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SPACs: Opportunities and risks for investors in Europe

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Special Purpose Acquisition Companies (SPACs) have been booming in the US. In 2020 alone, SPACs raised more than USD 83 billion in the United States. Also in 2020 and in the US, about 55% of IPOs were by SPACs. And now the SPAC wave has hit Germany, France and the rest of Europe.

SPACs are shell companies that are set up in order to acquire private companies and then take them public. The following current example illustrates how SPACs work. Klaus Hommels, the founder of the Zurich-based investment firm Lakestar Advisors, took his first step as a sponsor by launching a Luxembourg-based SPAC focused on European technology companies. In a second step, Lakestar SPAC I was floated, with its IPO reportedly eight times oversubscribed. The SPAC's management team, led by Stefan Winners (CEO) and Inga Schwarting (CIO), track potential acquisition targets in the European technology sector with the goal of taking over an IPO-ripe company. In the private placement 27.5 million units were on offer at EUR 10 each, each one consisting of one share and 1/3 of an option with a strike price of EUR 11.50. Since 22 February 2021, the issued SPAC shares and options have traded separately on the Frankfurt market. Lakestar SPAC I first quoted at EUR 11.15. Since then, it has traded within a range of between EUR 12.02 (its high so far, on 22 February 2021) and EUR 10.08 (its low so far, on 26 April 2021).

The example of Lakestar SPAC I illustrates the opportunities and risks of SPACs – investors entrust their funds to the most experienced management team possible in the hope that it will fill its empty shell with an attractive takeover that will push up the SPAC's market value. When SPACs come to market, they may have no track-record of revenues or profits to report, numbers that generally help guide investors. Moreover, at the time of the IPOs, most investors don't know what the SPAC's takeover target will be. They are literally buying "the pig in a poke".

That is why SPACs are also called "blank-cheque companies". They became prominent in the US in the 1980s and, after many scandals, became more strictly regulated in the 1990s with the Penny Stock Reform Act and SEC Rule 419.

In Europe, experienced entrepreneurs have caught SPAC fever in the past few months, with capital pairing off with expertise. Bernard Arnault, who – with the luxury goods group LVMH – has become one of the world's richest men, is working on the launch of SPACs Pegasus Acquisition Co. Europe together with former UniCredit boss Jean Pierre Mustier and ex-head of Bank of America's investment bank, Diego De Giorgi. Pegasus floated in Amsterdam on 29 April 2021. Francois Pinault, who became a billionaire with Kering and Gucci, has joined the EUR-345-million, New-York-listed SPAC launched by former Credit Suisse CEO Tidjane Thiam. Ex-Commerzbank head Martin Blessing, meanwhile, has teamed up with some A-list partners to launch European FinTech IPO Company 1 (EFIC1), raising about EUR 415 million. The EFIC1 SPAC is trading on the Amsterdam market. These examples show that SPACs have also been catching on increasingly in Europe in recent months. While the SPAC boom has roared ahead in the US, attracting more and more top-tier athletes and celebrities as sponsors, Europe is just getting started. In Europe, the vast majority of SPACs are launched and managed by experienced specialists.

Through SPACs, smaller companies gain access to capital without giving up control to private equity firms or slogging through a lengthy market-listing process. SPACs are also attractive to investors, as an average 97% of capital raised will be parked in a trust, to be paid back with interest if sponsors are unable to make an acquisition, something that typically takes 18 to 24 months. This deadline can often be extended. Sponsors generally acquire warrants at the time of the IPO, typically at a price of USD 1.50 for a USD 10 unit price. The funds raised can be used to pay off the IPO fees and costs. In this way, investors' capital is relatively well protected until the IPO. Investors are also protected by regulations requiring their consent for a takeover. If they refuse their consent, they get their invested capital back with interest. This is why experienced hedge fund managers and other institutional clients are among the largest SPAC investors. Upon the IPO, sponsors often invite PIPE (Private Investment in Public Equity) investors to put up additional funds in order to redeem investors who so wish and to raise capital for takeovers.

SPACs' drawbacks include the often-outsized incentive structure for sponsors, who typically get 20% of the SPAC for USD 25,000, even as investors are pouring millions of dollars into the SPAC. In November 2020, the *Financial Times* reported on the steep profits of sponsors around the former Citigroup Investment Banker Michael Klein, who brought Clarivate Analytics to market via a SPAC and then paid himself USD 60 million for his original share of USD 25,000 after just two years, and then still held a USD 400 million stake in the company (Figures: *FT* of 23 November 2020). We would like to see lawmakers and regulators enact more transparent and longer-term incentive systems for sponsors in Europe. Sponsors' high capital holdings are a good thing from the investor's point of view. After all, whoever has long-term “skin in the game“, is more careful in seeking out successful investments and in developing them fully. An academic study conducted by Gahng, Ritter and Zhang in March found that SPAC IPO investors had achieved attractive average returns over an eight-year observation period. Post-merger, however, investors in shares emerging from a SPAC achieved an equally weighted return of -15.6% and, hence, a 24.3% underperformance vs. the overall market.[1)] The early bird does indeed get the worm when it comes to SPACs.

On May 2, 2021, the FT reported that SPACs had fallen by two-fifths on average from their highs. As there are signs of exuberance in the SPAC market especially in the United States, we recommend carefully considering the risks – including dilution risks stemming from excessive benefits to sponsors – and only invest in blank-cheque companies with a very strong growth profile.

To sum up: In Europe as well, SPACs will be competing increasingly with private equity firms and strategic bidders for technology companies, fintechs and other IPO-ready growth companies. While things are already getting out of hand in the US, Europe is still in an early phase in the development of its SPACs. In addition to selecting management teams, a careful analysis of a SPAC's incentive structure is crucial before investing. From the investor's point of view, high sponsor capital holdings, long post-IPO management lock-ups and enhanced transparency are desirable. The mistakes that have arisen from flawed incentives in the US do not necessarily have to be repeated in Europe.

1) M Gahng, JR Ritter, D Zhang (2021), SPACs (March 2nd, 2021), available on the website of the Social Science Research Network

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