The shortcomings and hidden costs of SPACs

By Emir Hrnjic

AS THE Covid-19 pandemic devastated the global economy and created an unprecedented uncertainty in global markets in 2020, an alternative financial vehicle known as Special Purpose Acquisition Company (SPAC) flourished as an innovative capital-raising method. In 2020 alone, almost 250 SPAC initial public offerings (IPOs) raised more than U$81 billion – more than all previous SPAC IPOs combined.

While most SPACs are sponsored by investors in the United States, Asian investors started to catch up. For instance, Antony Leung, a former Hong Kong financial secretary and Blackstone executive, launched a U$1.5 billion SPAC. Additionally, SPACs sponsored by Richard Li, Citic Capital, Maso Capital and Malacca Straits – all based in Asia – have raised more than U$1 billion. More recently, Singapore-based Vickers Venture Partners started a process of raising US$100 million through a SPAC IPO.

When news broke that Bridgetown SPAC backed by Asian-based Mr Li and US-based Peter Thiel approached Tokopedia regarding a potential merger, the SPAC's price soared by more than 30 per cent. The largest e-commerce platform in South-east Asia, however, remained non-committal about the merger. Soon after, the Indonesian giant backed by Alibaba, SoftBank, and Temasek hired investment banks Morgan Stanley and Citigroup to advise them about the process of going public and announced that it is considering a traditional IPO.

While *Forbes* claimed that the "SPAC boom of 2020 is probably the biggest Wall Street story of the year", the business press paid very little attention to the shortcomings and hidden costs of these alternative financial vehicles.

HISTORICAL POPULARITY

Notwithstanding the historical popularity of SPACs and record-breaking amounts of capital, recent research study from New York University and Stanford does not support the popular argument that SPACs are a cheaper way of going public. In fact, the study documents that SPAC costs are opaque and exorbitant as the median SPAC share value starts at U$10 at the IPO stage, but the median SPAC holds only U$6.67 per share by the time of the merger.

This drop is mostly due to dilution of SPAC shares as sponsors are given 20 per cent of the acquired company as a reward for their efforts in finding a target company. This is akin to a "finder's fee" in return for leveraging their brand equity for fundraising for the SPAC. While the return to sponsors mostly comes from this reward, the resulting dilution represents the cost to other SPAC shareholders.

Furthermore, investors in SPACs may have different incentives and investment horizons that may not appeal to an acquisition target. For instance, IPO investors may have longer horizons because they invest in the IPO company. SPAC investors, on the other hand, may not be vested in the future of the acquired company.

A former Facebook executive, Chamath Palihapitiya, became the poster boy of the SPAC boom when he sponsored a SPAC that later acquired Virgin Galactic. Since an innovative company like Virgin Galactic will likely take a long time to generate a profit, long-term commitment of initial sponsors assumes oversized importance.

For instance, when Virgin Galactic aborted a recent test flight, its shares fell as much as 6 per cent. More importantly, Mr Palihapitiya sold 3.8 million shares worth U$98 million, thus sending bearish signals to the market.

Another research study from University of Exeter dubs SPACs "poor man's private equity funds" because, on average, they substantially underperform comparable companies. The average return in four years following the SPAC IPO is negative 51.9 per cent, significantly worse than an average return of 8.5 per cent by comparable IPO companies. Similarly, SPACs considerably underperform the competitors based on accounting measures such as operating margins and return on sales.

Moreover, SPAC performance is worse when deals are completed just before the deadline for a SPAC acquisition, suggesting that SPAC managers become desperate to do any acquisition when facing the impending deadline. Performance is also worse if the deal barely meets the minimum transaction value.

The overall research evidence is consistent with the notion that SPAC acquisitions attract companies to go public in difficult times. SPAC–acquired firms have lower growth opportunities, higher leverage and smaller size and thus lower quality than traditional IPO firms.

SLOWING DOWN

SPAC opponents claim that the boom will likely slow down. As retail investors start entering the market *en masse*, investor enthusiasm may lead to unsustainable overvaluations, it is argued.

Moreover, reduced regulatory scrutiny is a double-edged sword. Although the IPO process can be long and arduous, it was designed to provide transparency, thereby providing sufficient information for investors to make sound financial decisions. Comparatively, the SPAC acquisition process is more opaque, as investors are relying on the brand equity of the SPACs' sponsors as opposed to carrying out due diligence themselves.

While less due diligence allows an accelerated IPO process and reduces completion risk, it may fail to uncover potential accounting irregularities. For instance, the electric truck manufacturer Nikola's stock price skyrocketed to U$93.99 before falling to U$27 due to alleged false statements about its technology.

Finally, target companies are increasingly uneasy about being acquired by SPACs as evidenced by the recent example of Tokopedia. And Dave Girouard, the former Google executive who founded Upstart, said : "To me a SPAC feels like reaching the next level of a video game and handing the joystick to somebody else. It's an acquisition of your company despite how it might be described."

Notwithstanding the 2020 boom in SPACs, the fear remains that the boom will turn into a market bubble and eventually burst. Myriad factors can contribute to the eventual slowing down, such as reduced investor sentiment, increasing opposition of target companies, accounting misdeeds, eventual poor performance, or regulatory intervention.

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