March 2021

SPAC Attack

SPACs, or 'Special-Purpose Acquisition Company', are the latest investment frenzy as investors ranging from hedge funds to everyday investors, rush to access these speculative assets in the hope that they might be investing in the next Tesla or Amazon.

SPACs are essentially publicly traded companies that have no operations and hold nothing but cash. They provide an easier way, a back door, for companies to list on a stock exchange to be able to access public investors. Over the past two years there has been a significant rise in the number of private companies using a SPAC to list, and last year they accounted for 56% of all companies that went public in the US, up from 30% in 2019 and 21% in 2018[1]. This backdoor, coupled with investors' willingness to take on the speculative investment risk, has created a market that is now being compared to the tech bubble in the early 2000s.

In this month's commentary we take a closer look at this SPAC frenzy to understand why investors are lining up and to assess who the real winners and losers are.

What is a SPAC?

SPACs have been around for decades. Their predecessors, known as 'Blind Pools', had a questionable reputation in the 1980s because they were tied to penny stock fraud. The first SPAC was created in 1993 and they were popular for brief periods in the 1990s and 2000s, only to fade due to market crashes and the surge of traditional initial public offerings (IPOs)[2].

A SPAC is a publicly listed shell company whose sole purpose is to raise capital through an IPO and use those funds to buy a private company, which in doing so, takes that company public.

The founder of a SPAC is called a 'sponsor'. These sponsors are the face of the company and are responsible for:

- raising the funds that will be used to make the acquisition.
- the management of the SPAC in the lead up to the merger.
- finding potential businesses to acquire.

For this they are typically given a 20% stake in the SPAC with the other 80% going to investors. This stake is called a 'promote'.

SPACs are also known as 'blank-check companies', because investors commit funds months before they have any idea which company the SPAC is targeting to purchase, placing all of their trust in the ability of the sponsor to find a good deal. Since SPACs do not make anything or own any assets, it is the founders who are the main draw. Investors bet on founders having the right connections to identify a future winner, close a deal bring it to market.

In other words, it is a case of betting on the jockey (the founders) rather than the horse (the company).

From the time a SPAC is set up it has two years to complete a merger, failing which, investors can redeem their shares/funds. If this happens, the sponsor will refund all investors and will also lose any expenses they have incurred in the setting up and management of the SPAC, leaving the sponsor out of pocket.

Why have SPACs gained so much popularity recently?

Once dubbed 'the poor man's private equity fund', SPACs give everyday investors an opportunity to invest in an early-stage company in a *hot* sector before it goes public, an opportunity usually limited to institutional investors and wealthy individuals. This opportunity, coupled with the recent willingness of investors to take on the risk of speculative investments in search of the 'next big thing', has led to an insatiable increase in demand for SPACs. Evidence of this can be seen in the increase in the amount of capital raised by SPACs over the past few years. As seen below, 2020 was a bumper year with SPACs raising more than four times the amount of capital they did in 2019, and there is no sign of abating as SPACs have already raised more money this year than in 2020.

Contact Details
Phone: +27 10 020 6777 | Email: invest@investsense.co.za | www.investsense.co.za

