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An Overview of the SPAC Market: Problems, Solutions, and Prospects

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ABSTRACT

This paper aims to present the current problems, solutions, and prospects of SPACs in the United States. First, the report introduces how SPACs function and merge with private companies. Then, it examines the advantages and disadvantages of the SPAC process, especially when contrasted with traditional IPOs. Finally, moving to more current events, it establishes the decline of SPACs in the past year before concluding with the new rules proposed by the SEC. We will also predict the future of SPACs and how the SEC's reforms will impact the market. The paper provides a bird's-eye view of the current status of SPACs in the United States, serving as a foundation for any expectations regarding SPACs.

Introduction

Special Purpose Acquisition Companies, or SPACs, first emerged in the 1990s. Existing in various forms for decades, these blank check companies offered an alternative to the traditional initial public offering, or IPO, system. However, it was not until three years ago that the market took off in the U.S., and SPACs have grown exponentially since then. In 2020, roughly 60% of all IPOs were conducted through SPACs. By 2021, SPAC IPOs accounted for more than half of newly publicly listed U.S. companies (Klausner et al., 2022).

Nevertheless, despite the success, SPACs soon faced a string of scandals, poor performance, and heightened scrutiny, causing the bubble to bust (Asgari, 2022). In this paper, we will assess SPACs from an outside perspective. We will analyze the growing problems in the SPAC market, judge the proposed solutions, and evaluate the views of different SPAC participants. From this, we will better predict SPACs' prospects and what will come in the future.

SPAC Basics

SPACs mainly function to merge with a private company and enable it to go public. With a two-year lifespan, these publicly traded corporations raise funds through IPOs to acquire these private companies. This process is initiated by a sponsor, who is often associated with an enterprise focused on forming and managing SPACs. Although, sponsors may also be individuals or a group of individuals. The sponsor invests risk capital, such as nonrefundable payments, to cover operating costs (Bazerman & Patel, 2021). Then, once the money is raised, a SPAC must enter a combination with a target company.

Target companies are mostly start-up firms interested in pursuing an IPO, selling the business, or raising capital. These private companies view SPACs as an attractive alternative for their goals, as SPACs offer various advantages over other forms of funding and liquidity. Furthermore, SPACs are customizable and address multiple combination types.

SPACs must not have pre-identified target companies. However, both retail and institutional investors can buy shares before the target is determined. Once a SPAC enters a business combination transaction, public shareholders will vote on whether to approve the merger. Original investors have the right to redeem their shares with interest rather than participate in the merger (Cohen & Qadan, 2021). If IPO investors redeem their shares, they will face little to no risks in evaluating an investment in a private company. However, if the investors decide to see through the business combination, they will face substantial risks. The SPAC will then announce a business combination when an agreement is reached.

On the other hand, if a SPAC fails to merge with a private company, it will be liquidated and return all of its funds to shareholders with interest. A study showed that the average redemption rate per deal was 58%, with a median redemption rate of 73%. Additionally, over 90% of investors pulled out a third of the SPACs (Bazerman & Patel, 2021). Due to this, sponsors try to provide more certainty to public shareholders by encouraging Private Investment in Public Equity, or PIPE, investments. Securing PIPEs will also decrease the likelihood of SPAC investors redeeming their shares.

SPACs have gone mainstream after the market boom in the past years. As a result, both the quality of their targets and investment performance has improved. Still, the SPAC process is complex with tight timelines. In fact, research suggests that SPAC mergers typically take at least six months (from announcement to closing) to complete (Ritter et al., 2022).

Pros and Cons

Pros

An alternative to the IPO process, SPACs offer certain advantages to private companies. These advantages, based on the structure of SPACs, include better sponsor support, faster execution, revenue forecasts, greater certainty and transparency, and more contracting flexibility among different stakeholders. This section will further outline and explore these five main advantages.

First, since SPAC sponsors are typically financial and industrial professionals, they can provide advice and certification, bringing valuable business insights to private companies. Additionally, SPAC sponsors, experts in the field, can access a network of contacts to offer operational expertise or assemble a team. The expertise of the sponsors, paired with their focus on private companies, yields considerable profits for investors (Collins, 2012).

