SPACs: What's the Big Deal?

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- SPACs, or special-purpose acquisition companies, have become quite popular in recent years.
- While there are some safeguards for investors in a SPAC IPO, SPACs have tended to enrich their management teams well beyond the returns an average investor sees.
- Although it's not out of the question that our subadvisors might own some post-SPAC stocks if they view the underlying businesses as attractive, we generally view the SPAC craze as one that could, like prior bubbles, end poorly for investors.

Background

While SPACs, or special-purpose acquisition companies, are not new, they have become quite popular in recent years. These so-called "blank-check" investment vehicles provide their founding sponsor or management team with a pool of capital to carry out mergers, or the acquisition of existing private businesses, within a specified period. The private business benefits by going public without having to go through the more arduous initial public offering (IPO) process; instead, the SPAC goes through an IPO, although the process tends to be less intensive given the lack of existing operations and narrower business objective.

According to SPAC Analytics, the number of SPAC IPOs in 2020 increased by a factor of four over 2019, and they have vastly outnumbered more traditional IPOs thus far in 2021. This continues a trend that has seen SPACs go from 5% of the IPO market in 2014 to 55% in 2020 and nearly 80% year to date.[1] An increasing number of SPAC sponsorship/management teams have even included high-profile individuals, including professional athletes, ex-politicians and other types of celebrities.

Our view

Given their acquisitions of private companies, the most obvious question concerning SPACs is whether they have offered attractive returns relative to other risky areas of the market. Unfortunately, while there have been some high-profile successes among SPAC acquisitions, the performance history is not compelling for investors. For example, a study of recent SPAC returns found that while the median return was positive, it fell well short of returns offered by an IPO benchmark or small-cap growth index over the same period. In contrast, the estimated performance earned by SPAC sponsors was eye-watering, even under fairly conservative assumptions. The median return for SPAC sponsors was over 400% after expenses. The 85^{th} percentile outcome was over 1,000%, and even poorer outcomes were robustly positive, with a 15th percentile return of nearly 40%.[2]

While there are some safeguards for investors in a SPAC IPO (for example, many allow investors to vote on a proposed merger or acquisition or to redeem their initial IPO investment), SPACs have tended to enrich their sponsorship/management teams well beyond the returns an average investor sees. This is due in large part to the significant dilution of other investors that typically occurs when a SPAC closes an acquisition; at that point, an outsized share of the newly public company (often referred to as the "promote share") is allocated to the SPAC's sponsorship/management team. At least one notable recent SPAC offering has attempted to remedy this problem with more investor-friendly terms, but it is still the case that the interests of SPAC managements are often meaningfully misaligned with other investors in the SPAC. The initial and ongoing costs borne by the SPAC sponsorship also incentivize it to close a deal, even if attractive acquisition candidates aren't in ample supply.

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[1] www.spacanalytics.com, last accessed 2/24/2021.
[2] Michael Cembalest, JP Morgan, "Eye on the Market," February 8, 2021, https://privatebank.jpmorgan.com/content/dam/jpm-wm-aem/documents/en/investing/eotm/Hydraulic-Spacking.pdf, last accessed 2/24/2021.

With so many SPACs coming to market and competing for opportunities, this dimension could become even more problematic. And, as with any public entity, there are other decisions that SPAC management teams have to make, such as financing, which can work against the interests of other investors in a SPAC (although, to be fair, this tends to be true for any equity investment where investors delegate control to managers).

Finally, given the unique structure of SPACs—they have features of private-asset investing and essentially offer a cash-like return until an acquisition is made or the SPAC is liquidated—figuring out how the asset class might fit into a strategic asset allocation provides a somewhat interesting challenge.

Our funds

This is an area that our portfolio managers are paying attention to, given the frothy demand (and supply) that SPACs have seen this year. Given the uncertainty associated with such "blank-check" companies, explicit SPAC exposure is unlikely in our long-only equity funds. SEI's equity portfolio managers also see the SPAC craze as one that could, like prior bubbles, end poorly for investors. However, it's not out of the question that our subadvisors might own some post-SPAC stocks if they view the underlying businesses or share prices as attractive.

Certain managers in some of our non-traditional offerings are active in the SPAC space. These managers typically seek out attractive risk-to-reward asymmetries, such as buying close to the SPAC redemption floor price, which is typically $10/share (analogous to a cheap lottery ticket if the proposed target generates a lot of investor excitement once announced); participating in SPAC IPOs and obtaining additional warrants; making PIPE investments[3] (a somewhat riskier approach, though still with a degree of downside mitigation); or even acting as a SPAC sponsor (which, as noted, has been an attractive pursuit in recent years).

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[3] PIPE investments are private investments in public equity, which occur when large institutional investors make deals to buy large quantities of publicly-traded stocks at a preferred price below the current price available to the public; they are a way for publicly-traded companies to quickly raise a large amount of cash.