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By Robert Huebscher

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Special-purpose acquisition companies (SPACs) should be illegal, according to the legendary investment strategist Jeremy Grantham (Huebscher 2020). Moreover, Grantham says these structures are so speculative that investor enthusiasm for them is symptomatic of a pending collapse in equity prices.

But aside from Grantham, few observers have questioned the economic viability of SPACs, which accounted for approximately half of the initial public offering (IPO) volume in 2020.

That is why I was impressed when I read a recent study, "A Sober Look at SPACs," by Michael Klausner, Michael Ohlrogge, and Emily Ruan (hereafter Klausner et al. 2020). I also spoke with one of the authors, Michael Ohlrogge, who is an assistant professor at New York University School of Law, as I prepared this article.

Klausner et al. (2020) exposed the central flaw in the SPAC structure. They also demonstrated that the performance of SPACs in the public markets has been unimpressive and that purported benefits have been overstated or are nonexistent.

I review their research below. Because of the complexity of the SPAC structure, I use a hypothetical example to illustrate the destructive power SPACs inflict on investors' wealth.

I conclude with an example of a properly structured SPAC that resolves the problems in the typical structure.

SPACs are corporations that raise money through public offerings to pursue future acquisitions. They also are known as blank-check companies because they raise funds before they identify the companies they intend to acquire.

I also reference Lefteris Acquisition Corp., a SPAC that targets fintech investments, and other SPACs that target the acquisition of advisory practices (Martin 2020).

WHAT IS A SPAC?

SPACs are corporations that raise money through public offerings to pursue future acquisitions. They also are known as blank-check companies because they raise funds before they identify the companies they intend to acquire. A SPAC is led by a sponsor, and it has a board of directors and a management structure. Typically, the sponsor, board, and management have worked together before in the industry they intend to target for an acquisition.

The IPO investors purchase shares at a standard price of $10, which also gives them rights and/or warrants that usually may be exercised at $11.50 per share. The sponsor receives 20 percent of the post-IPO equity at essentially no cost. This is known as "the promote."

The sponsor typically also provides funding to the entity through the purchase of warrants exercisable at $11.50/share, often at a price of $1.00 to $1.50/share, which may approximate their fair market value.

The funds raised through the SPAC's IPO are held in a trust that invests in short-term Treasury securities. The SPAC must execute a transaction within two years; if not, the trust is liquidated, and the funds are returned to the investors.

Once a transaction is announced, the investors have the option to redeem their shares for the $10 purchase price plus interest earned by the trust. If they do, they get to keep their rights and warrants. The actual transaction is a merger between the SPAC and a private company that retains the public company identity of the SPAC. Typically, the SPAC must raise additional funds through private investment in public equities (a PIPE) to adequately fund the purchase of the private company.

HOW SPACs DESTROY WEALTH

A SPAC is a get-rich-quick scheme that benefits the sponsor, and that comes at the expense of the non-redeeming shareholders.

To understand why this is the case, I will use a hypothetical example.

Let's assume we have three individuals—Moe, Larry, and Curly. Moe is the sponsor, and he approaches Larry and Curly to invest sizeable sums in his

Table 1

POST-MERGER SPAC RETURNS, 2019–2020 MERGER COHORT

	Three-Month			Six-Month			Twelve-Month		
	All	HQ	Non-HQ	All	HQ	Non-HQ	All	HQ	Non-HQ
Mean Return	–2.9%	31.5%	–38.8%	–12.3%	15.8%	–37.6%	–34.9%	–6.0%	–57.3%
Median Return	–14.5%	–4.6%	–46.9%	–23.8%	–15.9%	–43.0%	–65.3%	–34.6%	–66.3%
Mean Return (Excess over IPO Index)	–13.1%	25.1%	–53.0%	–33.0%	0.4%	–63.1%	–47.1%	–11.8%	–74.6%
Median Return (Excess over IPO Index)	–32.8%	7.1%	–52.1%	–43.2%	–31.0%	–56.3%	–56.5%	–54.8%	–89.9%
Mean Return (Excess over Russell 2000)	–1.3%	37.5%	–41.9%	–10.9%	22.5%	–41.0%	–21.5%	9.7%	–45.7%
Median Return (Excess over Russell 2000)	–16.1%	16.9%	–47.2%	–17.5%	–2.4%	–57.0%	–44.9%	–36.3%	–55.0%
N SPACs	47	24	23	38	18	20	16	7	9

