"When a product has been mostly dormant for many years and suddenly finds immense popularity, investors should be cautious."

SPACulating

What a year.

When historians look back on 2020, they will no doubt marvel at the sheer magnitude of the chaos. The COVID-19 pandemic strained the foundation of the global economy as it tore its way through societies across the world, violence toward members of the Black community put renewed focus on the intensity of racial injustice in America, and the US presidential election tested the elasticity of democracy. The connective tissue that ran through each of these events was the role of information, displayed in its purest form as fact and its most noxious as deceit.

Reliable information is essential in every walk of life, including, of course, the evaluation of investment opportunities, and for investors in Special Purpose Acquisition Companies – better known as a SPACs – there's a lot to understand and evaluate. SPACs are publicly traded shell companies formed for the specific purpose of merging (not acquiring, despite the name) with a non-public company, and they've recently become a surrogate for the pain-staking work of the traditional IPO, the disclosure-heavy path for private companies looking to go public. No tiresome road show, no complicated price discovery process, and very little meddlesome public scrutiny. A fast track to a public listing with less regulatory noise. For sponsors – who range from established corporate and investment executives to celebrities like Hall of Fame basketball player Shaquille O'Neal, former House Speaker Paul Ryan, Grammy-winning singer-songwriter Ciara Wilson, and Moneyball impresario Billy Beane – the incentive is obvious. A pile of cash to invest, and economics that could make high-fee investment managers blush.

While SPACs were not born out of the chaos of 2020, they have certainly flourished under its conditions, moving from the fringes of investing straight into the mainstream. In 2015, the 20 SPAC IPOs completed that year comprised 12% of all IPO activity. In 2020, there were 248, and for the first time SPAC IPO activity was more than 50% of all IPO activity in terms of the number of IPOs completed.[1] When a product has been mostly dormant for many years and suddenly finds immense popularity, investors should be cautious. But caution is never an end point for information; it's the starting point. It's too early to tell whether they'll be as prominent going forward as they were last year, but having the right information to understand and discern the implications of SPACs is essential in understanding their role in financial markets today, the increased role they may play going forward, and their suitability for investors.

The Mechanics of SPAC Formation

The traditional life cycle from private company to public company has always been fairly straightforward. A company starts a business with private capital, that business grows to a scale where it has the resources and structures to support the process of raising capital in the public markets, and then the company undertakes an initial public offering and lists its securities on an exchange. Central to this process is a company with a real operating business that can be studied and analyzed, an observation that seems so obvious that it's almost ridiculous to mention. But in today's environment it's essential to make that distinction, because with SPACs, the business is to become a business. SPACs skip to the end, and

[1] Source: SPAC Analytics.

then attempt to fill in the beginning.

While "blank-check" public companies have been around for a long time, SPACs are a fairly recent innovation, a by-product of the fraud that was frequently associated with what had been a largely unregulated market. In 1992, the SEC stepped in to provide protections for investors, creating a regulatory framework and structure that gave birth to the vehicle in its present form[2]. The management team – often referred to as the founders or sponsors – puts up capital and forms a corporation, then works with an investment bank to raise a much larger pool of capital for an IPO, usually for a specific industry or purpose as reflected in its prospectus. Participants in the IPO receive units, each comprising a share of stock priced at $10, along with a warrant for a fractional share at $11.50. Most SPACs also offer rights to a fraction of a share if the SPAC ends up completing a merger. The capital raised in the IPO sits in a trust account, and then following the IPO, the stock starts trading on an exchange. At that point, the clock starts ticking, with the sponsors given two years to combine with an operating company. Once the SPAC has identified a target company, the shareholders of the SPAC will have the opportunity to vote on the transaction. This is where things get particularly interesting.

