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SPACs Flame Out in SPACtacular Fashion. Was It Inevitable?

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Within just a few years starting in 2019, Special Purpose Acquisition Companies (SPACs) went from being an innovative pathway for young high-growth companies to access public markets to a downtrodden asset class. Many factors, including the public markets' softened acceptance of "story stocks" and the dramatic increase in yields on short-term cash and near-cash assets, led to the selloff in SPAC stocks overall.

What started off as way for companies to tap into pre-committed capital combined with a public listing, while holding out the prospect for additional capital in the future through follow-on offerings, did not materialize for most SPAC stocks. While some may criticize the SPAC structure for the ultimate stock price performance, it is also likely a reflection of the industries targeted by many SPACs (*i.e.*, early stage, capital-intensive, tech-enabled companies, such as fin-tech, bio-tech, ag-tech, space and electric vehicles), whose public- and private-market valuations exhibited high volatility during the two-year period following the peak of SPAC activity.

There is an ample body of literature on the mechanics of the SPAC structure and the role played in taking companies public in recent years in lieu of a traditional initial public offering (IPO), including some excellent primers on SPACs.[2] This article will not go over that covered ground — assuming that the reader has familiarity with SPAC basics — and will instead focus on quantifying the relative underperformance since 2022 of SPACs that completed business combinations (also known as reverse mergers[3] or de-SPAC transactions) in recent years. The article also will generally discuss possible causes of these poor results. Moreover, there are also some excellent articles on financial bubbles worth reading, one of which describes the finding that a mere price increase arising from highly speculative interest by investors does not necessarily presage subsequent steep declines (*i.e.*, a "bubble"), but in fact suggests at best a 50/50 probability of continued price appreciation or a dramatic reversal.[4]

Too Much of a Good Thing?

SPAC IPOs (*i.e.*, the creation of a blank-check company and the raising of equity capital earmarked for an eventual business combination) represented a significant portion of IPO proceeds raised in 2019-22, raising extraordinary amounts of investment capital. Nearly 750 U.S. SPAC IPOs of at least $100 million were completed from 2019-22, totaling $210 billion of equity capital raised by SPACs in four years, with the lion's share occurring in 2021, when 479 SPAC IPOs raised $126 billion (see Exhibit 1).

The average size of a SPAC IPO was $280 million. The huge popularity of SPAC IPOs in 2020-21 coincided with an all-in, risk-on attitude of speculative investors and broad gains across equity markets during this period of near-zero interest rates, and likewise ended abruptly in 2022 when financial

1 The views expressed herein are those of the authors and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates or its other professionals.
2 Christopher S. Auguste, Adi Herman & Ernest S. Wechsler, "A SPAC Primer," Kramer Levin Naftalis & Frankel LLP (March 1, 2021), *available at* kramerlevin.com/en/perspectives-search/a-spac-primer.html; Max H. Bazerman & Paresh Patel, "SPACs: What You Need to Know," *Harvard Bus. Review* (July-August 2021), *available at* hbr.org/2021/07/spacs-what-you-need-to-know; Ramey Layne & Brenda Lenahan, "Special Purpose Acquisition Companies: An Introduction," Harvard Law School Forum on Corporate Governance (July 6, 2018), *available at* corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction (unless otherwise specified, all links in this article were last visited on Oct. 23, 2023).
3 It is referred to as a reverse merger because the target company is legally the acquiring entity and merges with the SPAC or SPAC subsidiary, which ceases to exist once the merger has been completed. From a legal perspective, the target company is the acquirer in a de-SPAC transaction while the SPAC is the target, hence the term "reverse merger." Yes, it is confusing.
4 Robin Greenwood, Andrei Shliefer & Yang You, "Bubbles for FAMA," *Journal of Fin. Econs.* 131 (2019) 20-43, *available at* scholar.harvard.edu/files/shleifer/files/bffs_20170217.pdf.

markets turned negative in response to the Fed's aggressive pivot to restrictive monetary policy, with just 32 SPAC IPOs raising $7 billion last year.

The completion of a SPAC IPO sets the clock ticking for its sponsor, who must identify a suitable target for a business combination, negotiate a transaction, conduct due diligence, get regulatory approval, solicit shareholder approval and consummate a reverse merger — all of which must be completed within two years following the IPO offering for the vast majority of SPACs. Failure to complete a de-SPAC transaction within the mandated time frame would require a sponsor to either get approval to extend the life of the SPAC investment period, or liquidate the SPAC, lose most or all of its at-risk capital (typically 2 percent to 3 percent of the total IPO proceeds) and return 100 percent of investors' equity capital from the SPAC trust, thereby rendering the sponsor's approximately 20 percent promoted interest (*i.e.*, founder shares or Class B shares) worthless.