Source: Klausner et al. (2020, table 6)

SPAC. Moe explains that he will retain 20-percent ownership of the entity without contributing his own money. Larry and Curly make their investments at $10/share and receive their stock and rights and warrants.

Moe subsequently identifies a target company to acquire and presents the transaction to Larry and Curly. Larry redeems his shares, but Curly does not.

The transaction proceeds, although Moe now has less capital to make the acquisition due to Larry's redemption. The merger is completed, and the new entity begins life as a public company.

Moe is ecstatic with his newly acquired wealth as a share of the public company, for which he contributed no capital.

Larry is happy too. He earned a risk-free return on his $10 investment and retained the rights and warrants, which have value that will increase if the public entity thrives.

Curly is despondent. He discovers that his $10 investment is now worth only two-thirds of the price he paid for it. He was the victim of the dilution that came from the sponsor's shares and the underwriting fees and other expenses incurred by the SPAC. A third of his wealth was destroyed.

This simplified hypothetical example reflects exactly what Klausner et al. (2020) found in their research. They studied all 47 SPACs that merged between January 2019 and June 2020. They found that the mean SPAC, at the time it merges with its target, has only $6.67 in cash—less than the IPO price of one share of the average SPAC.

My hypothetical example omits key elements in the life of the average SPAC, such as the need for more than three-quarters of them to raise additional funds through private placements. The non-redeeming shareholders are the only parties in a SPAC transaction that are exposed to the risk of dilution.[1] The sponsor, redeeming shareholders, underwriters and legal counsel, private placement investors, and shareholders in the target company will not suffer a certain loss through dilution.

Klausner et al. (2020) found that post-merger share prices dropped for a large majority of SPACs. Those price drops were highly correlated with the extent of dilution, or cash shortfall, in a SPAC.

"This implies that SPAC investors are bearing the cost of the dilution built into the SPAC structure, and in effect subsidizing the companies they bring public," they wrote. "We question whether this is a sustainable situation."

The complexity of the SPAC structure obscures the corrosive effect of the dilution. The Lefteris prospectus, for example, has approximately 160 pages, half of which are devoted to explaining the risks to investors. It requires a careful analysis to distill its economic structure and the effect on investors.

Indeed, Klausner et al. (2020) spent three years researching this subject before publishing their paper.

FALSE PROMISES OF SPACs

Several arguments have been advanced to justify the value that SPACs can provide. Klausner et al. (2020) show that those claims are unfounded.

SPACs do not perform well post-merger as public entities

Let's begin with the hype about post-merger performance. Table 1 is from Klausner et al. (2020, table 6):

Across the sample, SPACs were money-losing propositions over three-, six-, and 12-month timeframes, whether you look at the mean or median returns, and whether you compare those returns to the average of IPOs or to the Russell 2000.

Klausner et al. (2020) went further and investigated claims that certain SPAC sponsors deliver better performance. They selected the high-quality (HQ) SPACs that were run by a Fortune 500 chief executive officer or by a fund with more than $1 billion in assets. The HQ SPACs did slightly better than the non-HQ ones, but they were still money-losing propositions over the full 12-month horizon. The only exception is that the mean HQ SPAC had a positive return relative to the Russell 2000 over the 12-month horizon. But the median return was negative, implying that the mean return benefited from a small number of strong outperformers.