SPACs offer one other unique feature for investors: the right to approve a deal. After a merger target has been identified, the sponsor goes to the investors and seeks approval, with a majority required for the deal to move forward. Those who approve of the merger retain their shares, warrants, and rights. Those who do not approve will redeem their shares and get their IPO proceeds back, with interest, while still retaining their warrants.[3] A change introduced to the process in 2010 allows investors to redeem their shares but still approve the deal, giving the transaction a much higher probability of moving forward, a big boon to sponsors. As it turns out, outcomes like this are very common when a SPAC identifies a merger target. A joint NYU Law/Stanford Law research study found that the mean and median redemption rates among 47 SPACs that merged between January 2019 and June 2020 were 58% and 73%, respectively, and that a quarter of those SPACs saw redemptions over 95%.[4] This means that sponsors may find themselves with the votes to move forward, but not the financial resources to do so. If a SPAC that started with $400 million in IPO proceeds suddenly finds itself with $100 million after redemptions, it has to close that gap if it still wants to get the deal completed. How do they solve this problem? With additional forms of financing, usually in the form of a PIPE (private investment in public equity), which brings additional investors into the deal with the resources to complete the merger, diluting investors who are already experiencing the significantly dilutive headwinds of the underwriter fees, warrants, rights, and the sponsor fee, which comes in the form of founder shares, also known as "the promote."

To sponsors, the promote is everything. It is the single biggest motivation for getting a merger done, because if that doesn't happen, then the sponsor loses money. The economics of the promote are so utterly amazing that to most sponsors, the quality of the deal matters less than its completion, setting up a conflict for sponsors approaching the two-year mark without a deal in the works.

Insane Economics and Conflicted Interests

Pretend for a moment that you have the good fortune (both cosmically and financially) to form a SPAC. You're raising $200 million, and as the sponsor, you commit resources to cover the banking and legal fees associated with the IPO, say $2 million. If you don't find a deal within two years, this money won't be refunded, and so in return for this commitment, you

[2] The terms described here are by far the most common, but there are exceptions.
[3] Investors who purchase shares on the open market are only entitled to the pro rata share of the trust account and not the price at which the shares were purchased. For example, if a SPAC had an IPO at $10 per share, but an investor bought 100 shares on the open market at $11 per share, the shares purchased are still associated with a trust account balance of $10 per share.
[4] "A Sober Look at SPACs" Michael Klausner and Michael Ohlrogge, Oct 2020.

get your promote, which entitles you to 20% of the SPAC's common stock.[5]

As a sponsor, there are three basic outcomes:

You don't find a deal, the SPAC is dissolved, the investors receive all their money back plus interest, and you're out $2 million.

You find a deal, the majority of investors reject it, the SPAC is dissolved, the investors receive all their money back plus interest, and you're out $2 million.

You find a deal, the majority of investors accept it, any additional financing necessary is arranged, the SPAC merges with the operating company, and you earn your promote.

In two of those scenarios, you're out $2 million. In the other scenario, you own up to $40 million worth of shares (20% of $200 million) at the $10 share price.

A good transaction is of course always preferred, but even a bad transaction can be lucrative for sponsors. And herein lies a major conflict. A failed SPAC is fine for investors because they receive their money back, plus interest. But a failed SPAC is terrible for sponsors – they lose the capital they committed for banker and legal fees and earn no promote. And so, getting a deal done – any deal done – is paramount. Even if you overpay (and the closer you get to the end of the SPAC life, the more likely that may be), it's better than doing nothing at all and losing your founder shares. Once you get your founder shares, your risk profile changes significantly, not to mention any alignment you have with investors.

Alignment occurs when your economic interests are in sync, but the moment the merger occurs, this alignment bifurcates. Both you and your shareholders win if the merged company's stock goes up in price, but given the economics, you as the sponsor still win even if the stock goes down. In the example listed above, with $2 million invested and post-merger stock worth $40 million, your breakeven point is a 95% drop in the value of the stock. Investors at the IPO could lose almost everything, while you end up no worse than when you started.

While sponsors have a huge incentive to bring any deal they can to investors, practically speaking, the deal has to be sensible. Even more than that, it has to be sellable. SPACs today are effectively competing with the traditional IPO process, and one advantage they can offer is speed. For investors, though, the speed may present an additional cost: a lack of information. This can happen with traditional IPOs as well, but it's much harder to hide information during a process designed to endure much more investor scrutiny.

Information Discovery: The IPO vs. The SPAC

WeWork: A Cautionary IPO Tale

In 2019, one of the most high-profile and valuable private companies in the world was WeWork. Led by its colorful CEO Adam Neumann, the co-working space company had a mission to "elevate the world's consciousness." After a funding round in January, the We Company, WeWork's parent organization, was valued at $47 billion, and by mid-year the company announced that it was making plans to go public. Per SEC regulations, a quiet period began during which the company and the management team could not make any public forecasts or express any opinions about the value of the company to prevent an artificial

[5] This is not a typo. It really is 20%.

increase in demand before the issuance of securities.

