Justified excitement about SPACs?

Notes from
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Dear investors, dear friends of FPM AG,

Since at least 2003, there have been initiatives in SPACs. The abbreviation stands for "Special Purpose Acquisition Company" and is a special type of shell company. A SPAC is a company listed on the stock exchange with no operational activity. Its sole purpose is to raise capital in order to later merge with a private company and take it public that way. At the time of the SPAC issue, the initiators may not yet have a concrete target investment in mind. For a potential stock exchange candidate, this is cheaper and faster than an own share issue (IPO, Initial Public Offering). The implementation of a merger is only possible in certain time windows after the financial reporting, and the investment advisors and lawyers involved incur high costs. Companies that go public via SPAC estimate the time savings at about one third and the cost savings at 20 % to 50 % compared to a traditional IPO. These savings are the result of reduced requirements that the stock exchanges have introduced for IPOs, also to protect investors.

Over the past twelve months, securities markets, particularly in the US, have seen an unprecedented rise in the use and popularity of SPACs.
A brief overview can be found here: https://www.spacanalytics.com/

Shareholder protectors, business journalists, legal and banking experts and even SPAC enthusiasts themselves are all raising the alarm about this increase. For the past two months, securities regulators have also been increasingly voicing their opinions. Concerns include the risks of fees, conflicts and sponsor compensation, celebrity sponsorship and the potential involvement of retail investors lured by unfounded hype, as well as the sheer amount of capital flowing into SPACs, each designed to chase a private target to take it public. With the unprecedented rise has also come unprecedented scrutiny, and new problems with standard and innovative SPAC structures continue to emerge.

Like many financial innovations before them, SPACs were invented to circumvent regulation.

In order to combat fraud and the manipulations that were rampant among small blank check companies in the previous decade, the SEC introduced the so-called Rule 419 in 1993, which prohibits trading in the shares of such companies until a

merger is completed. Knowing that such a restriction would discourage investors from investing in these IPOs, they created a new structure to get around the rule: the Special-Purpose Acquisition Company (SPAC).

The SPAC structure allowed trading, but also contained many provisions similar to the new SEC mandate - such as the ability for investors to exit the merged company and get their money back once the merger is completed on the stock exchange. However, I am not aware of any regulatory provisions that specifically affect SPACs. Each prospectus explicitly states that Rule 419 does not apply.

What you should know about SPACs

Phase before or until possible merger

As a rule, SPACs must find their target investment within 24 months and thus merge. If there are many (too many) SPACs on the market without a target investment, this leads to different outcomes, especially if time is running out. The volume risk relative to potential target companies increases with each new SPAC. A time-shortening effect for the respective SPAC is that the investors must approve a merger with the target company within the 24 months by way of a shareholders' meeting. In the event that the investors do not agree to the merger or a merger does not take place for other reasons, they receive their money back, but only in the amount of the initial deposit minus ongoing costs. This sounds fair to the first investors (essentially the sponsors), but these sponsors already make a limited financial commitment pre-IPO and also initiate all other necessary requirements for an initial public offering (IPO). In the second step, when leaping onto the stock market - typically at a share price of 10 USD - the SPAC then raises further capital that can later be used to acquire a suitable company. As a rule, the shares are placed exclusively with institutional investors during the IPO, while private investors can only access them after the IPO and are thus at the end of the "food chain". Driven by speculation, many SPACs are already trading significantly higher at this point. Thus, most investors acquire SPAC shares at a premium. In a merger with unattractive terms, they face a personal choice. Approval of an unattractive merger condition at the AGM could occur if the current investors' buy-in conditions are far above the SPAC issue prices and they would realise a larger loss by rejecting it. Due to the time pressure and possible own economic loss, there is a risk that less favourable merger conditions will be accepted.

The number of potential targets for SPACs has not and will not increase in the market. Assuming that this inventory is limited, one should expect two things. First, SPACs might pay too high a price for the targets, which would lead to the investment ultimately performing poorly for the remaining investors. Or some SPACs, in their desperation, might accidentally buy bad or fraudulent companies.

For example, VectoIQ, the SPAC that merged with Nikola, ran out of time to find a partner before it would have had to return investors' capital. The company announced the merger agreement with Nikola on 3 March 2020, just over two months before the two-year deadline of 16 May 2020. To get the SPAC off the ground, VectoIQ had also offered investors a warrant for each share - a much richer deal than usual. Nikola was the company that released a video titled "Nikola One in Motion", which made it appear that the Nikola One semi-truck was travelling at high speed under its own power. The video was edited to make it look as if the semi was driving on a flat road or even uphill.

The early initiators (in some cases celebrities) and the banks involved in a SPAC incur no or only a small loss. According to "Refinitiv" (current FT article dated 9 April 2021), only 25 % of SPACs listed since 2019 have closed deals with target companies.