Chauviere et al. (2020), in a report done for McKinsey & Co., also documented better performance by SPACs run by sponsors with a track record of operating successful companies. But that study had a smaller sample size and used less-rigorous methodology than Klausner et al. (2020). One also must consider that there is a conflict of interest because of the consulting services McKinsey offers to the SPAC industry.

Gahng et al. (2021) confirmed the poor investor returns for SPACs, based on a database of nearly 500 deals since 2010. Gahng et al. (2021) compared the returns for SPACs that had consummated mergers to a buy-and-hold strategy. The SPACs had an average one-year return of −15.6 percent versus the value-weighted Center for Research in Security Prices total market return of 8.7 percent for the matched period—an underperformance of 24.3 percentage points. Gahng et al. (2021) also confirmed that SPACs overpay as the expiration of their funding approaches; the incentives for the sponsor to consummate a deal lead to overpaying for less-attractive target companies.

The flood of investments into SPACs explains the poor performance. This asset pool is competing for a fixed universe of target companies. Those companies also are being courted by private equity funds and many have the option to go public via an IPO. Buying a target company at an attractive price is analogous to a professional sports team trying to select the next superstar athlete in the draft of college players. SPACs are hoping to find the next Tom Brady, who was the 199th pick in the sixth round of the 2000 college football draft. But for every Tom Brady there are countless Sam Bowies. Bowie was drafted second in the 1984 college basketball draft, ahead of Michael Jordan, who went on to be one of the best-ever players. Bowie spent 10 injury-riddled seasons in the NBA, never coming close to fulling the promise he held at the time he was drafted.

SPACs do not have a lower regulatory burden than IPOs

Some claim that SPACs enjoy an advantage, relative to IPOs, in that they face a lower regulatory burden, thereby making it easier for companies to go public.

Klausner et al. (2020) find that is not true. They state, "SPACs have slight disadvantages regarding Sarbanes Oxley compliance compared to firms going public via traditional IPOs, though the differences are not large."

SPACs are insulated from section 11 and have faced very few legal challenges. But, as Klausner et al. (2020) point out, this may be to the detriment of investors, because it could lead to 'less due diligence and sloppier disclosure.'

Companies that go public through a SPAC do need to register with the Securities and Exchange Commission (SEC). They also typically need to perform the dog-and-pony ritual of presenting to prospective investors. This is because SPACs almost always need to raise capital through private placements to replace the capital lost by redeeming shareholders.

SPACs have some regulatory advantages. An IPO prospectus does not contain forward-looking projections because, if it did, the company would face legal vulnerability if those projections were wrong. But SPACs can and do provide projections because they have a safe harbor protection that IPO prospectuses do not. This may benefit SPACs that have businesses that are hard to understand or evaluate.

SPACs also have an advantage with respect to Section 11 liability under the Securities Act of 1933. Under Section 11, a company undergoing an IPO can face lawsuits with respect to its misstatements or omissions in its disclosure statements. This has resulted in many lawsuits for IPOs. SPACs are insulated from section 11 and have faced very few legal challenges. But, as Klausner et al. (2020) point out, this may be to the detriment of investors, because it could lead to "less due diligence and sloppier disclosure. The insulation of the underwriter in particular could reduce the discipline on the SPAC and its target to take care in its disclosures related to their merger."

SPACs do not have greater price certainty when they go public than an IPO

The price of an IPO is set the day before the offering. Some claim that a SPAC has an advantage because its price is set earlier, well before the merger.

But Klausner et al. (2020) explain that is often not so. SPACs face uncertainty in the number of shares that will be redeemed, which affects the amount of cash the private company will receive. SPACs often must negotiate with private-placement investors right up to weeks before the merger closes to ensure there is adequate capital to fund the deal.

"Overall, therefore, SPAC mergers do not inherently provide much price certainty, deal certainty, or certainty regarding how much total cash the target will receive," Klausner et al. (2020) wrote. They also found that it is unlikely that a company can go public through a SPAC faster than through an IPO.