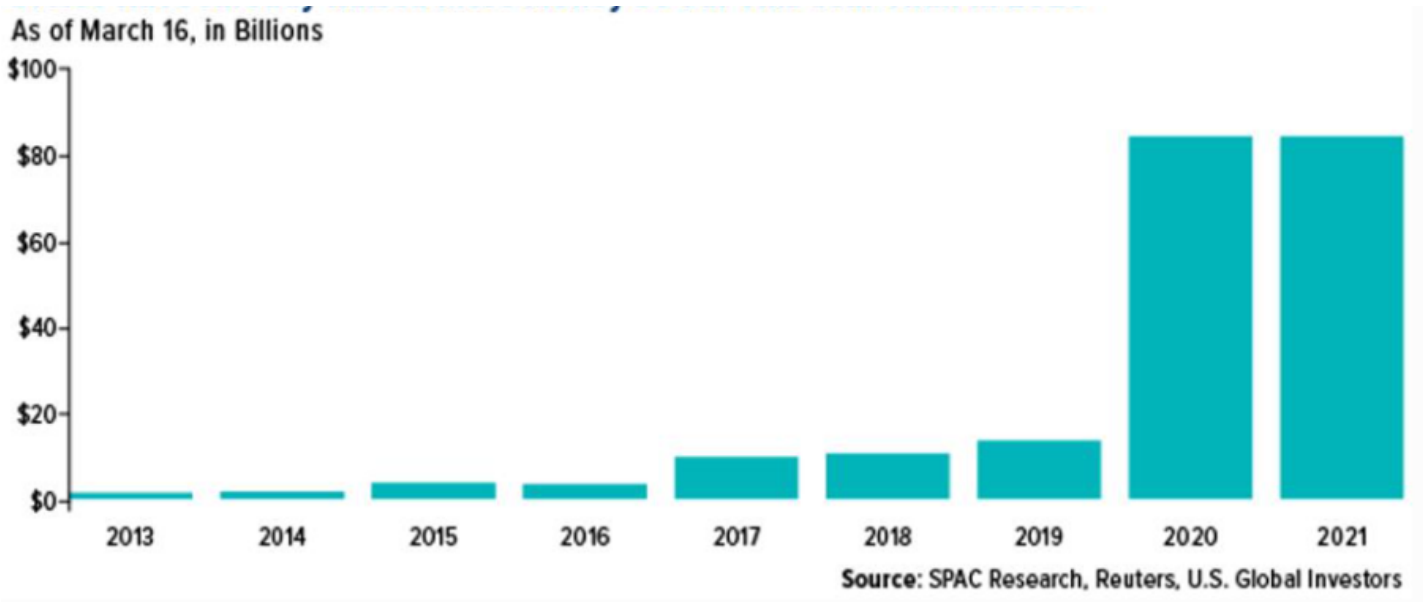

Figure 1: Capital Raised by SPACs

Because of this investor demand to invest in the next 'big thing', SPACs have focused on sectors that have given rise to some of the most successful and quickest growing companies in recent history. Below we can see which sectors have been favoured by SPACs. It should come as no surprise then that SPACs have focused on finding opportunities in the technology sector.

Table 1: Sectors SPACs are targeting. Source: https://spactrack.net/

Sector	Mergers completed	Searching
Tech*	74%	70%
Cannabis	3%	1%
Energy	7%	7%
Healthcare	11%	15%
Media, Telecom	4%	3%
Sustainability	6%	6%

**Tech" is inclusive of "Tech", "FinTech", "Property technology", and "Biotech".*

Although the increase in investor demand is the primary reason for the rising popularity of SPACs, a SPAC is also very beneficial for their founders as well as the private companies they take public

<u>Founders</u>

In addition to their 20% shareholding, founders receive an option[3] to buy additional shares at a significant discount at a future date, in exchange for providing the initial upfront capital. The result of this is that a founder will receive a sizeable shareholding in exchange for very little upfront investment.

Contact Details
Phone: +27 10 020 6777 | Email: invest@investsense.co.za | www.investsense.co.za

Private Companies looking to list

Taking a company public via a SPAC is much easier than going through the traditional IPO process. Firstly, it is quicker, as a standard IPO process can take anywhere between 8 – 18 months, whereas with a SPAC this can be done in under six months. Secondly, because the SPAC is already a listed business and has gone through the IPO process themselves, the regulatory requirement is far less, as the private company does not need to go through the full rigorous IPO process. This allows these companies to get around the upfront regulatory framework, which is why this SPAC process is sometimes referred to as an 'arbitrage on regulation'.

So far so good then … Not so much

At this point you might be thinking that the story so far sounds like a good one, as SPACs provide an investment vehicle that benefits all parties involved. However, like many investments, if the story sounds too good to be true then it probably is.

