Counting Chickens: Risk Management During the SPAC Lifecyle

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Unless you have avoided all financial publications during the past year, it is likely you have witnessed the proliferation of articles and analysis on special purpose acquisition companies, or SPACs. Numerous articles, interviews, and commentaries have focused on the emergence, exuberance, and volatility associated with these instruments. This is not unusual when a financial instrument goes from relative obscurity to a market focus in a short period of time, driving eye popping returns. That the excitement surrounding SPACs was quickly quenched in February and March as the IPO market cooled down and the space headed back toward reality is not surprising considering the history of the instrument, but as with any financial product du jour, new participants can be unaccustomed to the substantial volatility. As most of the commentary has focused on the risks and volatility, we believe reframing the conversation and addressing some of the risks/problems discussed surrounding SPACs can be useful as investors think about the structure and how to approach the use of SPACs in portfolio construction from an arbitrageur's perspective.

Frame of Reference is Important

Many articles often focus on two topics when discussing SPACs: the volume and cumulative size of SPAC IPOs and risks post deal announcement. These two topics are indeed important, but it is just as important to frame the discussions of these problems with the understanding that these risks can be mitigated by active management.

IPO PACING: TORRID BUT WILL BE SELF-REGULATING

In the public discussion we have observed, many good points have been made regarding the torrid pace of SPAC IPO activity. We agree that the pace was likely far too fast, having risen from around $10B in 2017 to >$90B so far in 2021, but as the return profile was attractive, inflow of capital was relentless. As more investors poured into the space and demand for the product boomed, supply moved in to meet the demand. The knock-on effect was that economics were negatively affected in terms of warrant coverage. SPACs are not unique in this way, and like other parts of the market, will eventually self-correct as returns/ economics become less attractive. One must keep in mind, despite the focus in the press, SPACs are still a niche structure. **The majority of the investor pool in the IPO spaces consists of multi-strategy hedge funds and arbitrage investors, and this limits the demand.** We view the recent IPO market pullback with a positive view as the IPO slowdown, combined with the SPAC space trading toward cash trust value, has allowed investors to demand better economics both in terms of warrant coverage as well as sponsor share structure changes that we believe will better align sponsors and investors in the future. In addition, with supply/demand at more sustainable levels, sponsors and management teams with track records and the capability to add real value to a potential target should stand out and provide for an attractive investment opportunity.

STRUCTURE: PRESENTS RISKS BUT DOWNSIDE MUST BE VIEWED IN REFERENCE TO THE LIFE CYCLE

Another common point mentioned is the risks investors face post deal announcement and de-spac. These concerns are not unfounded, **but it is important to dissect the lifecycle of a SPAC and discuss each part in isolation because the downside risks to each are unique.** The SPAC lifecycle can be separated into IPO/pre-deal announcement, post deal announce/pre de-spac, and post de-spac.

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IPO/Pre-deal announcement

SPACs raise capital at a fixed dollar price per unit (usually $10). A unit is comprised of one share of common stock and a portion of a warrant. Some high-quality sponsor offerings may have no warrant, and in that case only common stock is issued, not a warrant. The capital raised during the IPO is placed into a trust which is invested in short term treasuries. This trust provides downside protection via a redemption option for investors, generally at a minimum of the issue price. Investment risk during this period is comprised of the value or warrants received as well as incremental value above the baseline trust value. Earlier this year, most of the space traded far above trust value, reflecting a bullish view that each management team was poised to announce a great deal. During that time period, the risk was higher than it is presently since most of the SPAC universe is trading at or near trust value. While this period is discussed, this is not generally the focus in the press.

Post Deal Announcement/Pre-De-Spac

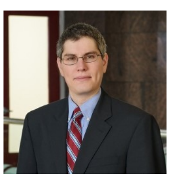
In general, the risks in this phase are similar to the first phase, with the exception, that a well-received deal may trade up upon announcement, boosting the value of the common shares and warrants.. The trust value still underpins the structure and provides downside support, however any value above trust is at risk and volatility can increase as more disclosure surrounding the prospects of the target or information about financing the transaction emerges. This is often touched upon in the press as the volatility caused by either a well-received deal or a poorly received deal can be a great story.

Post DE-SPAC

This is the period that seems to have a lot of focus both in terms of media coverage but also potentially from regulators. It is important to note that the trust value downside protection is removed at this point and the newly merged company will trade on its fundamentals/prospects like any other publicly traded company. Media and regulators have rightly pointed out that some targets have no revenues or rely on financial projections that may or may not come to pass. This is important to consider in terms of owning SPACs in a portfolio strategy as the risk posed by the investment is inherently different from the other stages of the SPAC lifecycle.

Portfolio Management: Practical Risk Mitigation During the SPAC Life Cycle

We view SPACs as having potential for an asymmetric upside with the caveat that downside risks are prudently managed. During the SPAC IPO process, it is important to assess what the sponsors and management of the prospective SPAC bring to the table: *Does their experience add value? How do they describe their strategy? Past success? What kinds of targets and competition exist for those targets?* Investment managers generally have time to ask these types of questions prior to committing to invest in the SPAC IPO. We consider this integral to managing the initial positioning as liquidity post IPO is not sufficient until a transaction is announced. After the IPO but prior to the de-SPAC it is critical to monitor the progress of the teams as they search for targets. Risk levels prior to de-SPAC are largely determined by value above trust combined with warrant value. Controlling the value at risk in in total and exposure to each SPAC is important for protecting the downside while trying to maximize the upside return potential. At de-SPAC, as discussed prior, the risk profile changes as downside protection is removed, and thus continued investment requires a greater focus on long term fundamental prospects of the target. From the prospective of an arbitrage focused investor, we work to limit and avoid our exposure to longer term fundamental positions.



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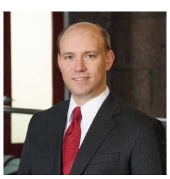

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