NEWPERSPECTIVES

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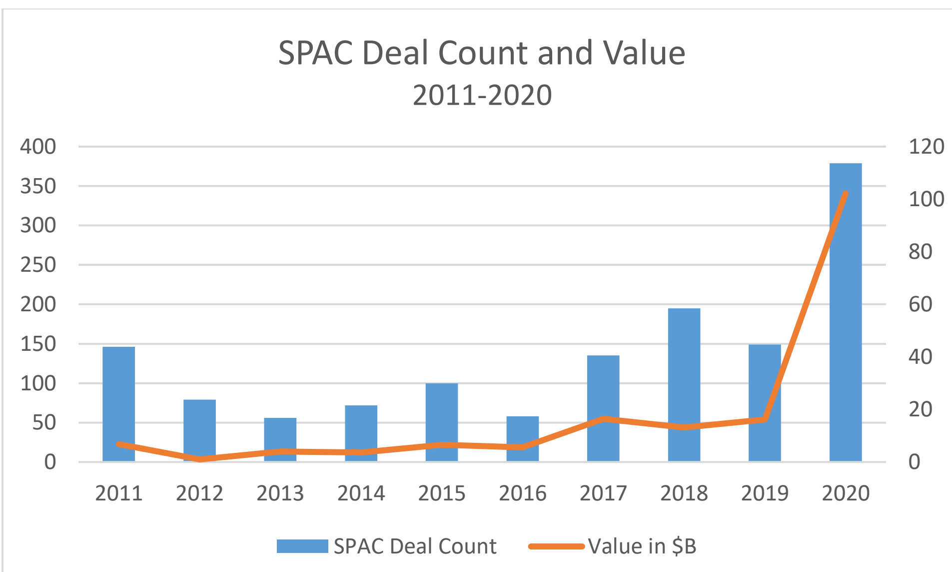
SPAC-Mania is Here! Are There Implications for the Broader Markets?

A Special Purpose Acquisition Company, or SPAC, is a blank-check company that an investor group sells to the public via an IPO. SPACS are not a new financial concept - they have been around for decades. Frankly, they have never had the best reputation. SPACs have typically been associated with spotty management teams and companies with murky futures. There were exceptions of course, but until lately it was a quiet, speculative corner in finance.

But something happened in 2020 as SPAC formation exploded. It seems everyone from hedge fund managers to celebrities now wants to be associated with a SPAC. Bill Ackman, baseball manager Billy Beane, and former White House advisor Gary Cohn each have a SPAC. So does the former CEO of Dick Clark Productions and Apollo Management. In fact, in 2020 these companies raised more equity than over the entire preceding decade. Half of all equity issuance in 2020 was SPAC-related.



Source: Bloomberg

The pitch for a SPAC is relatively simple: the management team announces that they are forming a SPAC that will invest in an industry or type of company. <u>This is akin to a bet on a professional athlete before the start of the season.</u> Typically, today's SPACs focus on high-growth segments of the economy, i.e. fintech or clean energy. Think about it like venture capital for the retail investor.

Once public, the SPAC holds the funds raised in a trust. The market caps of SPACs are small by institutional standards, in the range of $200-400 million. Bill Ackman's Tontine Holdings raised $4 billion. After the IPO, the management team has two years to identify a target private company and take it public via a merger. The target company skips the laborious process of going public on its own terms and enjoys a shortened timeline to this liquidity event. The typical timeline for mergers to finalize is three to four months. The SPAC management team invests some of its own capital in the SPAC and takes an additional 20% interest in the SPAC at a nominal price. The issued units typically contain one share and an additional security - a "right" and/or warrant which will trade on its own. If SPAC holders don't like the proposed targeted takeover, they can put the shares back to the company for $10 plus interest and keep the rights/warrants for free. There are arbitrage strategies involving the value of the underlying target company, the warrants, and the share price.

How important is this trend?

Frankly, we are not sure that this is an important financial development. It could be just another unique phenomenon during a 2020 that was full of them. But the pace of SPACs filing for IPOs has not let up during the first few weeks of 2021. The trend is charging ahead. *We believe we are seeing a perfect storm of near-zero cost of capital combined with insatiable demand for speculative vehicles.*

We note that the increasing popularity of SPACs coincided with newly minted retail traders piling their stimulus checks into the market during the 2020 lockdowns. According to JMP Securities, 10 million new brokerage accounts were opened last year. Robinhood, the brokerage aligning itself with younger traders, saw 500,000 downloads of its app last year. (For reference, Schwab had about 29 million accounts at the end of 2020.)

When we market geeks wake up in the morning, we turn on CNBC or Bloomberg to hear sober news about policy, economic or corporate events. But there is another public market discussion going on that does not focus on such mundane matters. Twitter, Reddit, and Tik-Tok investment discussions are all about speculation, not the path of interest rates. The posts are almost all the same: How I turned $5k into $15k; follow my advice to generate your own huge returns.

When investors see price charts like DraftKings, the online betting platform that merged with a SPAC, they say, "I want in!"

Source: Bloomberg

It was somewhat predictable to see the grey-haired pundits on financial TV warn these newer traders about speculative investments. (These pundits may not realize that the median age for cable news viewers is 65-years old.) But that advice is clearly falling on deaf ears for now. As Chuck Prince is often quoted as saying, "As long as the music is playing, you've got to get up and dance." Most people like dancing.

There are plenty of criticisms of SPACs out there. White papers discuss their historic lackluster performance. Dilution is often cited as a big issue for investors in the merger timeline. But SPACS give investors an option to own growth-oriented companies that otherwise would have been unavailable for the retail investor because they remained private. Some people made a lot of money buying and holding DraftKings at $10/share.

Perhaps SPACs will be viewed differently with different management teams entering the space. Historically the focus of SPACs was on value; now they are much more focused on growth. In this dynamic economy, it's hard to argue that being exposed to some growth companies is a bad thing. And maybe younger investors that lose money trading will be motivated to study more about disciplined investing.

SPACs could also be a nascent sign of growing speculative behavior that may be amplified in a post-COVID world. If a Roaring 20s redux is about to sweep markets and the economy, then we cannot ignore SPACs. Credit investors are generally allergic to excessive speculation; broader financial euphoria often comes at their expense. Management teams of bigger firms could start making aggressive forecasts to keep up with new market trends and fund growth via increasing leverage. *This idea keeps credit investors up at night.* While this phenomenon has yet to impact the credit market, it should be monitored.

Some decades are associated with popular financial products. The 1980s had high yield bonds. The last ten years brought us ETFs for every industry and popular investment theme. Will the 20s be the decade of the SPAC? It is too soon to tell, but we think this trend is here to stay for a while.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help your fixed income allocation, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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