SPACs: Catching flies with honey and vinegar

An ostensibly new financial vehicle is now causing a stir in investor circles. They say that it can generate rates of return in the triple digits. What is it? A Special Purpose Acquisition Company (SPAC) is a company with no commercial operations that is formed with the sole purpose of raising capital through an IPO in order to acquire an existing business. SPACs, also known as "blank check companies", have existed in the USA for decades. In recent years, however, this business has experienced a veritable boom.

Any increase in efficiency in the capital market is welcome. With SPACs, however, the danger lies in buying a pig in a poke and then being taken to the cleaners by rascals.

The first step for a SPAC is to found a shell corporation and organise a road show for major investors. Next, the shell company is listed on a stock exchange. With the capital thus acquired, the management of the shell company then searches for suitable target companies. The management typically has two years to identify acquisitions. Once a target company has been found and the management of the shell company has been able to negotiate a deal with the company to be acquired, a vote is held at the shell company. The moniker "blank check company" is not exactly correct insofar as the shareholders vote on whether the target selected by management should be acquired or not. Those opposed have the right to withdraw and their investment stake is returned. If there is no acquisition, the investors get their money back. The sponsor, or the management of the shell company, usually receives about 20 percent of the shares in the target company as compensation. These funds cover the costs of the IPO, set-up, listing and review of potential target companies. However, the sponsors only make money if an acquisition takes place. For this reason, they may be tempted to agree to a deal that is not advantageous for other investors.

SPACs are considered a far less regulated road to a stock market listing than a typical IPO. In the USA, the SEC review required for a traditional IPO may last up to six months, while such a review for a SPAC typically lasts about two months. The trend toward more SPACs had already been heating up in the years before corona. With the onset of the crisis, however, this has become even more pronounced. Many companies were sceptical about an IPO due to market volatility and therefore opted for the route via a SPAC. This offers companies greater certainty in pricing.

What to think of SPACs? Firstly, any increase in efficiency in the capital market is welcome. After all, it allows companies to obtain capital more easily, i.e. at lower cost. For the investor, it offers a number of additional investment opportunities, and the investment banks, those intermediaries who primarily profit from traditional IPOs, cannot immediately pocket the entire added value of the IPO for themselves. On the other hand, the "sponsors" get to grab a big slice, which is not wrong, since they also do the work. Or most of it.

With SPACs, the danger is that the *praenumerando* provision of capital leads to buying a pig in a poke and then being taken to the cleaners by rascals. At present, many SPACs are attempting to raise their profiles with promotion by celebrities, whose involvement may not be substantial. Be on your guard. Reality is more important than appearances, especially here. Otherwise, there is a risk of what we have already seen with SPVs from the time before the financial crisis: an accident waiting to happen.

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