Second, compared to a traditional IPO, it takes operating companies less time to negotiate a SPAC merger and win approval. This advantage is because specialized sponsors can make negotiations and the merger process much faster. Furthermore, traditional IPOs or direct listings require audited financial statements, while SPACs do not (Ritter et al., 2022). Evidence suggests it may even take an IPO six times the amount of time a SPAC merger takes (Lambert, 2021).

Third, private companies seeking to go public can make revenue or earning forecasts necessary with merger announcements where stakeholders must approve the combination. These projections are also shielded from lawsuits due to a provision in U.S. laws for mergers. Thus, private companies can engage in regulatory arbitrage to maximize their pre-money valuations (Ritter et al., 2022). Although this is disadvantageous for investors, sponsors and targets can benefit greatly.

Fourth, SPAC mergers may allow for more certainty and transparency than an IPO. For example, due to negotiating the offer price and proceeds after observing investor interest, traditional IPO terms are uncertain until the very last day (Bazerman & Patel, 2021). On the other hand, SPAC merger terms are negotiated before market conditions are known, as a pre-money value of the operating company is necessary.

Fifth, contingent features, such as earnout provisions, provide more contracting flexibility to different SPAC stakeholders. This flexibility is because contingent features, like with other merger agreements, can be

negotiated. Research has even shown that sponsor shares are often subject to lock-up and vesting provisions. In fact, 31% of completed 2015 SPAC mergers have vesting provisions for sponsor promotions (Ritter et al., 2022).

SPACs may be a net positive for capital markets, as they offer investors and targets a new set of financing opportunities. Through this process, companies can raise more funds, fueling innovation and growth in various industries. Also, successful SPACs create value for all stakeholders, as sponsors have profit opportunities, investors receive risk-adjusted returns, and targets raise capital. Due to all these factors, established venture firms and senior operating executives have both been drawn to SPACs.

Cons

On the other hand, the SPAC process comes with its own set of issues that have become increasingly concerning in recent years. These problems, also rooted in the SPAC structure, include high costs, conflicts of interest, and poor performance. In this section, we will outline and closely examine these three problems.

First, compared to traditional IPOs, SPACs are much more expensive for target companies. Research comparing the two costs shows that from January 2019 to June 2020, the median SPAC cost (as a percent of cash delivered) was twice as high as the median IPO cost. Furthermore, at the 25th and 75th percentiles, this discrepancy was even more extreme, with SPAC costs over four times as large as IPO costs (Klausner et al., 2022). However, this comparison may not be completely accurate, as the two costs are inherently different and have recalculations. Nevertheless, there is evidence that SPAC costs are much higher than previously believed.

Second, there are several misaligned incentives between SPAC sponsors and public investors. The root of this issue lies in the sponsor's promote shares, possible dilution brought about by warrants, and overpaying target companies. Furthermore, research suggests that nonredeeming SPAC shareholders bear most of the costs embedded in SPACs due to poor disclosure practices. Since the SPAC structure entails subtle costs, returns to sponsors are much higher than the returns to investors. Overall this conflict of interest means SPAC shareholders experience steep post-merger losses while SPAC sponsors profit (Klausner et al., 2022).

Third, SPACs are not sustainable and often perform poorly after merging. This problem is rooted mainly in the lack of emphasis on quality. SPACs are required to identify target companies within 24 months after they have raised their funds. If they fail to, the IPO proceeds return to investors. Thus, SPACs are encouraged to get any deal done rather than a good one (Sorkin et al., 2021). One example is Nikola, an electric car startup accused of fraud by short sellers three months after going public with a SPAC merger. In the end, Nikola's founder resigned as its stock prices fell to a fraction of their peak (Naumovska, 2021). This trend is not uncommon, as a recent study found that most SPACs' post-merger share prices fall.

While the SPAC process has numerous advantages, it is also essential to consider any associated issues. Especially in recent years, with the SPAC market boom causing more and more people to participate in the process, there are reasons to be wary. In fact, as time continued, these problems have even drawn the attention of the U.S. federal government.

