UCONN LIBRARY

University of Connecticut
OpenCommons@UConn

Honors Scholar Theses | Honors Scholar Program

Spring 4-27-2021

Exploring an Alternative to IPOs: Special-Purpose Acquisition Companies (SPACs)

Vaishali Kanamalla
vaishali.kanamalla@gmail.com

Follow this and additional works at: https://opencommons.uconn.edu/srhonors_theses

Part of the Corporate Finance Commons, and the Finance and Financial Management Commons

Recommended Citation
Kanamalla, Vaishali, "Exploring an Alternative to IPOs: Special-Purpose Acquisition Companies (SPACs)" (2021). *Honors Scholar Theses*. 801.
https://opencommons.uconn.edu/srhonors_theses/801

Exploring an Alternative to IPOs: Special-Purpose Acquisition Companies (SPACs)

Vaishali Kanamalla

Thesis Advisor: Liping Qiu

Honors Advisor: Alexander Amati

University of Connecticut

Spring 2021

Abstract

The purpose of this research paper is to provide an overview of Special Purpose Acquisition Companies (SPACs) which has gained popularity relatively recently. First, an introduction to SPACs will be provided including its historical roots, structure, and investment process. Thereafter, the paper will walk through the current landscape of SPACs, criticisms, and comparisons with traditional IPOs. The paper will conclude with discussions on the future outlook of the investment vehicle along with a study on SPAC returns vs. those of traditional IPOs.

Table of Contents

Introduction to SPACs

Historical Roots of Blank Check Companies:

Special purpose acquisition companies (SPACs) have a "sort of shady origin story" according to Usha Rodrigues, professor at the University of Georgia School of Law [1]. SPACs are direct "descendants" or the "modern form" of the blank check corporations of the 1980s which were infamously known for being corrupt [3]. The U.S. Securities and Exchange Commission (SEC) defines a blank check company as "a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person" [2]. In other words, the blank check company undergoes an initial public offering (IPO) with the goal of raising money to buy assets in the market (i.e. merging with or acquiring another company).

These blank check companies were often used as a way to defraud unsophisticated investors in the 1980s. This fraudulent activity was a result of penny stocks which were not registered nor traded on a national securities exchange. As a result, investor's expectations could be easily manipulated without the oversight of the SEC or state regulators. Penny stock fraud was contributed to by blank check companies. Moreover, one form of fraud was when penny stocks were sold as blank check companies. Brokerage firms and clients bought blank check companies and used collusion in order to manipulate prices. Inexperienced investors, however, did not know that their stock was essentially worthless as blank check companies, as discussed above, have no operating history, discernable assets, or future profitability/success. When investors tried to cash out of their investment, there was no market available to do so [3]. In this case, the blank check companies were marketed as though they were pursuing real and profitable business venture when, in reality, they are merely an investment vehicle [4].

As a result of the penny stock fraud, the SEC created new regulations which required disclosure and management requirements for blank check companies [2]. With the passage of federal legislations and this increased regulatory oversight, there was a large decline in the number of blank check offerings after the 1980s. From 1987-1990, for example, there were about 2,700 blank check companies. This number decreased to less than fifteen by the early 1990s. Although a majority (thirty-six) U.S. states prohibited or restricted blank check companies, however, they were not outlawed completely. This was the result of the former SEC Chairman, Richard Breeden, and National Association of Securities Dealers (NASD) enforcement director, John Pinto, who supported the use of blank check offerings as vehicles for “legitimate business transactions outside of the penny stock area” [3].

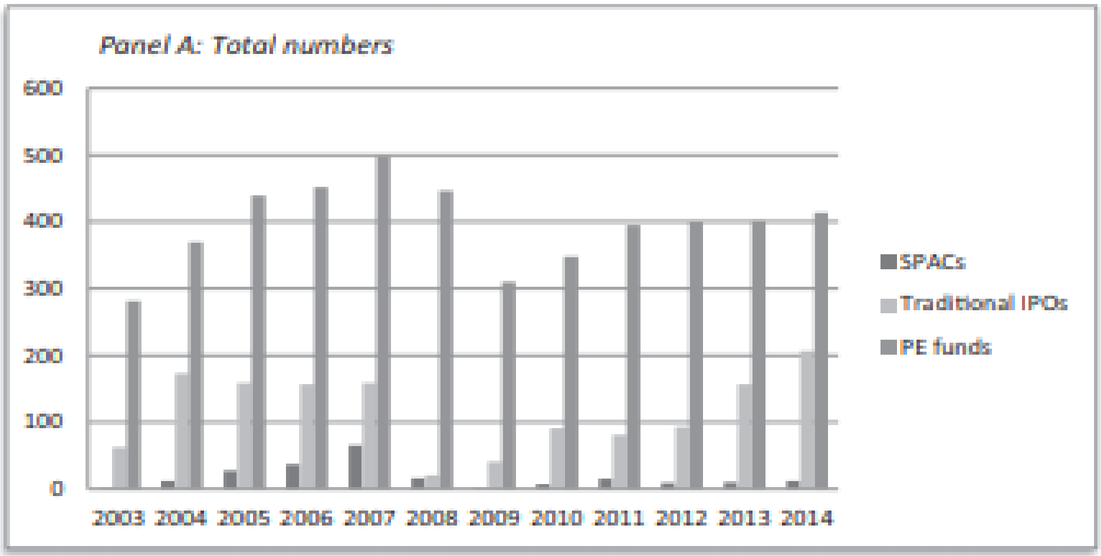
Emergence of SPACs:

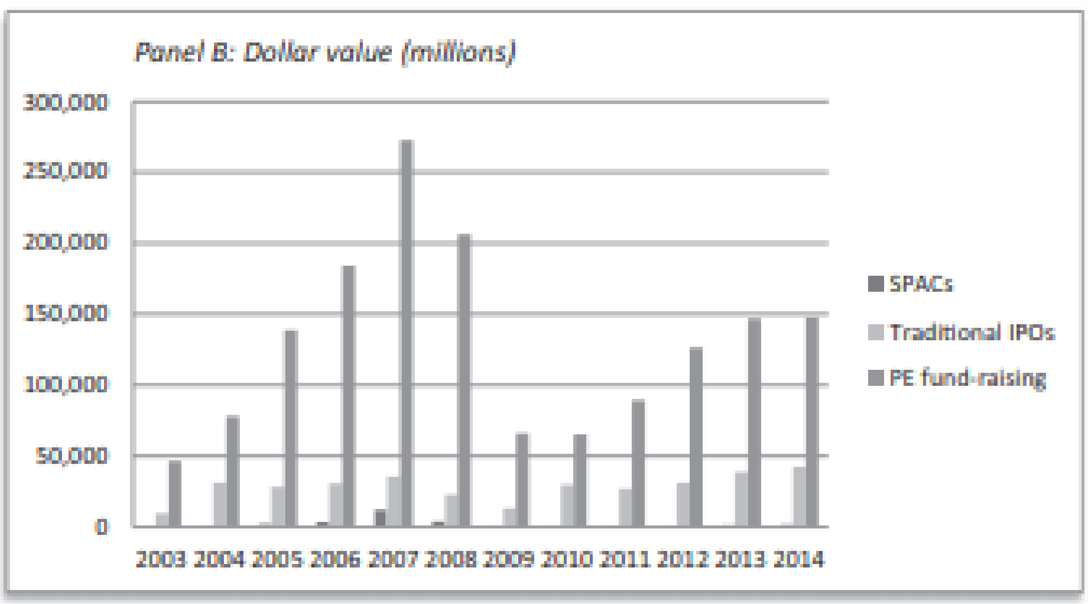
SPACs are similar to blank check companies, but with an added layer of increased protection for investors. SPACs are also shell (blank check) companies which are created to merge, acquire, or combine with an operating company. These investments have a “private equity style” which provides investors with increased liquidity, especially as they are traded on organized exchanges vs. over the counter (OTC) [5]. SPACs are involved within various transactions, but the most common is when the shell company acquires or merges with a private company. This business combination usually occurs after many months or more than a year after the SPAC goes through an IPO to become public. Therefore, once the public SPAC mergers or acquires with a private operating company, that target entity will also become public, while continuing its operating business thereafter. This type of transaction is often referred to as a “reverse merger” [6].