Digging a little deeper we realise that once again this is a case of large institutional investors benefitting at the expense of the everyday investor. Below we look at some of the reasons why this is the case.

1. Poor long-term performance

The performance of SPACs between the time of listing and the actual merger is often very good. A study performed in December 2020[4] found that out of the 193 SPACs still looking for investment opportunities, only one was trading below their initial share price. It is often at this point that everyday investors get lured in by the hype and the promise of opportunity to invest. Like the recent GameStop debacle, this hype is often created by online message boards such as Reddit and other media that speculate about the potential of an investment.

Unfortunately for investors, the performance of SPACs after a merger has been far more disappointing compared to the pre-merger hype and promise. In fact, a recent study[5] that examined 47 SPACs that merged between January 2019 and June 2020, found that on average SPACs lost about a third of their value in the 12-month period following a merger.

Despite this, retail investors remain keen to invest. This is likely due to the attention drawn by the few SPAC mergers that have generated significant returns, such as Virgin Galactic and Draft Kings. These success stories help feed the narrative that SPAC investing provides an avenue for everyday investors to profit from access to high-tech, disruptive industries[6].

This however is not the case for *founders* and *pre-IPO investors* (who are largely institutional investors) as the same study found that 58% of early investors (pre-IPO) sold their investment prior to the merger and received an average return of 11.6%. SPAC sponsors did even better by achieving an average return of 32% for the 12-month period post the merger.

2. Conflicts of Interest

One of the biggest criticisms of the SPAC structure is the inherent conflict of interest that sits between the sponsor and everyday investors. This conflict arises because a sponsor only gets 'paid' (i.e receives their 'promote') when a deal is made. Therefore, it is in their best interest to get a deal done and *not* to drive a hard bargain when negotiating and risk losing the deal – something that would be in the investor's best interests.

This conflict can also lead to situations where a weaker company that is not able to list via the traditional IPO process chooses the SPAC route instead. A good example of this is WeWork, who announced in March this year that it planned on listing via a SPAC called BowX. This comes after its failed IPO in 2019 after it struggled to explain issues raised about its business model and governance during the due diligence process.

Contact Details
Phone: +27 10 020 6777 | Email: invest@investsense.co.za | www.investsense.co.za

Putting it all together

With such a sharp rise in the popularity of SPACs and the speculative nature of the investments, many market commentators have likened this SPAC mania to the tech bubble and are predicting this will all come crashing down. Although the odds do not seem to be in the end investors favour, it is too early to say whether this will be the case. However, for us one thing remains true, focusing on the fundamentals of an investment and understanding what you are investing in, versus taking a speculative bet chasing big returns, will more often than not lead to a much better investment outcome.

---

[1] https://www.pwc.com/us/en/services/deals/library/us-capital-markets-watch.html

[2] When a private company first sells shares of stock to the public, the process is known as an initial public offering (IPO). In essence, an IPO means that a company's ownership is transitioning from private ownership to public ownership

[3] Options are financial derivatives that give buyers the right, but not the obligation, to buy or sell an underlying asset at an agreed-upon price and date.

[4] https://www.investec.com/en_gb/focus/economy/lost-in-spacs.html

[5] https://corpgov.law.harvard.edu/2020/11/19/a-sober-look-at-spacs/

[6] https://ourfinancialsecurity.org/2021/02/letters-to-congress-letter-urging-congress-to-address-risks-in-growing-spac-mania/

Contact Details
Phone: +27 10 020 6777 | Email: invest@investsense.co.za | www.investsense.co.za