Another claim is that SPACs enjoy an advantage because they can raise funds through private placements, and those investors have greater access to information about the target company (in Wall Street parlance, they can go "over the wall"). But Klausner et al. (2020) explain that nothing prevents a company undergoing an IPO from also using private placements.

The issue of price certainty should be a major concern for the target companies a SPAC seeks to acquire, such as advisory practices. Given the incentive for IPO shareholders to redeem their shares, target companies cannot predict how much cash will be available in the SPAC to complete the acquisition. Redemptions are not known until the merger closes. Ohlrogge told me it is moderately common for the SPAC to have 100-percent redemptions. The target company must rely on the sponsor to provide funding through private placements.

Indeed, sometimes the sponsor negotiates a private placement, where the new investors buy in at a low price, say $8 per share or sometimes even less, according to Ohlrogge. In one case, private-placement investors bought convertible notes. If you priced it all out, Ohlrogge said, they bought in at effectively about $3 per share.

When there are very high redemptions, a private placement brings in new cash—but not always, Ohlrogge said. In eight of the 47 SPACs in the Klausner et al. (2020) sample, the SPAC had $10 million in cash or less by the time of the merger. A target is taking a big gamble by merging with a SPAC, knowing that if redemptions get too high, it could be left with a bad deal.

An investor needs to ask, "How good must the deal look to the target, in order for it to be willing to take such a big risk?" If redemptions are only 50 percent to 75 percent, Ohlrogge said, it likely means that the target is getting a great deal, and it's coming at the expense of SPAC investors.

It is more costly for a SPAC to go public than for an IPO

The underwriting fee for an IPO is typically 5 percent to 7 percent, versus 5.5 percent for a SPAC. But that is not the full story. The underwriters of an IPO routinely underprice the offering to ensure that it is fully subscribed. This leads to a "pop" on the first day of trading—roughly 20 percent, according to Klausner et al. (2020). Some observers may disagree, but that 20 percent is a cost to the company. Thus, the total cost of an IPO is 25 percent to 27 percent.

Even among the 15 percent of holders that are not institutions, it is likely that many of them are wealthy individuals who do not need to disclose holdings through a 13F filing with the SEC.

But what about a SPAC? Because approximately 73 percent of the shares in a SPAC are redeemed, its 5.5-percent underwriting fee should be applied to only the remaining 27 percent of the IPO proceeds, not to the full amount. One also must consider the dilution imposed by the sponsor's promote and the rights and warrants issued to redeeming and non-redeeming shareholders. Once those are considered, Klausner et al. (2020) estimate the true cost of underwriting a SPAC is 50.4 percent.

There is one notable feature of the Lefteris offering. Its prospectus states: "Unlike many other similarly structured blank check companies, our initial stockholders will receive additional shares of Class A common stock if we issue shares to consummate an initial business combination." This clause imposes dilution on the non-redeeming shareholders beyond what Klausner et al. (2020) analyzed in their study. This means that the sponsor will not face any dilution as a result of private-placement funding. Among other things, this means that the non-redeeming shareholders and private-placement lenders will absorb all the underwriting costs.

SPACs are not a 'poor man's private equity'

Some contend that SPACs are a way for retail investors to make private-equity-like investments without having to pay the fees associated with private equity funds.

But approximately 85 percent of SPAC investors are institutions, typically hedge funds. Even among the 15 percent of holders that are not institutions, it is likely that many of them are wealthy individuals who do not need to disclose holdings through a 13F filing with the SEC.

A group of those hedge funds has become known as "the SPAC Mafia" because they routinely invest in SPACs and redeem their shares (retaining the rights and warrants they were issued). Klausner et al. (2020) estimated that the SPAC Mafia controls 70 percent of post-IPO capital. The median SPAC Mafia investor divests 97 percent of its shares once the merger is completed.