SPACs were officially created in 1992 by a group of lawyers and underwriters in response to the SEC Rule 419. This rule was created as a way to impose stringent controls on the proceeds of blank check offerings while providing investors with the ability to reconsider their investment after gaining detailed information on company and its acquisition target. The rule includes six different provisions which all work to deter blank check companies from being used to conduct fraud. These regulations, however, have “been so limiting that no one would bother to do a blank check offering as a legitimate way of raising funds” [3]. Thus, the SPAC was created as a way to continue blank check IPOs without being limited by the reputation of 1980s blank check offerings or the features of Rule 419. In fact, SPACs were designed as the SEC was creating Rule 419, which exempted the investment vehicle from certain limitations. Nevertheless, the SEC was pleased by the fact that SPACs increased investor protection and were not to be used to conduct fraudulent activity. The overall structure of SPACs still followed and were in-line with many of the requirements included in Rule 419 [3].

In the mid-to-late 1990s, SPACs decreased in popularity due to market conditions which made it easier for companies to raise capital through traditional IPOs [3]. However, by the early 2000s, SPACs gained more popularity. In fact, from 2003-2014, SPACs have raised over $31 billion within the U.S. market. SPACs especially became a popular investment vehicle during the financial crisis and made up over one-third of U.S. IPO volume in 2007 [7].

L. Dimitrova / Journal of Accounting and Economics 63 (2017) 99–120





SPAC Investment Opportunities:

There are three main ways that one can participate within a SPAC offering, and is dependent on the level of investment. The first is known as a Sponsor Group in which senior investors who have experience with buying and operating businesses, sponsor the SPAC offering. These sponsors usually take on greater risk as investors are able to withdraw their money after the deal announcement. However, they also have the potential to achieve very high returns. The next investment mode is through the SPAC IPO, which is focused on within this paper. This investment level is for retail investors who can use platforms such as Robinhood to invest in SPAC IPOs. Another level of investment is through private investment in public equity (PIPE) which sponsors use in order to raise money after the target has been identified for the business combination. PIPEs serve as a form of insurance for the capital that was raised through the SPAC IPO and is available for institutional investors [8].

SPAC Process:

A SPAC begins by undergoing the traditional IPO process which includes filing registration with the SEC, clearing SEC comments, and performing a road show and firm commitment underwriting. The IPO proceeds go into a trust account (and are invested in Treasury notes) until business combination, or the raised capital is used to redeem shares that are sold as part of the IPO. The "sponsor" or the management team or entity that makes up and carries out the SPAC, will fund offering expenses which include portions of the underwriting discount and working capital. Once the SPAC IPO process is completed, the business combination will take place with negotiations in place for a merger or acquisition of a target business or asset. Before finalizing the acquisition, the SPAC can commit either debt or equity to finance a part of the acquisition price. After a public announcement of the acquisition target and financing commitment, a shareholder vote or tender offer will take place. This will give investors the right to return their public shares back to the SPAC in exchange for cash (approximately equivalent to the price paid during the IPO). After the business combination is approved by shareholders, it will take place and the SPAC will successfully convert the target business into a public exchange-traded company [9].

Structure of SPACs:

As mentioned previously, SPACs follow many of the requirements outlined in Rule 419. One such requirement is that after the deduction of underwriting costs, 90% of the IPO proceeds have to be deposited within an escrow or trust account with 10% used to finance the merger or acquisition of the target. SPACs also follow this and use trust accounts to place a majority of the capital raised. Unlike Rule 419, however, SPACs only allow warrants to be exercised after the business combination takes place. SPACs also have a requirement that the target firm's net assets are at least 80% of those of the SPAC while having a more flexible 2-3 year time-frame for the business combination to complete, before facing liquidation. SPACs also allow for a time extension if the shell company has identified the target but has not yet completed a business combination [10].

The prospectuses of SPACs are generally standardized, and all SPAC IPOs are considered to be unit offers. Each unit consists of one share and a fraction of a warrant which are used if investors want to purchase common stock in the future. The per unit purchase price is usually $10. After the SPAC IPO takes place, the units are separated so that investors can either trade units, shares, or whole warrants as each is listed individually on the securities exchange. The sponsor usually pays a nominal amount for founder shares (usually worth 20% of the number of shares outstanding after the IPO) as well as purchases whole warrants. Usually, these founder shares will convert to public shares once the business combination process is completed [8]. With the IPO of the shell company, the majority of the SPAC's assets is cash. SPAC sponsors usually comprise of directors who are often associated with a private equity, investment, or venture capital fund. The SPAC IPO is underwritten based on firm commitment and the underwriter's compensation is usually held within a trust account until business combination is completed. Underwriters also may receive options in order to purchase additional units. This highlights how underwriters have financial interests within the SPAC as they work to find and complete business combinations [5].

The shell companies within SPACs do not necessarily need to identify a target business right away, which introduces additional risks to investors. In order to decrease these risks, SPACs work to increase shareholder protection through their structure. One way is through the trust accounts in which a majority of the capital raised through the SPAC IPO is deposited in until the business combination is approved. Additionally, stockholders are provided with the opportunity to convert their stock into a share of the trust account in the event that they vote against the future business combination. As mentioned, if the SPAC does not find a business combination within the maximum 2 year time frame, the public shell company will be liquidated. All of these investor protections (trust or escrow accounts, stock conversion opportunity, time limits, and shareholder voting on business combination) were derived from the SEC Rule 419 [5].

SPAC Acquisition Target:

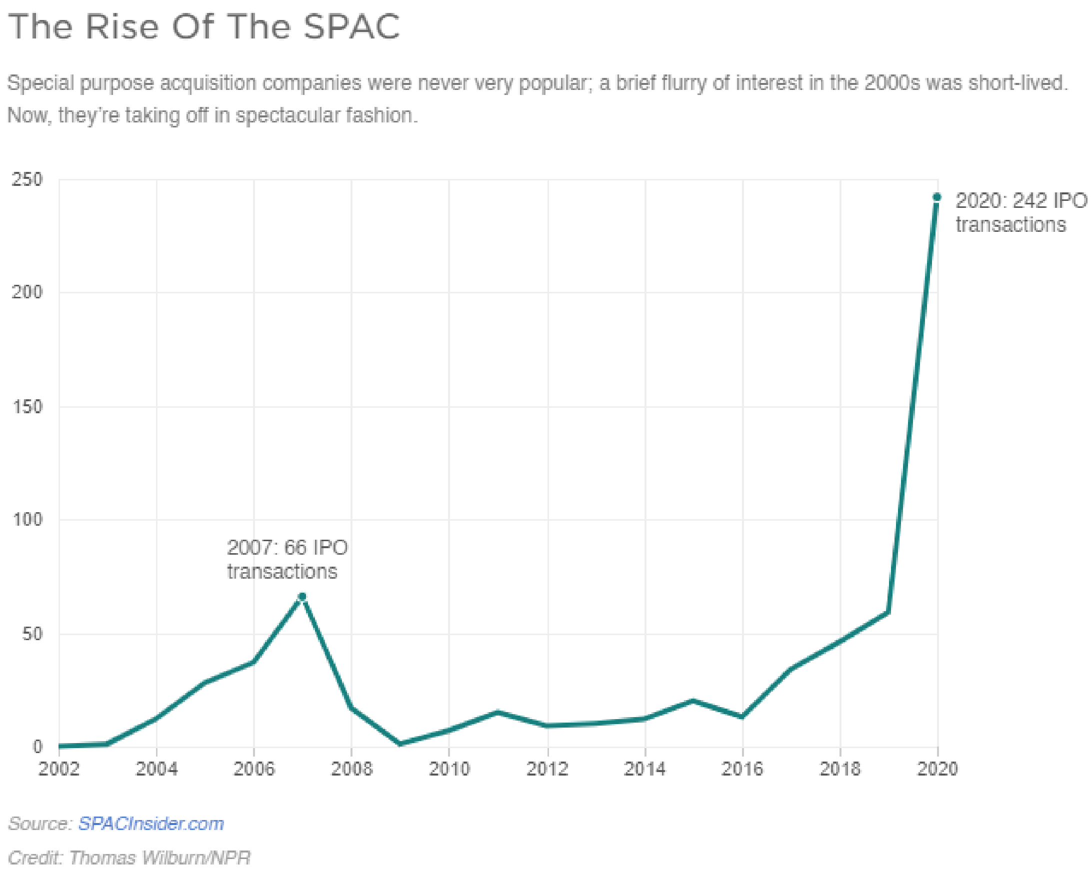
One aspect of SPACs is that they cannot identify acquisition targets before the IPO process completes or closes. In the case that the SPAC has a specific target outlined during the time of the IPO, information including the target IPO registration statement and in some cases, that of the target company, must be included within the financial statements. This is similar to that of a traditional IPO. In accordance with the SEC, the SPAC also needs to disclose, within the IPO prospectus, if it does not have a target company under consideration. Even if potential targets in the market express interest, the SPAC including its management team must refuse to consider any targets until the IPO is closed. In the case that the SPAC is carried out by sponsors from a private equity group, the SPAC IPO prospectus notes that the companies already identified by the firm cannot be potential target candidates [9].

In compliance with the SEC regulations, the business combination must be completed with targets or assets that have a total fair market value of at least 80% of the assets that are within the trust account. SPACs also tend to seek targets that are at least 2-3 times the size of the shell company in order to reduce any dilution caused by the founder shares. While acquiring a larger company is more practical, there is no maximum transaction size that is required for the target. In terms of target industry, many SPACs tend to specify the geographic and industry focus of the target business or assets. However, there is no requirement that the industry or geographical focus must be specified. For example, from January 1, 2014 to November 30, 2017, 34% of SPACs did not specify an industry focus while 66% of SPAC offerings did have a specified focus. Of the SPACs that had an industry focus, the most popular target industries were energy (38%), other/various (19%), and technology (14%) as seen on the diagram below [9].

Current Landscape

Growing Popularity of SPACs:

This past year, 2020, has been known as the "year of SPAC IPOs" within the financial services industry [11]. The numbers seem to agree with this statement as SPACs have raised about $83 billion in gross proceeds from 248 transactions which is far greater than 2019 which raised approximately $13 billion from 59 SPAC IPOs [12]. Therefore, SPACs made the largest contribution to the growth of the U.S. IPO market in 2020. The recent popularity of SPACs is highlighted by the fact that traditional IPOs only rose about $67 billion in 2020. Looking back to 2007, research has also shown that SPACs made up approximately 14% of the IPO market vs. about 50% in 2020 [11].



Advantages of SPACs vs. Traditional IPOs:

There are many advantages provided by a SPAC vs. a traditional IPO which has contributed to its growing popularity. One of the main benefits that SPACs offer is their efficiency in terms of timing to execute the transaction. Usually, SPAC business combinations take about 3-4 months from the letter of intent (LOI) to the closing, while traditional IPOs may take 6-9 months from the drafting of the initial prospectus to the transaction close.

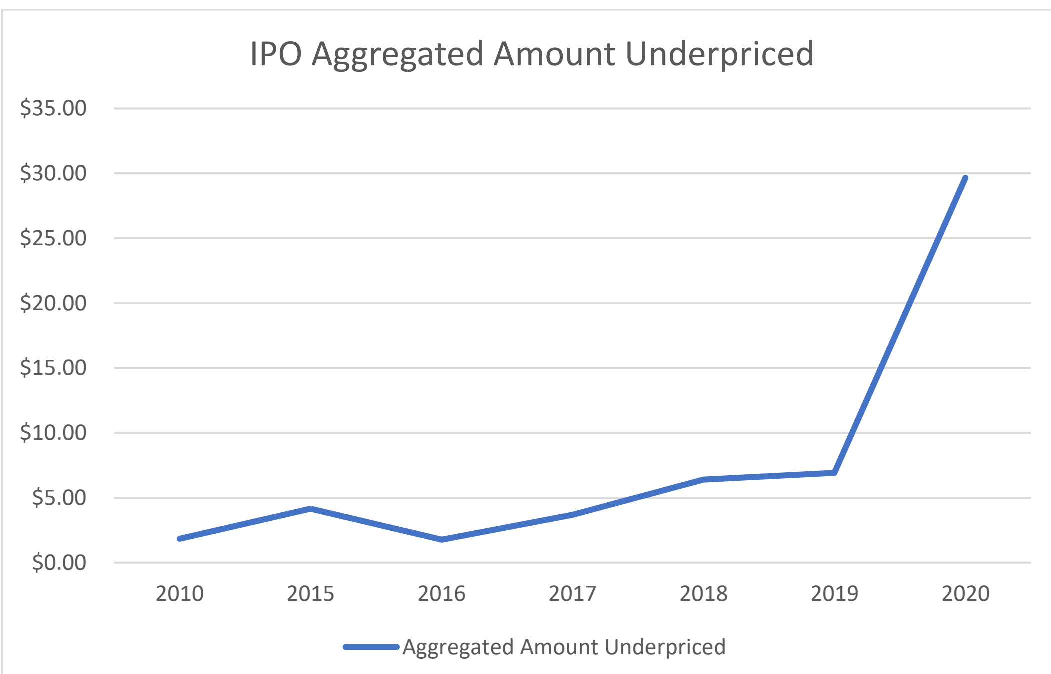
In terms of the processes for both transactions, SPACs require smaller teams to conduct the due diligence process while that of IPOs is much more intensive and often requires interacting with analysts and market participants early-on. Additionally, while both SPACs and traditional IPOs are required to undergo a SEC review, SPACs have the added-benefit of being able to defer this process until the deal close. Traditional IPOs, however, have to go through the entire comprehensive SEC review process.

Traditional IPOs also tend to be more expensive than SPACs which have lower direct expenses and indirect costs. The underwriter fee with a SPAC (5.5%) is also slightly lower than that of a traditional IPO transaction (6%) [13]. In addition to being less expensive to execute, SPACs also have increased price certainty compared to traditional IPOs. As mentioned previously, when the SPAC or shell company goes public through the IPO, it is priced at $10/unit which includes the share and warrant. Additionally, within the SPAC merger agreement, there is usually a price or share exchange rate specified prior to the deal closing. On the other hand, IPOs are priced the day before the company enters the public markets [14].

From a valuation perspective, a disadvantage of traditional IPOs is the growing underpricing of companies. As shown in the chart below, an average company in 2020 that went through an IPO was underpriced by 31%. Including the 7% IPO fee, this means that companies were underpriced by up to 38%. The dollar amount listed below is for a time period of only 6 months which highlights the large amounts investment banks are making or on the flip side, the IPO company's management is losing. SPACs, on the other hand, have much more price certainty as the company is able to negotiate its value/pricing directly with the sponsor. As SPAC IPOs have much more control over the valuation, they tend to face less underpricing [15].