The IPO process is intended to provide maximum transparency to investors, to wipe the glossy sheen off companies so they can be seen without makeup on, and in the case of WeWork, what investors saw wasn't pretty. For starters, the company was losing over $5,000 per year for each customer who inhabited its office space, it had long-term lease obligations approaching $50 billion while signing customers to short-term contracts, and it had a very complicated corporate structure with very favorable tax benefits for Neumann, who would also control the majority of the voting rights through super-voting shares. Further complicating things, WeWork leased and paid rent on buildings owned in part by Neumann, who also profited from selling the company a trademark for "We" when it rebranded to become the We Company. Investors also learned that should Neumann ever become permanently disabled or deceased, his wife Rebekah, who served as the company's chief brand and impact officer, would be one of two people who would choose his successor.[6]

To cap everything off, right before the IPO, it was discovered that Neumann cashed out $700 million in WeWork stock, which is almost unheard of before a public listing, and spoke volumes about his priorities and judgment. True to the company's mission, the world's consciousness about the company and its leader was elevated, and the more investors learned, the less faith they had in both. By the time the dust settled, the IPO was postponed indefinitely and Neumann was ousted from the company. What was supposed to be WeWork's coronation became an investor rebellion, stoked by the power of information.

VectoIQ/Nikola: A Cautionary SPAC Tale

The exposure of WeWork occurred before investors could get burned in the public market, but Nikola investors were not afforded the same luxury. The zero-emission truck manufacturer that shamelessly took the first name of Tesla's inspirational nom de guerre was founded in 2014 by Trevor Milton, who aimed to build semi-trucks powered by batteries and hydrogen. In 2016, the company unveiled a high-level design for a hydrogen-fueled Class 8 truck called the Nikola One, a sleeper cab with ten wheels that aimed to be in production by 2020. This was the beginning of what turned out to be a pretty rich history of planned production without actually putting any trucks on the road, outside of incomplete demos. Regardless, in March of 2020, Nikola merged with VectoIQ Acquisition Corporation, a SPAC run by former General Motors executive Steve Girsky that was only a few months away from reaching the end of its two-year life and needed to get a deal completed if the promote was to be earned. As part of the deal, the combined company raised $525 million in a private placement from investors.

Unlike traditional IPOs, SPACs have no quiet period before they start trading, and so there's no muzzle preventing management from being as promotional as it wants. Prior to Nikola's public market debut, Milton was not shy about hyping the company and its prospects. "We want to fully vertically integrate the whole supply chain. And by doing that, we are going to make five times as much revenue as our competitors do per truck we sell. Those kinds of numbers are going to disrupt the entire world."[7] Nikola's stock began trading on June 4, 2020, a day after the merger was completed. By June 9, the shares had more than doubled, and by early August, the company was valued at around $13 billion. This was especially impressive given the revenues it had generated for the year to that point. Nikola booked a mere $80,000 during the first six months of 2020, around half of which was oddly attributed to the installation of solar facilities for Milton's home.[8]

[6] "The strangest and most alarming things in WeWork's IPO filing" CNBC.com, Aug 17 2019.
[7] "Nikola Goes Public; Class 8 Battery-Electric Vehicle Due in 2021" Transport Topics, June 3 2020.
[8] "Nikola's entire quarterly revenue of $36,000 was from solar installation for the executive chairman" CNBC.com, Aug 5 2020.

From a public-market valuation perspective, everything was still humming along into September. But then disaster, in the form of a fiery investigative dirigible, struck the company. Hindenburg Research, a forensic financial research group, published a piece in which it stated, "Today, we reveal why we believe Nikola is an intricate fraud built on dozens of lies over the course of its Founder and Executive Chairman Trevor Milton's career." They further stated that, "We have gathered extensive evidence—including recorded phone calls, text messages, private emails, and behind-the-scenes photographs—detailing dozens of false statements by Nikola Founder Trevor Milton. We have never seen this level of deception at a public company, especially of this size."[9] This was not an accusation delivered in a social media soundbite. Hindenburg produced an extensive and detailed account that closed with a section that challenged Milton to prove them wrong: "On the off chance we are just flat out wrong about absolutely everything, here is Trevor's opportunity to prove it. These are the specific questions we think investors in Nikola and, largely, investors in Trevor deserve the answers to." What followed were 53 questions, ten of which Nikola later answered, which Hindenburg said, "largely confirmed our findings or raised new questions."