Investors who invest in such blank cheque companies invest in the competence and skill of the initiator, who must accordingly have a certain degree of name recognition. If initiators lack name recognition, they like to fall back on other prominent persons (e.g. football players, actors). A few days ago, the SEC published an explicit warning against subscribing to SPAC shares only on the basis of a recommendation from prominent promoters.

Merger phase

It is obvious that the safeguards of regulation of IPOs are being circumvented. This can be seen as positive and negative. The cost and time savings mentioned above seem beneficial. What disclosures do investors need to make sound investment and selection decisions? Do certain disclosures, procedures and liability rules reduce the overall cost of capital? Information should be cost-effective and reliable, not misleading, in any securities transaction. Investors should have access to this information and then be able to make their own decisions about how to invest or vote. Unlike IPOs, target companies often provide forecasts for the future. Forward-looking information, such as that given here, can obviously be valuable. Modern financial and valuation techniques focus on risks and expected future cash flows. Investors and owners typically view forward-looking information as decision-useful and relevant. This is true for companies that are acquired as well as for companies that go public. However, forward-looking information can also be unaudited, speculative, misleading or even fraudulent, which is reflected in the limitations of liability protection. In particular, the presentation of future very high profits creates incentives without being liable for them (as in an IPO). This clear exclusion of "initial public offerings" rules and thus the reduction of liability risks reflects the higher risk of investors compared to IPOs.

As an example of misleading or even fraudulent information, one may like to look at the Nikola case just mentioned or more recently "Lordstown".

Very good research is available, among others, from Hindenburg-Research https://hindenburgresearch.com/lordstown/

According to a study by Stanford University professor Michael Klausner, sponsors averaged a 500 percent return on investment between January 2019 and June 2020. Institutional early entrants also did well, according to the study, but most investors in shares of companies that went public via SPAC mergers suffered losses. On average, they lost 12 per cent of their value in the first six months, even though the stock market as a whole rose strongly, according to the analysis. According to Stanford University, eight lawsuits have been filed in connection with SPAC deals since the beginning of the year. Among other things, the plaintiffs accuse the SPACs, their banks and their sponsors, who reap lavish fees in successful mergers, of concealing weaknesses in the takeover targets.

Differences in countries and regulators

BaFin issued a general warning about SPACs on 24 February 2021, but no restrictions or barriers to acquisition were introduced for retail clients.

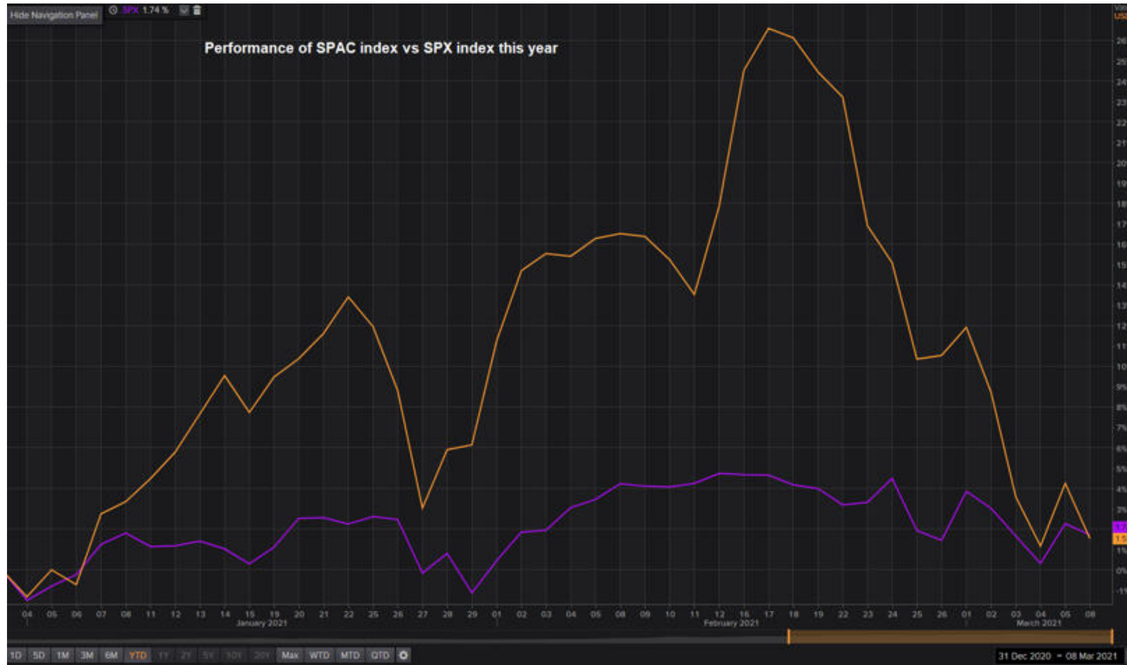
In Germany, the investor Klaus Hommels (from Zurich) has just launched a first SPAC (Lakestar) on the stock exchange. The SPAC was nine times oversubscribed and raised 275 million euros. In Europe, Amsterdam in particular seems to be establishing itself as a SPAC hub.