Mean First-day Returns and Money Left on the Table, 1980-2020

		Mean First-day Return			
Year	Number of IPOs	Equal-weighted	Proceeds-weighted	Aggregate Amount Underpriced	Aggregate Proceeds (billion)
2010	91	9.40%	6.20%	$1.84	$29.82
2011	81	13.90%	13.00%	$3.51	$26.97
2012	93	17.70%	8.90%	$2.75	$31.11
2013	158	20.90%	19.00%	$7.89	$41.56
2014	206	15.50%	12.80%	$5.40	$42.20
2015	118	19.20%	18.90%	$4.16	$22.00
2016	75	14.50%	14.20%	$1.77	$12.52
2017	106	12.90%	16.00%	$3.68	$22.98
2018	134	18.60%	19.10%	$6.39	$33.47
2019	112	23.50%	17.70%	$6.93	$39.18
2020	165	41.60%	47.90%	$29.66	$61.86
1980-1989	2,047	7.20%	6.10%	$3.30	$53.99
1990-1998	3,614	14.80%	13.30%	$30.07	$222.38
1999-2000	856	64.60%	51.60%	$66.79	$129.47
2001-2020	2,258	16.70%	17.20%	$101.57	$592.02
1980-2020	8,775	18.40%	20.10%	$201.73	$1,001.86



Introduction to Direct Listings:

Other than SPACs and traditional IPOs, companies can go public through a direct listing. A direct listing is a way that companies can enter the public markets by selling existing shares. In other words, investors and employees sell their existing stocks to the public. This is in stark contrast to a traditional IPO in which companies sell newly issued stocks. Therefore, the main reason companies carry out IPOs is to raise capital – this is not the goal of direct listings. Another difference between a traditional IPO is that direct listings do not have underwriters or any "lock-up" periods which prevent shareholders from selling their shares in the market. The lock-up periods in traditional IPOs prevent the stock supply from becoming too large, and the stock price from facing large declines. Direct listings, on the other hand, provide shareholders with the right to sell their shares as soon as the company goes public [16].

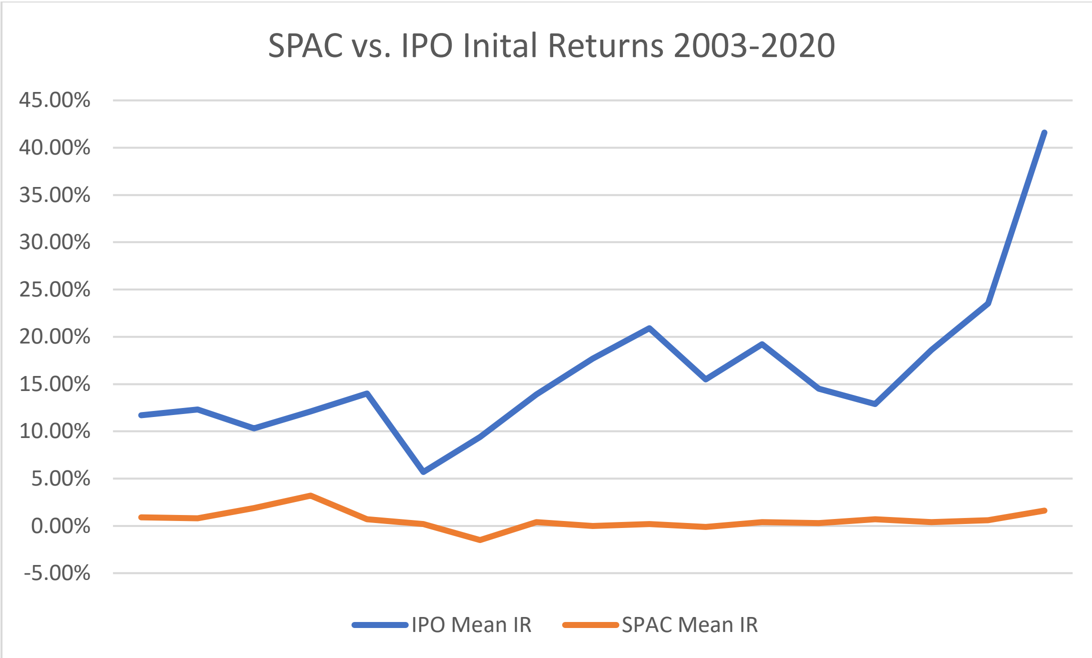
Advantages of SPACs vs. Direct Listings:

Similarly to the advantages of SPACs vs. traditional IPOs, an argument that favors SPACs is that there is a lot of price certainty. As mentioned, investors buy shares in the SPAC shell-company at $10/unit – this is the same price that a sponsor has to pay. However, with a direct listing, it is more difficult to get in on the initial IPO price especially with the stock is very popular in the market. This was the case when companies such as Slack and Spotify went public via direct listings. Considering this, a direct listing may be more beneficial to the company itself, as no new shares are offered when the company goes public. In other words, the company that undergoes a direct listing does not have to pay underwriters, go on roadshows, or price the IPO. This results in a lot of cost-savings. However, there is no direct benefit to investors. SPACs, on the other hand, "level the playing field between investors and institutional buyers" and offer more direct benefits to investors (i.e. price certainty) as discussed previously [16].

SPAC vs. IPO Returns

In order to compare the average returns between a traditional IPO and SPACs, data from the University of Florida was used which calculated the initial return (IR) from the offer price to the first close (Appendix 1). As shown in the graph below, the average returns of the operating company IPO was 15.76% from 2003-2020 while that for the SPAC had a mean IR of 0.63% over the same period. Additionally, as SPACs gained popularity relatively recently, the returns were calculated using a total number of operating company IPOs of 2,112 and 631 SPAC offerings. After collecting this data, an independent unit t-test was performed in order to find the statistical significance between the two transactions considered.

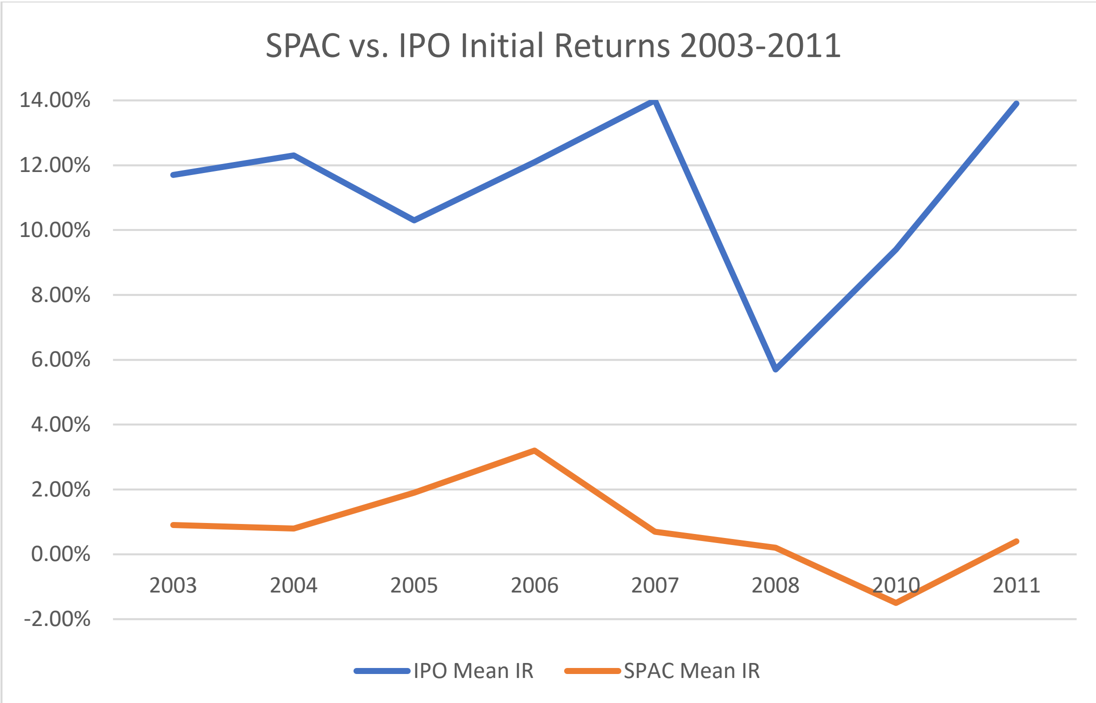
As there were no SPAC IPOs in 2009, this data point was removed from consideration. Additionally, analysis was conducted by splitting up the data period into smaller periods from 2003- 2011 and 2012-2020. The graphical representations of the SPAC and traditional IPO returns data show that throughout the 2003-2020 period (excluding year 2009), the SPAC returns have averaged lower than those of traditional IPOs. The results of the two-tailed tests conducted also show that the p-values are consistently less than 0.05 for all time periods between 2003-2020. This conveys how the average difference between the IPO and SPAC mean IR is statistically significant and is not caused by chance.



