SPACs: Wall Street's Latest Way to Raise Money

Special Purpose Acquisition Companies, or SPACs, are rapidly displacing traditional IPOs as Wall Street's preferred method of funding a budding enterprise. But like IPOs, SPACs can entail high risk, and prospective investors should use caution.

SPACs accounted for over 50% of new publicly listed U.S. companies in 2020.

Among the many acronyms bandied about by brokers, investment bankers, and the financial press, "SPACs" has gained particular traction of late. It stands for special purpose acquisition companies -- entities used to raise funds.

SPACs are not new. They first appeared in the 1990s, but were very limited in use until about a year ago when a proliferation of start-ups gave rise to major players launching SPACs in significant numbers. In fact, SPACs accounted for $80 billion in new investments and more than 50% of new publicly listed U.S. companies in 2020 alone.[1]

What exactly is a SPAC?

A SPAC is a public shell company that acquires a private company and takes it public. Also called "blank check" companies, SPACs go public before their acquisition target is identified. Sometimes the sponsor of the SPAC will specify a target industry, while in other cases, it has free rein to choose a candidate.

SPAC sponsors come from diverse backgrounds ranging from hedge funds and private equity firms, to former CEOs and entrepreneurs, to entertainers and other celebrities.

In a typical SPAC transaction, investors pay $10 a unit, which consists of a share in the SPAC and a warrant, which represents the right to buy shares at a specific price on a specific date. Investors have the right to redeem the share, while keeping the warrant, if the deal seems unfavorable. Investors also get their money back after two years if the sponsor hasn't completed an acquisition.

SPACs Versus Traditional IPOs
A thumbnail glance of how SPACs compare with traditional IPOs

	SPACs	Traditional IPOs
What you invest in	Shell company that will invest in an unnamed target company	Existing private company with a track record
How it's marketed and sold	Through sponsor companies, typically industry executives or M&A companies	Through large syndications and road shows
Offering process	Simpler, shorter process	Longer, highly regulated process
Information availability	None on target company at time of offering	Management, background, and financial records of company
Shares	Refundable units and warrants that can be converted to stock	Shares of the company's stock

Much of the appeal of a SPAC is the ability of investors to get in on the ground floor of an investment. SPACs are more accessible to retail investors than traditional initial public offerings (IPOs), shares of which are often pre-subscribed by large broker-dealers and made available only to favored clients.

Success Rate

Similar to a conventional IPO, the ultimate success of a SPAC offering depends on the success of the company it invests in. And like other IPOs, the success rate with SPACs is spotty. Some have done well, others have not. One study of deals from 2016 through 2020 found that 65% of SPAC stocks had declined a month after their merger closing, and 71% were down a year later.[2]

Other studies have found more positive results. But the one thing they all seem to agree on is that the biggest upside is for those who invest before the shell company completes its acquisition. Once the acquisition is done, the stock trades on the company's fundamentals and performance, which may not live up to the pre-merger hype and expectations.

Risky Business

When they call SPACs "blank check" investing, it's for a reason. Investors don't know what company is being targeted, what it does, its history, management, or even its business model. What you are essentially investing in is the knowledge and experience of the sponsor -- its ability to identify a candidate with high potential for success. So prospective investors will want to research the sponsor and its success rate in launching previous SPACs. They'll also want to identify the downside: What is the worst-case scenario if the target company fails?

Here are other risks that FINRA advises prospective SPAC investors to consider.

- **Limited information.** Because the target company is unknown at the time of the SPAC offering, there is no information on it in the offering memorandum. With a traditional IPO, the company seeking to go public must provide a wealth of disclosures and go through a lengthy due diligence process prior to launch.
- **Speculative investments.** SPAC investors may encounter a "hype-based" business model that focuses on investors' hopes for outsized gains without sufficient attention paid to potential long-term risks. The speed of the SPAC process may attract "hot" sectors or business models that may be only short-term fads instead of viable long-term businesses.
- **Fees and sponsor incentives.** SPACs can entail more fees than traditional IPOs, with an estimated one-third of funds raised from IPO investors removed on average from the trust account in fees and compensation by the time the merger takes place.
- **Conflicts of interest and fraud.** SPAC investors should be aware of the potential for conflicts of interest between SPAC sponsors and SPAC shareholders since sponsors may profit when an acquisition is completed even if the acquisition proves unsuccessful for the investors. SPAC sponsors may possess material, non-public information regarding potential SPAC acquisition targets and trade around that knowledge.
- **Trading price.** SPACs are typically priced at $10 per unit during the IPO, but when these units begin trading their market prices may fluctuate -- sometimes significantly -- even before a merger target is identified.

Whether you are new to investing or an experienced trader, make sure you thoroughly research any prospective SPAC you may be considering, and talk to a financial professional, who may be more familiar with these specialized investment vehicles.

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[1]Harvard Business Review, *SPACs: What You Need to Know*, July 2021.

[2]Barrons, *Stocks of Companies That Emerge From SPACs Don't Do Well. It's a Reminder to Not Buy the Hype*, February 5, 2021, based on a study by The Edge Consulting Group.

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