The stock had just been on a tear, advancing around 50% following an announced $2 billion partnership with General Motors, but after the report came out, the party came to a halt. Not only did GM cancel its deal, but Nikola also lost an order from waste-management company Republic Services for 2,500 zero-emissions garbage trucks, a deal which Milton referred to as "a game-changer" for Nikola when it was signed.[10] The year ended with the stock in the mid-teens, along with an SEC investigation into the company that remains ongoing. It also ended with no trucks on the road, and competition that appeared to be much further along. When asked by USA Today business reporter Nathan Bomney about Nikola's strategy, Toyota's chief hydrogen trucks engineer, Andrew Lund, said, "Our strategy is different. They've been outspoken about what they're going to do. Our culture is to explain to you what we've done."

Nikola is a perfect example of why companies with a more speculative future may choose to go the SPAC merger route rather than IPO. It's faster, it doesn't have the same level of information and regulatory scrutiny, and it doesn't have to endure a more arduous negotiated process of price discovery, all of which work for the company and against investors. Nikola's Chief Financial Officer Kim Brady said in an interview with the Wall Street Journal, "We chose the SPAC route because there was simply too much uncertainty in the market with the coronavirus. If we had pursued the IPO path, we would not be a public company at this point."[11] Well, maybe. Nikola may have had trouble going the IPO route because it simply wasn't ready to be a public company, coronavirus or no coronavirus. It had plans but no products, and that's a pretty important distinction.

Merging with a SPAC may provide the easiest and quickest source of capital for private companies, but investors should ask whether they want to own a company that is looking for the easiest and quickest source of entry into the public markets, where the degree of scrutiny increases many-fold. It may have some appeal at the beginning, but many don't enjoy that financial appeal for long. The overall performance of SPAC mergers bears this out.

Performance of Post-Merger SPACs: The Pain of Dilution

SPACs have not been around for very long and so there aren't reams of data to parse through in an effort to draw more definitive conclusions about long-term performance. However, we can take a look at the data that's available to at least get an understanding of how they have done thus far. And the results haven't been pretty.

[9] "Nikola: How to Parlay An Ocean of Lies Into a Partnership With the Largest Auto OEM in America" Hindenburg Research, Sept 10 2020.
[10] "Nikola Motor loses another crucial deal, capping a catastrophic 2020" Fortune, December 23 2020.
[11] "Blank-Check Boom Gets Boost From Coronavirus" Wall Street Journal, July 13 2020.

The NYU Law/Stanford Law study[12] looked at one-year returns for all SPACs that have merged in each year since 2010, and there has never been a year in which SPAC mergers outperformed the Russell 2000, a diversified small-cap index useful for comparison given the small-cap characteristics of SPACs. As the study point out, "Even the best of years underperform by 10% within the first year post-merger, and many years see excess returns of negative 40% or more. SPAC returns compared to the IPO index are even worse, but that index has coverage going back only to 2013, so we use the Russell 2000 to allow a longer time period for comparing historical SPAC returns." The authors put a high degree of emphasis on dilution as a significant factor, especially given the fact that SPACs with less cash per share at the time of their mergers did much worse than those with less dilution.

For sponsors, it's been a completely different story. The study looked at returns for 47 SPAC sponsors at the three-, six-, and twelve-month mark following a merger. At three and six months the returns were substantial, with the most successful seeing returns north of 1000% and the mean return around 400%, with four sponsors actually (and quite amazingly) losing money[13]. For those with twelve months of post-merger performance, sponsor returns dropped to a still massive average of 187%, with a median of 32%. It's not just a different zip code from investor returns, it's a different galaxy. And a system like that is only sustainable until more reasonable options emerge.

Hope in The Form of… Bill Ackman?