Years 2003-2020

t-Test: Two-Sample Assuming Unequal Variances

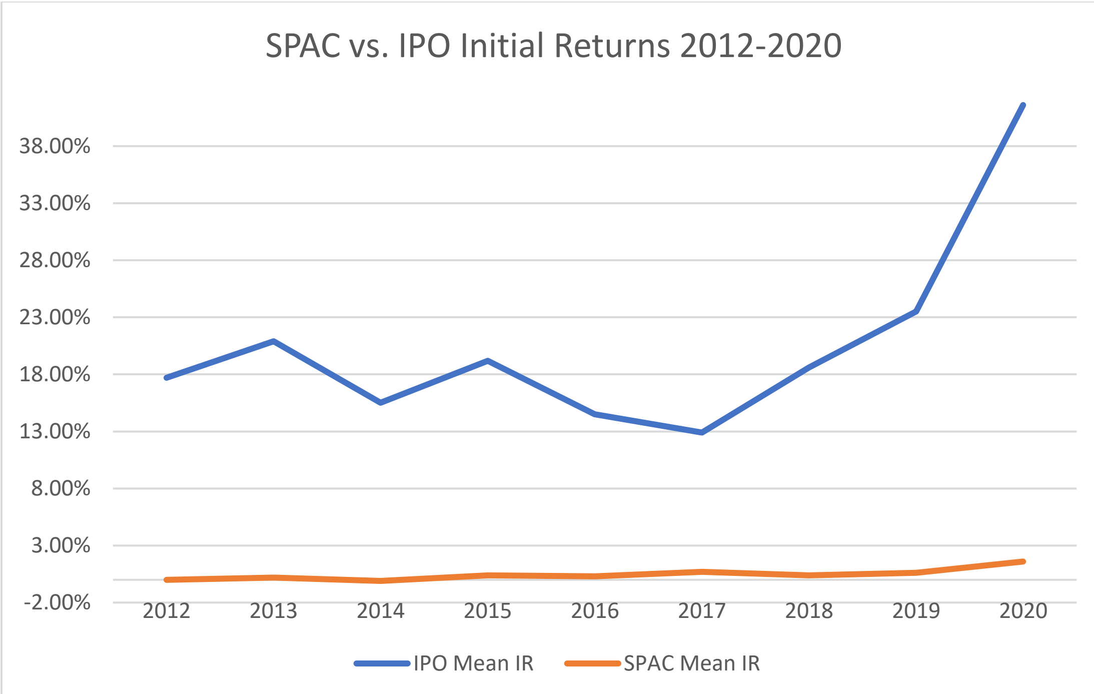
	IPO Mean IR	*SPAC Mean IR*
Mean	0.16106	0.00629
Variance	0.00628	0.00010
Observations	17.00000	17.00000
Hypothesized Mean Difference	0.00000	
df	16.00000	
t Stat	7.98910	
P(T<=t) one-tail	0.00000	
t Critical one-tail	1.74588	
P(T<=t) two-tail	0.00000	
t Critical two-tail	2.11991	



Years 2003-2011

t-Test: Two-Sample Assuming Unequal Variances

	IPO Mean IR	*SPAC Mean IR*
Mean	0.11175	0.00825
Variance	0.00074	0.00018
Observations	8.00000	8.00000
Hypothesized Mean Difference	0.00000	
df	10.00000	
t Stat	9.64469	
P(T<=t) one-tail	0.00000	
t Critical one-tail	1.81246	
P(T<=t) two-tail	0.00000	
t Critical two-tail	2.22814	



Years 2012-2020

t-Test: Two-Sample Assuming Unequal Variances

	IPO Mean IR	*SPAC Mean IR*
Mean	0.20489	0.00456
Variance	0.00733	0.00003
Observations	9.00000	9.00000
Hypothesized Mean Difference	0.00000	
df	8.00000	
t Stat	7.00859	
P(T<=t) one-tail	0.00006	
t Critical one-tail	1.85955	
P(T<=t) two-tail	0.00011	
t Critical two-tail	2.30600	

Covid-19 Pandemic:

Although the benefits and advantages of SPACs vs. traditional IPOs have always existed, the popularity of SPACs has grown relatively recently. The main catalyst behind this trend is the global pandemic. Moreover, SPACs tend to gain attention as a popular investment vehicle especially during times of market and economic volatility. The pandemic has caused many companies to postpone their IPOs as a result of increased uncertainty within the financial markets. As these companies explored new ways to go public, SPACs were particularly attractive options especially because they can forego the “grueling process” behind traditional IPOs. Therefore, the SPAC offering allows companies to raise capital much quicker and efficiently. In addition to the cheaper and less complicated nature of SPACs, companies are increasingly using these investment vehicles because of the increased certainty they provide. Not only do SPACs have high price certainty, but they also allow the target company to negotiate a fixed valuation with the transaction sponsors. Together, these characteristics of SPACs contributed to its immense growth recently [17].

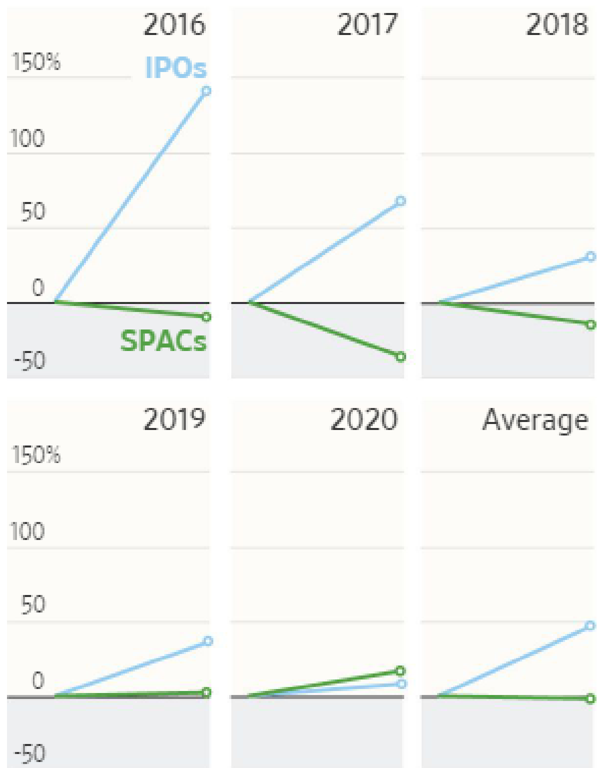
Criticisms of SPACs:

While SPACs are popular investment vehicles and have many advantages, they do have associated risks. The target company, for example, may face the risk that it is rejected by the shareholders of the SPAC. Additionally, in the case that the SPAC does not announce the acquisition target within the prospectus, investors face a lot of uncertainty in terms of their investment. As CNBC notes, investors are “going blindly into the investment” [17].