The US supervisory authority has sent out three warnings in the last five weeks; in addition to the one mentioned regarding celebrities, the supervisory authority is reviewing the accounting of the option rights that are granted along with the issue. If these have to be accounted for directly as expenses, the vehicle would become less attractive in the future.

In contrast, a SPAC revolution is soon to trigger Big Bang 2.0 for the City of London. Britain is on the brink of a second post-Brexit big bang for the City. A landmark government report is calling on regulators to allow SPACs to list in London and to relax a number of restrictions on share listings. Lord Jonathan Hill's report on the future regulation of financial services, published on 3 March 2021, calls for a series of deregulatory measures to ensure the UK remains one of the most attractive places for successful innovative companies to grow and list. The report, which is said to have been warmly received by Finance Minister Rishi Sunak and Prime Minister Boris Johnson, proposes opening up London to SPACs. Hill also called for a series of deregulatory measures that would make London a more enticing destination for companies to go public, including more power for start-up founders after listing on the London Stock Exchange. Amsterdam had overtaken London as Europe's largest stock trading venue in January, weeks after the end of the Brexit transition period, increasing pressure on Sunak to improve the City's competitiveness. Sunak told City

A.M. newspaper in January that the City could experience a post-Brexit Big Bang 2.0 - alluding to the period of deregulation of financial services in London in the 1980s - after it was freed from EU laws. The FCA will consult on its proposals shortly.

There are also current political efforts in Hong Kong to allow SPACs.



Source: Bloomberg

More and more market participants are concerned about the high valuations. The IPOX SPAC Index, which tracks the performance of listed SPACs, fell by over 12.5 % last month, compared to a 2.4 % decline in the broader index.

Deutsche Bank AG, which was one of the major winners in this SPAC development last year, expresses through its manager Eric Hackel via several media outlets that it is unconcerned despite the large volume in SPAC.

My conclusion

I believe that we as market participants cannot be "unconcerned" and the current publications also show that many are not unconcerned. Sometimes I rub my eyes in amazement at how long people stand by while rules are clearly circumvented, no limits are set and the products have a broad positive reputation, especially in the media.

The products are not bad in themselves, if the producers did not circumvent numerous protective rules with them. But the volume of empty shells that has increased so rapidly, relative to potential target companies, will lead to serious undesirable developments, in my view. The lack of illiquid target companies alone will probably lead to many redemptions of SPACs with losses for stock market

investors. Fraudulent investments will increasingly come to light, damaging the equity culture. Mergers will be concluded on poor terms just to meet existing accounting time frames and not realize premature losses.

The risk/reward profile of SPACs is clearly to the detriment of investors, especially with regard to information or pay-back in the event of a "non" merger. The winners are the sponsors and their banks.

There is too much capital in the market that is looking for new targets and thus more risk is being taken in many areas. Greed eats brain in some cases, not only with SPACs. How high must my expected return be above that of established stocks if I invest in products that can be used to circumvent existing regulations to my disadvantage?

I hope that BaFin in Germany will impose higher hurdles or even prohibitions on the acquisition of SPACs for market participants that need protection, such as private clients. The question of the extent to which stock exchanges and stock exchange regulators should insist on compliance with their rules would have to be discussed. Perhaps similar rules should apply to mergers as to IPOs. Existing IPO rules could be re-examined for improvements.

It is very astonishing that the financial market and stock exchange regulators have been watching their own rules being actively circumvented for some time now, and that important investor protection is thereby being sacrificed. The investors whose investments go wrong will claim the missing protection from them, the securities regulators. On the other hand, investors are responsible for their investments and how they work. It cannot remain hidden from any investor that they are taking increased risks with SPACs. In terms of expected returns, investors should look at returns of current, ongoing SPACs and not be guided by the historical returns of the sponsors.

Investments in FPM Funds

At FPM, we have been investing in equities for over 20 years and consider most stock exchange/IPO rules to be sensible.

At FPM, you also invest in the expertise of our fund managers and our valuation models. But our fund managers Raik Hoffmann and Martin Wirth do not invest under time pressure.

Since we are invested in our funds to a large extent with our own equity and personally, we also have the right risk/reward ratio with our investors.

We also invest in companies, but on the basis of fundamental valuation, including direct discussions with management. In the last 12 months, we have investigated

many new business ideas, especially in the field of technological CO2 reduction, as target investments, for example for the FPM Funds Ladon. There are also a high number of IPOs here, i.e. companies that have not shied away from the high hurdles of regulation and have very attractive business models. We have not invested in SPACs and "nevertheless" our investment decisions have performed very well for investors.

I promise you that each and every one of us will help to make the FPM Funds very successful again this year.

Your Thomas Seppi