SPAC CRIB SHEET: WHAT INVESTORS NEED TO KNOW BEFORE THEY INVEST

The mission of CFA Institute is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

CFA Institute, with more than 170,000 members worldwide, is the not-for-profit organization that awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations. CFA®, Chartered Financial Analyst®, AIMR-PPS®, and GIPS® are just a few of the trademarks owned by CFA Institute. To view a list of CFA Institute trademarks and the Guide for the Use of CFA Institute Marks, please visit our website at www.cfainstitute.org.

© 2022 CFA Institute. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the copyright holder. This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Contents

Introduction 1

Setting the Scene 2

Key Considerations 3

1. Highly Speculative Investments 3
2. Financial Market Engineering 3
3. SPAC Units, Shares, and Warrants 3
4. Trading SPACs pre-IBC 3
5. Sponsor Conflicts 4
6. Merger Announcement Trading 4
7. Redeeming SPAC Shares 5
8. Long-Term Prospects for SPAC IBC Investments 6

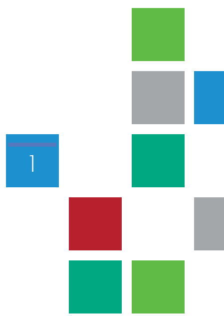
© 2022 CFA INSTITUTE. ALL RIGHTS RESERVED.

This page intentionally left blank

Introduction

Special Purpose Acquisition Companies (SPACs) typically involve a two-part process of first raising capital from public investors in a SPAC initial public offering (IPO) and then using this capital to invest in a private operating business. That business becomes a public company in what is referred to as the initial business combination (IBC). The result is two distinct phases to SPAC investing. The first phase, investing in the SPAC IPO shares at $10 per share, comes with principal protection—that is, investors can redeem these shares and receive $10 per share back if they do not want to invest in the proposed IBC. The second SPAC investing phase begins with the completion of the IBC. Owning shares in the post-IBC company is akin to traditional public equity investing and no longer comes with redemption rights or principal protection.

© 2022 CFA INSTITUTE. ALL RIGHTS RESERVED.



Setting the Scene

A Record Numbers of SPAC IPOs. The mounting numbers of SPACs already in the public market pose growing investor protection concerns. With more than 700 SPACs in various stages in the marketplace this year and dozens more SPAC IPOs coming online each month, investors should be aware that competition is fierce. Most of these SPACs will be competing to find a merger target this year to complete an IBC. Investors must understand the key risks. SPACs or "blank-check companies" (as they historically were called) initially present a risk-free yield opportunity, yet owning SPAC shares is essentially a bet on the SPAC management's ability to complete an IBC. Little information is available about the SPAC at the time of the IPO and no information is provided about its ultimate IBC target. Investors literally give the SPAC management (the "sponsor") a blank check.

Two SPAC Investment Phases. Retail investors should understand the investment prospects of this complicated SPAC structure and must frame their performance expectations for a SPAC investment in each of the two phases noted. Each phase has important nuances and risks to consider.

SPACs as a Trading Strategy. Retail investors who seek to invest in the SPAC shares and treat them as a trading vehicle, should fully understand how the structure works; the different securities involved, including shares, warrants, and rights; and how to take advantage of (arbitrage) the $10 redemption price. In short, traders can attempt to buy SPAC shares for less than $10 and later redeem them for $10 to play the risk-free yield opportunity. This process, however, requires paying vigilant attention to redemption periods and having some familiarity with corporate actions. Many professional investors use the SPAC structure in these ways without considering fundamental investments in SPAC target companies after the redemption opportunity has been presented.

SPACs as a Long-Term Investment Strategy. Long-term investors who buy a SPAC with the intention of holding through the IBC to participate in emerging growth opportunities, must understand this: successful, long-term venture capital investing requires (1) a diversified portfolio of plausible business prospects (not celebrity sponsors or futuristic dreams) and (2) a holding period of five to seven years. Picking one or two SPACs on a whim and expecting to strike performance gold is more like buying a lottery ticket.

Key Considerations

CFA Institute created this "SPAC Crib Sheet" for investors to highlight the key structural, risk, and conflict issues that investors should understand as they consider these SPAC investment vehicles.

1. Highly Speculative Investments

SPAC investments can be complex and speculative once the redemption opportunity has passed.

2. Financial Market Engineering

These structures are used by financial engineers and professionals, primarily for their benefit and the benefit of the target company. SPAC sponsors can have more advantageous financial outcomes than other SPAC stakeholders depending on the completion and performance of the IBC.