The SPAC Downfall

In the past year, after SPACs soared in popularity at the pandemic's peak, the SPAC boom has gradually declined due to scandals, poorly performing deals, and heightened regulatory scrutiny of the market. Then, paired with global market volatility caused by rising interest rates and the war in Ukraine, more and more investors have turned away from SPAC mergers. A study even shows that in the early months of 2022, there were more

SPAC listings withdrawn than there were new listings (Asgari, 2022). Finally, when the PIPE financial market also dried up and the SEC proposed to strip SPACs of legal safeguards, the SPAC market sharply fell out of favor.

However, further research suggests an institutionally and sociologically informed explanation for the SPAC downfall. It is supported that not only do cognitive biases drive market bubbles, but so do institutionally driven dynamics (Turco & Zuckerman, 2014). In one study, it was found that the more popular a practice became, the more skeptical investors and the media were. When the skepticism and negative reactions intensified, an adverse market reaction was triggered, causing the specific practice to decline (Naumovska, 2021). In essence, negative media coverage weighed on stock market valuations, which may be the case with SPACs. Thus, SPACs rise in popularity led to its own demise.

Proposed Solutions

In March of 2022, the U.S. Securities and Exchange Commission, or SEC, outlined reforms for SPACs. These reforms included: enhancing investor protection, amending the Securities Act of 1933, guiding projection usage, and assessing SPACs under the Investment Company Act of 1940. Additionally, the proposal will primarily seek to inform SPAC investors better and amend existing rules (Crenshaw, 2022).

First, the SEC requires enhanced disclosure and additional investor protections in IPOs by SPACs and in de-SPAC transactions. These changes target SPAC sponsors, conflicts of interest, and dilution while supporting SPAC investors. In particular, the reform requires private operating companies to be a co-registrant when filing a registration statement (on Form S-4 or Form F-4) for de-SPAC transactions. Furthermore, there will be a re-determination of a reporting company's status within four days after a de-SPAC transaction, and underwriters in a SPAC's IPO must be underwriters in a subsequent de-SPAC transaction. The SEC will also amend the definition of "blank check company" to make the liability safe harbor in the Private Securities Litigation Reform Act of 1995 unavailable to SPACs.

Second, the proposed rules focus on business combination transactions involving all shell companies, not only SPACs. The SEC deems that for purposes of the Securities Act, business combinations involving a shell company and a non-shell company constitute a sale of securities to the shell company's shareholders. Also, the SEC seeks to align the financial statements of private operating companies in shell company transactions with those required in registration statements for IPOs.

Third, the reforms include a proposed amendment to Item 10(b) of Regulation S-K, which would expand and update the SEC's guidance on projections of future economic performance. This change would allow investors to better judge the reliability of the projections and whether they are reasonable. Furthermore, the SEC proposed additional disclosure requirements to help investors assess the basis of projections in SPAC business combination transactions.

Fourth, the SEC addresses the status of SPACs as "investment companies" under the Investment Company Act. If a SPAC fully complies with certain conditions, it would not need to register as an investment company. The conditions state that a SPAC must: maintain assets comprising only cash items, government securities, and money market funds, engage in the target company's business after a de-SPAC transaction, and reach an agreement with a target company to engage in a de-SPAC transaction within 18 months of its IPO. These proposed conditions intend to distinguish SPACs from investment companies.

As the situation surrounding SPACs continues to change, it is difficult to predict how these reforms will impact the market. However, since SPACs were designed to avoid the SEC's regulation, it is inferred that the purpose of SPACs would be mostly negated (Celarier, 2021). Nevertheless, it is hopeful that if the proposed rules and amendments are adopted, the SPAC market could function more efficiently due to improved SPAC disclosures and greater investor confidence (U.S. Securities and Exchange Commission [SEC], 2022).

Conclusion

Despite the quick rise to fame, SPACs have been on the decline in the past year. This downfall, mainly due to a volatile global market and high-interest rates, saw investors continuously turning away from SPAC mergers. Then, following the turn of events, the SEC proposed new reforms for regulating blank check companies. If adopted, these changes may both positively and negatively impact the SPAC market, causing the market's future to be ambiguous. Nevertheless, even if the future unfolds unexpectedly, this occurrence can teach a valuable lesson for market bubbles to come.

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