Another criticism of SPACs has to do with its history of lower returns compared to traditional IPOs. For example, research performed by Renaissance Capital concluded that the average return on common stock for 107 SPACs have been a loss of 1.4% since 2015 up to last year. During this period, the average return for companies using traditional IPOs was 49%. However, Renaissance Capital also describes how the more recent SPACs have been generating strong returns. For example, in 2020, the average return was 17%. These returns were driven by SPACs such as DraftKings, a sports betting operator, which had its stock quadruple, as well as Nikola, a company within the automotive industry, whose stock has roughly doubled in 2020 [18].

As mentioned previously, SPACs offer protection to investors by allowing them to redeem shares in exchange for cash equal to the IPO price of $10/share in addition to interest. Research on 47 SPAC transactions from 2019 and 2020, however, found that investors who did not redeem their shares tended to face loses after the deal close. One of the underlying reasons for this occurrence has to do with the rewards that sponsors receive during the transaction, particularly, the “sponsor promote” which allows the management team to purchase 20% of the company for $25,000. Therefore, the sponsors receive millions in equity. Analysts have mentioned how the sponsor promote has the potential to encourage “bad deals” as sponsors will receive the reward regardless of the company’s performance after the deal closes. Additionally, while SPACs go through the SEC review, underwriters have a smaller role than within traditional IPOs. In turn, this “eliminates one gatekeeper” for the deal. This issue is being tackled by newer SPACs which are working to tie the performance of the company, after the business combination, to sponsor payoffs [18].

Performance of special-purpose acquisition companies vs. initial public offerings



Note: Figures show returns through Thursday. Years reflect when a merger took place (for SPACs) or year of IPO. SPAC returns are based on price of common stock only. IPO returns are calculated from closing price on first day of trading.
Source: Renaissance Capital

Recent SPAC Deals:

QuantumScape (NYSE: QS) which is a solid-state battery developer for electric vehicles, was created through a business combination with the SPAC company Kensington Capital Acquisition. On the first day that QuantumScape traded, its shares increased by about 50% on the first trading day in November 2020.

DraftKings Inc. (NASDAQ: DKNG) is a digital sports entertainment and gaming company which merged with the SPAC shell company Diamond Eagle Acquisition Corp. and SBTech. The company officially entered the public markets in April 2020 and ended its trading day with a 11% gain.

Paya Holdings Inc. (NASDAQ: PAYA) is an integrated payments provider which was acquired by the shell company FinTech Acquisition Corp. III in October 2020 [11].

It is important to note that market analysts used to have a perception that “only shaky companies go public via blank-check deals”. However, with the rise of numerous SPAC deals, some of which are mentioned above, perceptions on SPACs have largely improved. Individuals such as Chamath Palihapitiya, a venture capitalist and early senior executive at Facebook, and William Ackman, a billionaire and hedge fund manager, largely contributed to the credibility of SPAC offerings [18]. Moreover, they have led numerous SPAC offerings such as Social Capital Hedosophia Holdings acquisition of Virgin Galactic (led by Chamath) while Ackman’s shell company Pershing Square Tontine Holdings raised over $4 billion in capital as it is currently identifying a target for business combination [19].

Future Outlook

While there is no way to tell if SPACs will continue to be the choice over traditional IPOs 10 years into the future, 2021 data shows that this investment vehicle is growing in popularity. This year alone, for example, there have already been 297 SPAC IPOs with gross proceeds of about $97 billion which is already higher than the total SPAC IPOs for the entire year of 2020 [12]. In the words of Paul Dellaquila, who heads the Defiance Next Gen SPAC ETF (SPAK), “nothing succeeds like success. Up until a couple years ago, most SPACs were small-cap affairs with low profiles. Then companies like Virgin Galactic and DraftKings went public via SPACs, which greatly lifted the profile” [20]. On the flip side, proponents of traditional IPOs such as Kathleen

Smith, believe that a lot of tech unicorns such as SpaceX (space vehicles), Stripe (mobile payments), and Waymo (Alphabet's autonomous vehicle unit) are on track to use traditional IPOs in 2021. Nevertheless, Smith describes how there is "room for both IPOs and SPACs" [20]. Considering that about 210 SPACs or shell companies are currently looking for targets for a business combination (with time limits approaching) 2021, in its entirety, may be a good year for SPACs [20].

New Accounting Changes & Recent Slowdown in SPACs:

Despite the fact that SPAC transactions have experienced tremendous growth this year and had a record 109 new SPAC deals in March, there has been a standstill of SPACs recently. In fact, data presented by SPAC Research shows that there has been only 10 SPACs in April [21].

The reason for this standstill has to do with the Securities and Exchange Commission's (SEC) recent issuance of accounting guidance. While no rule has been officially instated yet, the SEC specified that SPAC warrants would be considered as liabilities rather than equity instruments. As a result, both existing and new SPAC offerings are required to revise the value of the warrants quarterly within their 10-Ks and 10-Qs. As Anthony Decandido, a partner at RSM LLP discusses, these new accounting changes are very costly for companies as they must determine the value of the SPAC warrants each quarter, rather than at the beginning of the offering [21].

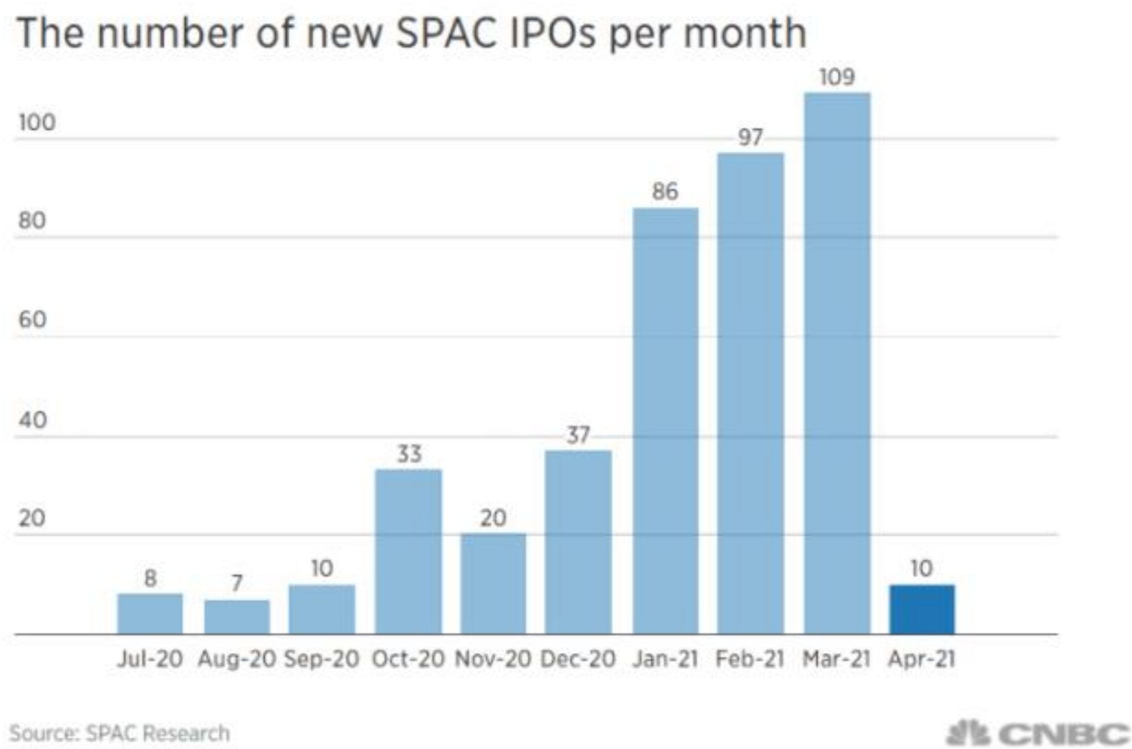
As mentioned previously, SPACs raise capital through the shell-company IPO and then use the proceeds in order to, most oftentimes, take a private company public through a merger or acquisition (business combination). In order to incentive early investors, warrants are used as compensation for the cash they contribute to the SPAC. Therefore, when this accounting change is in place, both operating companies and the sponsors of the transaction may be more inclined to seek alternative routes to go public, such as a traditional IPO. Another point to consider is that this accounting rule could cause investor's confidence in SPACs to decrease due to the fact that the company's financials have to be restated very often. Furthermore, the SPAC market already carries a public perception of being highly volatile and even speculative in nature [21].