InvestSense

March 2021

data provided by Reuters and Datastream

MARKET REPORT

31/03/2021

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	13.1%	13.1%	54.0%	9.7%	8.2%	10.9%	15.2%	13.4%
FTSE/JSE SA Listed Property	ZAR	6.4%	6.4%	34.4%	-12.9%	-9.0%	4.4%	25.3%	20.7%
SA All Bond Index (ALBI)	ZAR	-1.7%	-1.7%	17.0%	5.5%	8.7%	8.2%	8.2%	7.9%
SA Cash Index (SteFI)	ZAR	0.9%	0.9%	4.6%	6.4%	6.8%	6.3%	0.3%	0.3%
Balanced Benchmark	ZAR	7.2%	7.2%	33.8%	9.7%	8.0%	11.2%	10.5%	8.9%
SA Inflation (1 month lag)	ZAR	1.2%	1.0%	2.9%	4.1%	4.4%	5.1%	1.2%	1.3%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	5.0%	5.0%	54.8%	13.4%	14.0%	10.5%	14.6%	14.0%
Emerging Markets Equity (Datastream EM)	USD	2.3%	2.3%	58.9%	6.9%	12.5%	4.0%	16.4%	17.7%
Global Property	USD	6.2%	6.2%	32.3%	7.3%	6.3%	7.4%	14.2%	14.7%
Global Bonds (Barclays Global Bond Index)	USD	-5.7%	-5.7%	1.8%	2.1%	2.1%	1.7%	5.4%	5.1%
Global Cash	USD	0.0%	0.0%	0.3%	1.6%	1.4%	0.9%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	13.1%	13.1%	54.0%	9.7%	8.2%	10.9%	15.2%	13.4%
Global Equity (Datastream World)	ZAR	5.6%	5.6%	28.0%	22.1%	14.1%	19.5%	16.9%	14.5%
Emerging Markets Equity (Datastream EM)	ZAR	2.9%	2.9%	31.4%	15.0%	12.6%	12.5%	14.4%	13.4%
Global Property	ZAR	6.8%	4.8%	9.4%	15.5%	6.4%	16.1%	16.7%	14.3%
SA All Bond Index (ALBI)	ZAR	-1.7%	-1.7%	17.0%	5.5%	8.7%	8.2%	8.2%	7.9%
Global Bonds (Citigroup)	ZAR	-5.2%	-5.2%	-15.8%	9.9%	2.2%	9.9%	16.3%	14.5%
COMMODITIES									
Gold (US Dollars)	USD	-10.2%	-10.2%	5.7%	8.8%	6.7%	1.7%	13.3%	16.1%
Gold (Rands)	ZAR	-9.7%	-9.7%	-12.6%	17.1%	6.8%	10.0%		
CURRENCIES									
Rand / Dollar	ZAR	-0.5%	-0.5%	17.3%	-7.6%	-0.1%	-8.1%	16.8%	15.5%
Rand / GBP Pound	ZAR	-1.5%	-1.5%	8.0%	-7.0%	0.7%	-6.5%	17.7%	14.7%
Rand / Euro	ZAR	3.4%	3.4%	11.4%	-6.0%	-0.7%	-6.1%	15.5%	13.7%

Spot Rates		31-Mar-21	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	14.77	14.69	17.97	14.71	6.76	7.99
Rand/GBP	Rand	20.38	19.88	22.30	21.16	10.85	11.48
Rand/EUR	Rand	17.35	17.97	19.82	16.76	9.59	7.05
RATES							
Libor 6m $	US$	0.21	0.26	1.09	0.90	0.46	4.71
Repo Rate	Rand	3.50	3.50	5.25	7.00	5.50	12.00
Prime	Rand	7.00	7.00	8.75	10.25	9.00	14.50
All Bond Index Yield	Rand	10.24	9.62	11.84	9.53	8.75	9.74
COMMODITIES							
Gold ($/oz)	US$	1 704.74	1 897.77	1 621.69	1 234.34	1 437.13	260.65
Platinum	US$	1 182.00	1 068.00	726.00	976.00	1 773.00	567.00
Oil (Brent Crude) $	US$	63.52	51.89	22.79	39.95	116.84	24.34
INFLATION							
SA Inflation	%	2.9	3.1	4.1	6.3	4.1	9.4

Email: adviser@fundhouse.co.za | Web: www.fundhouse.co.za