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The Rise and Fall of SPACs

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One of the most significant recent developments in capital markets is the boom and subsequent bust of Special Purpose Acquisition Companies, or SPACs, which garnered a great deal of attention over the last two years as an alternative to traditional initial public offerings (IPOs). Driven in part by the reemergence of retail trading and cheap capital due to COVID-19, hundreds of companies utilized this pathway to public markets and speculative excess took hold. While we have come to expect investment bubbles from time to time, the recent SPAC boom stands out as a unique moment in time.

A Quick Path to IPO...a Bubble Forms

A SPAC, also known as a blank check company, is a publicly traded corporation that typically has a 24-month lifespan and is formed with the mandate to merge with a privately held business, allowing it to go public. They primarily raise money from public equity investors and have the potential to reduce risk and shorten the IPO process for target companies, often offering them better terms than a traditional IPO. The entire SPAC process can take as little as three to six months and the valuation is set in the first month, whereas the IPO process can take up to a year with little certainty about the ultimate valuation or proceeds raised.

SPAC valuations tend to be higher as they are negotiated and do not cede to an underwriter who solicits investors, often by allocating shares priced below market. This avoids the IPO pop whereby companies leave money on the table by raising too little capital at too low of a price. Additionally, SPAC marketing costs are lower than IPO costs and there are fewer regulatory demands as due diligence is narrower in scope and does not involve an underwriter comfort letter. Perhaps the most attractive aspect of SPACs was their protection under the safe harbor provision of the Private Securities Litigation Reform Act of 1995, which restricts investors' ability to sue over financial projections, whereas traditional IPOs do not have safe-harbor protection and thus do not include forward-looking financial projections in prospectuses.

While the concept has been around for decades, we've recently witnessed an explosion in companies entering public markets via SPACs — in 2019, 59 were created and by 2021 613 were created with roughly $163 billion invested. Given that it's a quick way to enter the public markets and include promises and projections about the future, it's not surprising that the SPAC model especially appealed to venture capitalists looking for exits. During the run-up in SPAC activity, investor enthusiasm soared as financiers, hedge funds, politicians and celebrities got involved in deals, and many deals coming to market were speculative, promising disruption in technology, consumer, industrial or biotech markets. Numerous SPAC targets were start-up companies exiting the venture capital world where overly rosy projections and nebulous operating metrics are the norm, and it was not uncommon to see multibillion-dollar valuations awarded to companies that promised to create entirely new industries, or ecosystems, in relatively short order. As speculation took hold, fundamental financial analysis and traditional valuation metrics were largely ignored as investors focused on hype and quick riches.

The Valuation Folly

One valuation hallmark of SPAC deals was the price-to-sales ratio, which values a company based on expected future revenue, not operating profits or cash flows. Often, revenue expectations were wildly divorced from reason. The following quote from Sun Microsystems co-founder and CEO Scott McNealy discussing technology company valuations during the late-90's bubble stands out as a satirical reminder of such a valuation folly.

"At 10x revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"

What stands out most from the quote is the concept of treating an investment in a company as an ownership stake in a business and employing reason in comparing business fundamentals with valuation expectations.

Bubble Bursts, Regulators Take Notice

By late 2021 and into 2022, market conditions changed dramatically as SPAC hype died down and investors grappled with new post-pandemic realities. Many SPAC darlings experienced massive drawdowns after publishing earnings reports that pulled the rug out from under their aggressive marketing projections. As of May 2022, an index exchange-traded fund tracking companies that have merged with SPACs was down nearly 50% year to date and more than 60% since May 2021. Many high-profile SPACs had drawdowns of 75% or more from their highs.

During the carnage, the SEC proposed a rule that would add a greater level of scrutiny and investor protection to SPACs. One of the strongest conditions of the new SPAC rules would not only end safe-harbor provision for SPACs, but it would also make various players — companies, sponsors, underwriters, advisers — liable for false claims just as they are for IPOs. As a result, some of the large investment banks indicated that they would exit the SPAC market completely or significantly limit their involvement, leaving over 250 raised SPACs left scrambling to find deals before their 24-month merger window closes.

Conclusion

Despite the recent boom and bust, we think SPACs are likely to be a net long-term positive for publicly traded investment banks, brokers and exchanges, albeit with more regulatory oversight. SPAC deals also deepen markets through the increase in publicly traded companies, which creates more opportunity for capital formation and investor participation. For investors, the recent boom is a reminder of the importance of distinguishing between fundamental business drivers and valuation expectations. Adhering to an investment philosophy that prioritizes patience, discipline and a long-term ownership mindset helps us stay grounded during periods of market euphoria. Often, by steering clear of particular stocks, sectors or even entire investment categories, investors can avoid permanent capital losses and maintain dry powder to search for any gems that emerge from the washout.

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