPO. As mentioned before, these investors have the right to redeem their shares and maintain their warrants and rights when a merger is announced. This allows them to be invested in the target company with little or no "skin" in the game. Finally, the study argues that SPACs need to create a long-term perspective for sponsors by using lock-up agreements and that there should be measures involved to reduce the dilutive impacts on shareholders who do not redeem at the time of the merger. By contrast, (Berger 2008) considers incentives from the point of view of the target company to pursue an acquisition by a SPAC. To these companies, a SPAC provides an acquisition vehicle to enter a highly structured, creative transaction that facilitates access the public markets in a way that a traditional IPO cannot. Thus, the research shows that the current SPAC structure incentivizes all main stakeholders of SPACs to complete a merger, and the fact that the company is publicly traded post-merger provides an exit opportunity for these stakeholders.

In terms of stock performance, research has highlighted the lackluster post-merger performance of SPACs and the irregular returns of sponsors and investors who buy during SPAC IPO, and public investors who buy after the merger. (Vulanovic 2017) observed 105 SPACs in the period 2003-2013 with a final sample taken in 2016 and documents that SPACs' failure rate is at the level of 58%. This is higher than any previously reported failure rate in the post-IPO survival literature and, according to the study, comparable only to failure rates found in 1997 at 55% percent for general companies. (Dimitrova 2017) observes a sample of 73 post-merger SPACs in the period 2003-2010. The study finds that the average four-year buy-and-hold return following the SPAC IPO is -51.9%, while the same strategy returned 8.5% for all other companies that became public in the same year. Turning towards investor and sponsor returns, (Klausner et al 2020) evaluates 47 SPAC that merger between January 2019 and June 2020 and finds that the mean sponsor return was 187%. For this same cohort, the mean annualized return for IPO investors that redeemed their shares was 11.6%, for a virtually risk-free investment. Lastly, the one year mean post-merger return is -34.9%, which represents the returns that a public investor would earn. The literature shows that while sponsors and investors earn high returns on their investment, public investors tend to do worse after investing in the company that went public through a SPAC.

While the post-merger performance has been well studied among researchers, there has been a lack of focus on the companies that go public through a SPAC. While most studies incorporate some accounting financial information in their analysis, the research has focused on post-merger stock price performance or the SPAC structure itself. To my knowledge, there are no studies that analyze the effects of the shift in incentives due to decoupling, and how it affects the companies that are targeted for acquisition by SPACs.

Conclusion

Although all stock investments involve risk, many companies going public by merging with a SPAC recently are often years away from generating revenues, which makes the investment even riskier. This is important because the public investors who invest in SPACs are looking for attractive public equity investment. To the retail investors SPACs are purely a speculative investment and as the speculation intensifies, so is the risk that investors are willing to accept as they are eager to find the next Tesla or Amazon. It's unlikely that this level of risk and its negative effect on the health of the financial markets will be tolerated for much longer and will result in either another decline in SPACs or another structural change in SPACs.

Proposed Methodology and Preliminary Results

To answer this question, I will obtain data from EDGAR database. As SPACs follow Securities Act of 1933, they file all the security issuance forms, quarterly and annual financial statements and corporate changes with the SEC. My plan is to take a "snapshot" of the company's financials at the time they went public, focusing on revenue, profitability, and sources of cash flow. Using this data, I'll be able to analyze the maturity of the company and how far they are from being profitable. I'll be separating the SPACs into 2 cohorts, one will be companies that went public prior between 2003 and 2010, and the second cohort will be companies that went public between 2011 and 2021 July. I will be comparing these two cohorts to identify changes in the companies that went public through a SPAC over time. My assumption is that there will be a degrading maturity after 2010, and I expect the rate at which companies degrade to increase closer to the 2020 boom.

In my preliminary analysis of companies that have went public post 2010 through SPACs, such as Virgin Galactic, Nikola, QuantumScape, Lucid, and Fisker Inc., I find that these company have not generated any revenue at the time of acquisition. However, they experience high valuations and have been able to go public with a market capitalization of over $1 billion. Several other companies that have gone public through SPACs (such as Draftkings) are at least generating revenue but are generally far from profitability. These initial findings support my hypothesis.

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