According to SPAC Research, there are currently only two accounting firms, Marcum and WithumSmith + Brown, which have been performing the auditing for SPAC transactions over the past six years. In fact, over 90% of SPACs use these two accounting firms. This suggests the emergence of an additional problem of having significant backlogs as SPAC offerings work to implement these new accounting changes [21].

Impact of Accounting Changes on SPAC Market:

The market's reaction to the change in SPAC warrant accounting has already been substantial. Moreover, Bank of America's client data has shown that SPAC investing has decreased from $120 million in net weekly purchases at the start of the year, to single digits in April. This highlights how retail investors are slowly preferring alternative investments to SPACs [21].

While this new accounting rule could potentially lead to a longer-term slowdown of SPAC offerings once it is in effect, some analysts believe that it may not have as profound as an effect. For example, Brendan Quigley, a securities enforcement partner at Baker Botts, describes how "[it is] hard to imagine the SPAC trend getting even faster than it was before. But at the same time… this warrant issue by itself will not cause a stop to SPAC deals. Companies will make appropriate assessments, do what they need to do, and move on". Therefore, a potential outlook for SPACs is that while there may be a decline in these offerings, the SPAC trend is not completely over. In other words, SPACs will continue to be a popular investment vehicle among the ranks of traditional IPOs [22].



Heightened Regulatory Landscape:

Along with the potential for new accounting standards, SPACs are increasingly under the scrutiny of the SEC. During year-end 2020, for example, the SEC has provided further disclosure guidance to SPACs offerings. For example, specifying that SPACs must clearly describe the sponsors in addition to any conflicts of interest the underwriters may have in identifying potential targets for business combination. While the SEC is only providing guidance rather than a concrete rule, regulation, or statement, it is apparent that SPACs are coming under increasing regulatory oversight [23].

In addition to the disclosure provided, the SEC has issued a recent statement regarding celebrity involvement with SPACs. Moreover, the exchange commission described how celebrities, from professional athletes to well-known professional investors, have been involved in SPAC investments. As a result, many retail investors made similar investments to celebrities without conducting in-depth research themselves. The SEC, therefore, stressed how an investment is not a good one solely because a famous individual states that it is. In other words, the SEC described how all SPAC investments come with their unique set of risks that investors should be aware of. The SEC's statement again highlights the commission's belief that SPACs require further regulatory oversight in order to ensure that investors are fully educated on the investment's potential risks and rewards [24]. While the regulatory environment surrounding SPACs has certainly become more stringent since the transaction's origin back in the 1980s, there is still more work to be done in order to protect investors from making risky investments without the proper due-diligence. Therefore, considering that SPACs have regained popularity relatively recently, it is likely that there will be the creation of new laws or rules to further achieve this.

Potential SPAC Bubble Burst:

According to Harvard Business Review (HBR), research shows that people tend to adopt a given practice as it becomes more widespread and legitimate. While this is intuitive, there is evidence that controversial practices, such as SPACs, often undergo a pattern from boom to bust [25].

HBR collected data on SPACs or reverse mergers, market responses, and firm characteristics (i.e. market value, earnings, debt) between the period of 2001-2012. Additionally, studies were conducted on how the media evaluates reverse mergers. Published news articles were used to do so. Of these articles, 148 were neutral, 133 were negative, and only 6 expressed positive perceptions on SPACs. Share price data was also collected in order to consider the valuation of reverse mergers by the public market [25].

The results of this research showed that, as expected, the popularity of SPACs lead to further adoption and use. However, along with the growing popularity of reverse mergers, investors and the media became increasingly skeptic about the practice. These negative criticisms and media coverage were only fueled by the fact that firms with lower reputations tended to use SPAC offerings. As a result, firms were more discouraged from taking the SPAC route to enter the public markets due to the low stock market valuations for reverse mergers. The SEC's 2005 disclosure rules and 2011 warnings to SPAC investors also contributed to a decline in the use of this transaction. We see this SEC regulatory oversight continuing to heighten today [25].

By 2010, when there was a large peak and popularity in SPACs, about 70% of media articles had negative perceptions on the practice. Firms that went through a SPAC offering simultaneously saw a decline in their cumulative returns by about 45%. In the next year, reverse merger activity had decreased by 35% and in a way, the increased popularity of the practice led to its eventual decline as the regulatory environment and skepticism strengthened [25].

The "rapid proliferation of a controversial financial innovation, plagued by poor-quality players, bad publicity and regulatory concern" summarizes today's SPAC boom. This can be further understood by analyzing recent SPACs. One such example is Nikola Motors which specializes in zero-emission vehicle concepts. Nikola merged with the SPAC shell-company VectoIQ Acquisition Corp in 2020. After just three months of going public, the company faced accusations of short-selling fraud. In turn, this led to numerous lawsuits made by investors and even the resignation of the company's founder. Nikola, as expected, faced a large decrease in its stock price to a mere fraction of its June peak. While there have been some successful and high-return SPACs such as that of DraftKings as mentioned above, most post-merger share prices or SPAC returns have been relatively low [25].

Similarly to 2010-2011, SPACs are also facing negative media sentiment in addition to increased concerns surrounding their regulatory landscape. For example, in December 2020, the Financial Times warned SPAC investors while SEC Chairman Jay Clayton is working to ensure that the offering has the “same rigorous disclosure” that traditional IPOs receive. One relatively new regulation for SPACs is that a target firm for business combination must be identified within 24 months after the shell-company IPO, or the proceeds will be returned to shareholders. This regulation may contribute to a future decline in SPAC transactions. Moreover, considering the limited targets in the market and the incentives of SPAC founders to complete deals, reverse mergers may see a similar fate as it did in its history due to the poor quality of deals, negative press, and heightened regulations [25]. Nevertheless, it is ultimately up to the market and investors to decide whether SPACs will continue to be a popular investment vehicle in the near-future.

Conclusion

Special purpose acquisition companies (SPACs), or reverse mergers, originated in the 1980s as blank check companies. This offering has regained popularity relatively recently as an alternative to the traditional IPO. Moreover, a SPAC shell company, which does not have any specific business purpose or operations, enters the public markets through an IPO and subsequently acquires or mergers with a private company. After the business combination, the private company has now entered the public market and can start trading as any other listed company.

SPACs provide numerous advantages over traditional IPOs which have contributed to its recent rise. For example, SPACs decrease the transaction execution time from 6-9 months, which is required for a traditional IPO, to about 3-4 months. SPACs also require less due-diligence and have lower direct and indirect costs. From a valuation perspective, the price certainty provided by SPACs also mitigates potential underpricing which traditional IPOs are increasingly facing.

One of the main disadvantages provided by SPACs in comparison to IPOs has to do with its relatively low returns. By using initial return (IR) data, this claim is further substantiated. For example, over the period of 2003-2020, SPACs had a mean IR of 0.63% while that of traditional IPOs was 15.76%. Additionally, t-tests performed between the periods 2003-2011 and 2012-2020 show that the average difference in mean IR between IPOs and SPACs is statistically significant and is not caused by chance.