Back in July, Bill Ackman, the billionaire founder of hedge fund Pershing Square, launched the biggest SPAC yet, a $4 billion vehicle called Pershing Square Tontine Holdings ("PSTH"). PSTH consists of 200 million units priced not at $10 but at $20, with no sponsor promote. As Ackman described it in a recent letter to shareholders of Pershing Square Holdings, Ltd, "We designed PSTH to be the most investor- and merger-friendly SPAC in the world," and pointed out that "One of the limitations of SPACs has been the compensation arrangements of their sponsors, which in almost all cases are best described as egregious. These compensation structures are also counterproductive to the intended goal of a SPAC because of the large amount of dilution they create in a merger transaction."[14]

PSTH addresses these issues in a variety of ways in an effort to improve alignment with investors. It eliminates all forms of compensation, advisory fees, and founder shares (it bears mentioning again: no sponsor promote), commits Pershing Square funds to purchasing a minimum of $1 billion of common stock and shareholder warrants on the same terms as PSTH's public shareholders, caps underwriting fees, and makes a number of changes to the typical shareholder warrant structure to minimize the risk of shareholder redemptions, which should have the effect of eliminating the need to raise expensive PIPE capital. Ackman clearly knows that redeeming shares and holding onto warrants is a common strategy for investors, and while he can't eliminate it, he can certainly add provisions to reduce it.

It's hard to make a case for Bill Ackman being heroic, and we're not going to do that here. But at least someone prominent has called out SPACs for what many of them are: vehicles with misaligned incentives where sponsors get rich at the expense of investors. Pershing's goal is obviously to make a lot of money for itself, but with much tighter investor alignment and thus a higher likelihood of investor success. Yes, there are existing success stories for investors, but they are far less common. For sponsors, however, almost every SPAC that completes a merger is a moneymaker. That's the system we have today, but it's not sustainable if the market for SPACs is going to continue thriving as it did this past year,

[12] "A Sober Look at SPACs" Michael Klausner and Michael Ohlrogge, Oct 2020.
[13] The authors note that in each of these cases, the losses occurred because the sponsors made large additional investments at the time of the merger.
[14] Pershing Square Holdings, Ltd. Letter to Shareholders, June 30 2020.

especially if SPAC proponents expect it to supplant IPOs as the most common means of entry into the public markets.

SPACs Are Not Going Away, But Buyer Beware

In a blog post from this summer, Bill Gurley, a prominent and longtime venture capitalist, wrote about what he termed the two fatal flaws of the IPO process, “that IPO advocates are embarrassed to discuss: 1) The traditional IPO process does not use a market-based approach (like an order-matching system) to efficiently match supply and demand and to discover price despite the fact that almost all other financial assets are all priced/sold this way… and 2) Most potential buyers of stocks are blocked out of the IPO process. Access is limited to the best clients of the investment bank, (and) most investors have little to no shot of getting an IPO allocation.”[15]

Gurley makes a persuasive point, especially when he talks about how the banks tell management teams to shoot for an optimal target of being 30x over-subscribed (he notes that this is not a joke – “Talk to any management team from any IPO in the past three years, and you will find they had this exact conversation”). There used to be no alternatives for private companies looking to go public, but now there are two: the direct listing[16] and the SPAC merger. Today, the SEC does not allow direct listings to go public and simultaneously raise capital, which leaves the SPAC merger as the only alternative to a traditional IPO. Gurley concludes that given the lower cost of capital, the access to primary capital, the ability to negotiate the company’s value/price with the sponsor, and the relative speed of entry to the public market, SPACs are going to become a more legitimate option for high-profile companies going forward. If Gurley is right, in all likelihood this means that SPACs are here to stay.

But they’re less likely to survive in their current condition, with the dilutive economics skewed so dramatically to the sponsors. However, as investors become more knowledgeable and the environment become more competitive, the baseline terms will probably change. Maybe not to the level that Bill Ackman established, but something far less expensive to investors than a 20% promote. This is where the power of information is vital. As with all investments, investors need to understand the details of what they’re buying, and particularly with SPACs, the destructive impact of dilution. Investing without a consideration of these factors isn’t really investing at all.

It’s speculating.

[15] “Above the Crowd - Going Public Circa 2020; Door #3: The SPAC” August 23 2020.
[16] In a direct listing, a company goes public by selling existing shares instead of offering new ones.

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