Through 13F disclosures, we know that two Lefteris investors are hedge funds that fit the description of the SPAC Mafia (although that distinction is not a formal one). According to Ohlrogge, one of them, Weiss Multi-Strategy Advisers, is quite large. From 2010 to 2019, Weiss had at least 100,000 shares in 65 different SPACs and a divestment rate greater than 95 percent. The other, Linden Advisors, had 21 SPACs with at least 100,000 shares, and it retained about 35 percent of its IPO-stage holdings, which is uncommonly high.

Because Weiss and Linden control about two-thirds of Lefteris' IPO shares, investors should expect substantial redemptions at the time a merger is announced.

FINAL THOUGHTS

Ohlrogge told me that he did not receive any pushback on Klausner et al. (2020). He said he has spoken with many people in the SPAC industry and they often acknowledge the problems identified in Klausner et al. (2020) but then claim that their SPAC will be "different."

I showed a preliminary draft of this article to two SPAC sponsors. Neither identified any factual errors.

SPACs are a financial structure designed to bring a company public. That company eventually will merge with a private company to create a publicly held operating company. But by the time that merger has completed, most of the SPAC investors will be gone, either having redeemed their shares or sold them on the open market.

That post-merger company will be led by the SPAC sponsor, which will acquire substantial wealth through the promote—essentially free shares granted at the time of the SPAC's IPO. The cost of the promote, and that of the warrants and rights still held by redeeming shareholders, and of the underwriting and other fees incurred by the SPAC, will be paid disproportionately by the non-redeeming shareholders. Their wealth will be destroyed.

The SPAC sponsor may do a lot of work to consummate the merger. But a SPAC is still a get-rich-quick scheme for the sponsor when compared to traditional IPOs.

The problem with SPACs is a gross misalignment of incentives among the sponsor and the non-redeeming investors. This is built into the traditional SPAC structure.

But it does not have to be that way.

In July 2020, Pershing Square, a hedge fund run by Bill Ackman, launched a SPAC without any promote. It was the largest SPAC to date, and as part of the deal Pershing purchased warrants that were 20 percent out of the money and do not vest until three years after the merger. Pershing also committed to invest $1 billion at the time of the merger and another $2 billion later in exchange for further warrants.

The SPAC sponsor may do a lot of work to consummate the merger. But a SPAC is still a get-rich-quick scheme for the sponsor when compared to traditional IPOs.

Pershing's SPAC also has unique redemption features. It issued warrants for only one-ninth of a share, far less than other SPACs. It rewards non-redeeming shareholders with additional warrants. It has a tontine feature that allocates warrants from redeeming to non-redeeming shareholders. Those features are designed to eliminate the incentive to redeem shares.

The net effect of the Pershing SPAC structure is to align incentives among the sponsor and all its shareholders. A validation of the improvement in Pershing's structure is that Seth Klarman's Baupost Group purchased 17.5 million shares in its IPO.

Until regulatory reforms are imposed on the SPAC structure or more issuers adopt the Pershing template, investors in deals such as Lefteris and Kingswood Acquisition Corp. should redeem their shares. Target companies should be extremely cautious about merging with a SPAC.

SPACs are among a group of risky, difficult-to-analyze investments with high embedded fees and a lack of transparency—a group that includes non-traded real estate investment trusts and certain types of broker-sold annuities. I see no reason to make SPACs illegal, as Jeremy Grantham advocates. They are no more dangerous to investors than those other products. But SPACs have come under the scrutiny of the SEC.[2] I hope that regulators will educate the public about the perils retail investors face when buying a SPAC.

Robert Huebscher is founder and chief executive officer of Advisor Perspectives, a newsletter for financial advisors. He earned a BA from Connecticut College and an MBA from Harvard Business School. Contact him at rhuebscher@advisorperspectives.com.

ENDNOTES

1. Public shareholders that bought stock on the open market pre-merger also will be victims of dilution. This could happen if, for example, the market price of the SPAC rises above $10 and initial IPO investors sell their stock.
2. See John Coates, "SPACs, IPOs and Liability Risk under the Securities Laws" (April 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

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