3. SPAC Units, Shares, and Warrants.

- SPAC Components. An investment in the SPAC public shares (before the merger) has component parts.
- Trading of Components. Understand the differences among SPAC units, shares, and warrants, and how each security will trade.
- Warrants. Understand how the warrant works, including its term, strike price, and whether they are "fractional" or "callable."

4. Trading SPACs pre-IBC

- Promotional Factors. Be aware of rumors and other social media hype. These shares are particularly vulnerable to IBC speculation and celebrity sponsor attention because they lack other fundamental information.

© 2022 CFA INSTITUTE. ALL RIGHTS RESERVED.

- Track Record. Understand if the sponsor has any experience or track record with other SPACs or otherwise finding profitable acquisitions.

- Redemption Rights. Investors can redeem their shares for only $10 at the time of the IBC. If they pay more than $10 in trading leading up to the IBC and then redeem, they will lose money (see "7. Redeeming SPAC Shares").

- No IBC. If the sponsor cannot find a merger target within 18–24 months, the SPAC typically terminates and returns funds to SPAC investors. This is known as a *no-deal* event. Again, even if an investor has paid more than $10 per share, they will receive only $10 per share in a liquidation scenario.

5. Sponsor Conflicts

- SPAC Liquidation Consequences. A SPAC sponsor must find a merger target and complete an IBC within the allotted time limit or liquidate the SPAC. In this *no-deal* scenario, the expenses and fees related to the original SPAC IPO will not be reimbursed to the sponsor and the sponsor's free shares and warrants will become worthless.

- Liquidation Consequences May Affect the Quality of the IBC. The sponsor has the objective of finding a strong merger target and completing the IBC. Faced with the choice of a weak target and avoiding a liquidation, however, the sponsor is highly incentivized to move forward with merger targets of any quality. Ultimately, the market will weigh in on IBC quality. Investors should be cautious holding on to shares past redemption for any SPAC that is trading below its cash-in-trust value per share at the time of the shareholder meeting.

- Increased Performance Risk. Investors need to consider the merger quality and potential no-deal conflict when deciding whether to redeem their SPAC shares and receive their funds back.

6. Merger Announcement Trading

- Gap Trading. Investors are able to trade the SPAC shares after the merger announcement but before the SPAC files legally required and regulated merger registration and proxy statements (the information gap).

- Lack of Fundamentals. During this information gap, investors who trade will be doing so on rumor, hype, speculation, and minimal regulatory or other detailed information about the target company or IBC.
- Buying Above $10 per Share. If investors purchase SPAC shares for more than $10 during the gap, they will lose money when they redeem these shares. They will receive only the redemption price—typically $10 per share plus interest.

7. Redeeming SPAC Shares

- Right of Redemption. Investors must know their rights and the *deadline* for redeeming shares.
- Merger Vote. SPAC shareholders can vote in favor of the merger and still redeem their shares.
- Redemption Amount. If investors redeem, they typically receive $10 plus a small interest earnings per share.
- Holding the Shares. If investors do not redeem their shares, they will receive shares in the new IBC company. IBC shares may or may not trade at $10 once public trading begins.
- Key Considerations When Deciding to Redeem:

  i. know as much as possible about the target company,

  ii. identify whether the sponsor has expertise in the target company's business sector,

  iii. identify if and for how long the sponsor is locked up from selling their IBC shares,

  iv. identify if and for how long other anchor investors like private investment in public equity (PIPE) investors are locked up from selling their IBC shares, and

  v. confirm the sponsor's track record in operations, mergers and acquisitions generally, and other SPACs specifically (this information is in the IBC documentation).

© 2022 CFA INSTITUTE. ALL RIGHTS RESERVED.

8. Long-Term Prospects for SPAC IBC Investments

- IBCs as Venture Capital Investments. Many recent IBCs have been for emerging growth-stage companies. Such investments may have a return profile similar to that of venture capital and may experience a higher failure rate than more traditional or mature public companies.

- Track Developments. Investors should know something about the emerging business they are invested in and follow its progress.

- Holding Period. Accept the notion that early stage firms may take several years to emerge as profitable and successful growth companies.

- Diversified Approach. Be aware that early stage firms generally have high failure rates. Professional venture capital investors own a diversified portfolio of firms to balance out winners and losers. Buying one or two SPACs that are acquiring early stage companies, and holding shares through the redemption deadline, is a risky strategy.