While there is no way to predict the future outlook for SPAC offerings with full certainty, it is likely that there will be a slowdown in the popularity of this offering in the near-future. Furthermore, SPACs continue to face increasing regulatory oversight, low returns, and negative publicity as they are often noted as being a popular choice among less reputable companies. Along with the heightened regulatory landscape, a potential accounting change that reconsiders SPAC warrants as liabilities vs. equity may further decrease the popularity of SPACs. Similarly to 2010-2011, we may see the current SPAC bubble slowly deflate.

Limitations & Future Research Discussion:

As SPACs have regained popularity recently, a limitation of this paper was performing analysis on more nuanced topics which require current data. For example, one such topic is determining the impact of SPAC target announcement on returns. Specifically, this research would explore how SPAC investor returns vary when the target for business combination is identified vs. unannounced within the prospectus. Therefore, if time permits and the required data is readily available, this topic is very relevant for future research on SPACs.

References

1. Domonoske, C. (2020, December 29). The Spectacular Rise Of SPACs: The Backwards IPO That's Taking Over Wall Street. Retrieved April 1, 2021, from https://www.npr.org/2020/12/29/949257672/the-spectacular-rise-of-spacs-the-backwards-ipo-thats-taking-over-wall-street
2. Daniel S. Riemer, Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?, 85 WASH. U. L. REV. 931 (2007). Available at: https://openscholarship.wustl.edu/law_lawreview/vol85/iss4/5
3. Heyman, D. K. (1970, January 01). From Blank Check to SPAC: The Regulator's Response to the Market, and the Market's Response to the Regulation. Retrieved April 1, 2021, from https://core.ac.uk/display/159610375
4. Blank Check Company Manufacturer Charged With Fraud. (2016, September 21). Retrieved April 1, 2021, from http://sec.gov/news/pressrelease/2016-190.html
5. Murray, J. S. (2011). The Regulation and Pricing of Special Purpose Acquisition Corporation IPOs. SSRN Electronic Journal. doi:10.2139/ssrn.1746530
6. What You Need to Know About SPACs – Investor Bulletin. (2020, December 10). Retrieved April 1, 2021, from https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin
7. Dimitrova, L. (2017). Perverse incentives of special purpose acquisition companies, the “poor mans private equity funds”. Journal of Accounting and Economics, 63(1), 99-120. doi:10.1016/j.jacceco.2016.10.003

8. What is a SPAC and Why are They Suddenly so Popular? (2020, October 16). Retrieved April 1, 2021, from https://www.excelsiorgp.com/resources/what-is-a-spac-and-why-are-they-suddenly-so-popular/

9. Lenahan, B., Boxwala, M., Layne, R., Bokosha, T., & Swartz, Z. (2018, July 6). Special Purpose Acquisition Companies: An Introduction. Retrieved April 1, 2021, from https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/

10. Murray, James S., Innovation, Imitation and Regulation in Finance: The Evolution of Special Purpose Acquisition Corporations (April 12, 2017). Review of Integrative Business and Economics Research, Vol. 6, No. 2, pp.1-27, April 2017, Available at SSRN: https://ssrn.com/abstract=2952119

11. Saha, S. (2020, December 28). 2020 Has Been the Year of SPAC IPOs: Here Are the Prominent 4. Retrieved April 1, 2021, from https://www.nasdaq.com/articles/2020-has-been-the-year-of-spac-ipos:-here-are-the-prominent-4-2020-12-28

12. SPAC IPO Transactions Statistics - by SPACInsider. (2021, March 20). Retrieved April 1, 2021, from https://spacinsider.com/stats/

13. SPAC vs Traditional IPO & Reverse Takeover. (n.d.). Retrieved April 1, 2021, from http://18.218.104.51/spac-vs-ipo/

14. McElhaney, A. (2020, December 10). SPAC Costs Are ‘Far Higher’ Than Previously Realized, Study Finds. Retrieved April 1, 2021.

15. Gurley, B. (2020, August 24). Going Public Circa 2020; Door #3: The SPAC. Retrieved April 7, 2021, from https://abovethecrowd.com/2020/08/23/going-public-circa-2020-door-3-the-spac/

16. Frankel Matthew Frankel The Motley Fool, M. (2021, February 1). SPACs vs. Direct Listings: Key Differences Investors Should Know. Retrieved April 24, 2021, from https://www.nasdaq.com/articles/spacs-vs.-direct-listings:-key-differences-investors-should-know-2021-02-01

17. Jr., T. H. (2021, February 24). What is a SPAC? Explaining one of Wall Street's hottest trends. Retrieved April 1, 2021, from https://www.cnbc.com/2021/01/30/what-is-a-spac.html#:~:text=WeWork is just the latest,public by merging with SPACs.

18. Osipovich, A., & Michaels, D. (2020, November 13). Investors Flock to SPACs, Where Risks Lurk and Track Records Are Poor. Retrieved April 1, 2021, from https://www.wsj.com/articles/investors-flock-to-spacs-where-risks-lurk-and-track-records-are-poor-11605263402

19. Anwar, N. (2020, December 11). SPAC listings hit a record high in 2020 - but what are these 'shell companies'? Retrieved April 1, 2021, from https://www.cnbc.com/2020/11/23/what-are-spacs-2020-saw-record-number-of-shell-companies-listed.html

20. Pisani, B. (2020, December 07). The 2021 outlook for the booming SPAC market and traditional IPOs. Retrieved April 1, 2021, from https://www.cnbc.com/2020/12/07/the-2021-outlook-for-the-booming-spac-market-and-traditional-ipos.html

21. Li, Y. (2021, April 22). SPAC transactions come to a halt amid SEC crackdown, cooling retail investor interest. Retrieved April 24, 2021, from https://www.cnbc.com/2021/04/21/spac-transactions-come-to-a-halt-amid-sec-crackdown-cooling-retail-investor-interest.html?utm_source=morning_brew

22. Cao, S. (2021, April 23). SPAC Bubble Pops: Deals Drop 90% in April After SEC Warns of Crackdown. Retrieved April 24, 2021, from https://observer.com/2021/04/spac-deal-ipo-slowdown-april-sec-crackdown/

23. Division of Corporation Finance Securities and Exchange Commission CF Disclosure Guidance: Topic No. 11. (2020, December 22). Retrieved April 24, 2021, from https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies

24. Celebrity Involvement with SPACs – Investor Alert. (2021, March 10). Retrieved April 24, 2021, from https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert

25. Naumovska, I. (2021, February 18). The SPAC Bubble Is About to Burst. Retrieved April 24, 2021, from https://hbr.org/2021/02/the-spac-bubble-is-about-to-burst#

Appendix

1.

	Operating Company IPO		SPAC IPOs	
Year	Number	IPO Mean IR	Number	SPAC Mean IR
2003	63	11.70%	1	0.90%
2004	173	12.30%	12	0.80%
2005	159	10.30%	27	1.90%
2006	157	12.10%	35	3.20%
2007	159	14.00%	65	0.70%
2008	21	5.70%	17	0.20%
2009	41	9.80%	0	
2010	91	9.40%	7	-1.50%
2011	81	13.90%	16	0.40%
2012	93	17.70%	9	0.00%
2013	158	20.90%	10	0.20%
2014	206	15.50%	12	-0.10%
2015	118	19.20%	20	0.40%
2016	75	14.50%	13	0.30%
2017	106	12.90%	34	0.70%
2018	134	18.60%	46	0.40%
2019	112	23.50%	59	0.60%
2020	165	41.60%	248	1.60%
Total/Avg	**2112**	**15.76%**	**631**	**0.63%**