All told, that is a considerable economic cost for a SPAC sponsor unable to complete a business combination — not to mention the time and effort expended in this endeavor. This provides strong incentives for a sponsor to get a deal done, a core tenet by which SPAC investors chose SPACs to invest in. However, it is potentially problematic when hundreds of SPACs are searching the deal landscape to find suitable merger targets. While some market participants have pointed to "over a thousand" so-called unicorn companies (with private market values over a billion dollars) as a target-rich environment for SPACs, the market lost steam in successfully winning over enough companies to satisfy the number of SPACs seeking deals.

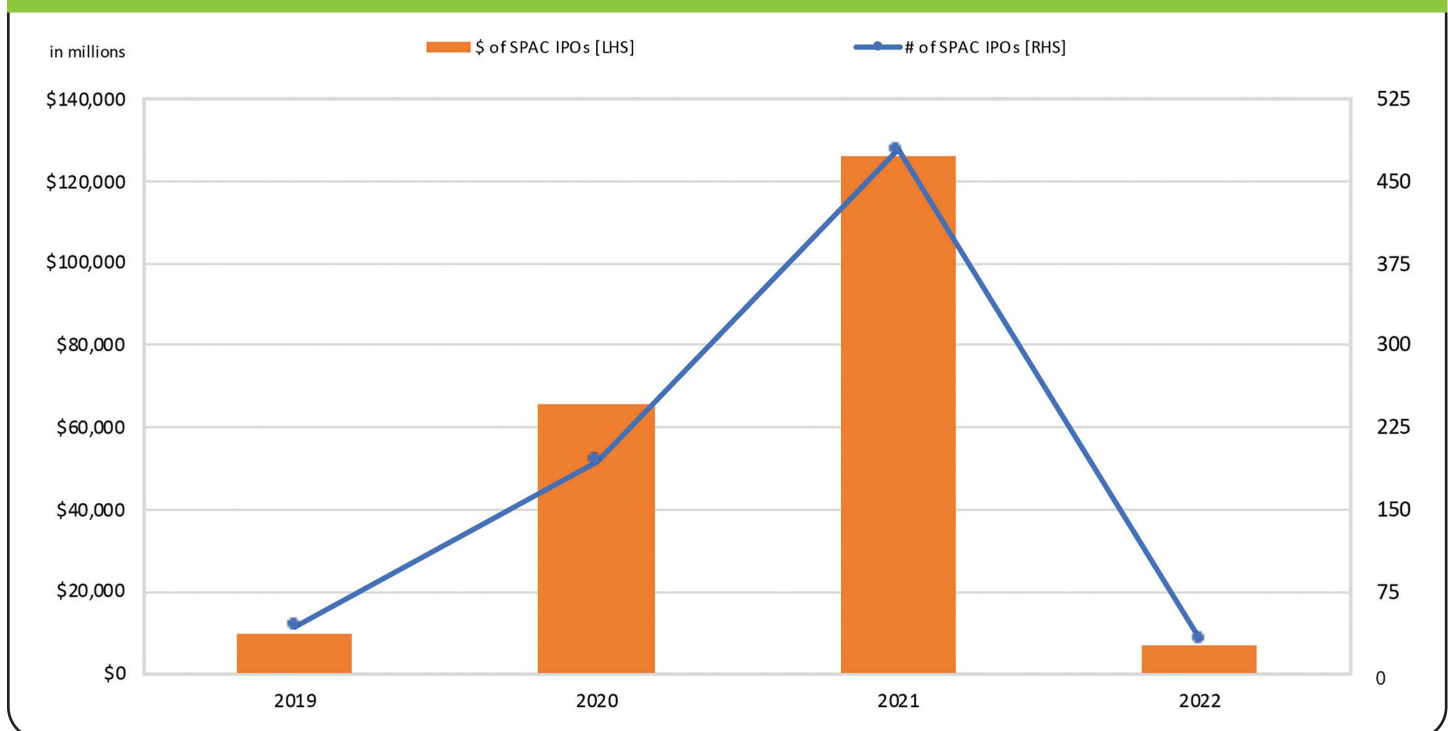
The data bears this out: While 76 percent of SPAC IPOs completed in 2019-20 were acquired by mid-2023 (*i.e.*, a de-SPAC transaction was consummated), that percentage drops to 23 percent (as of mid-2023) for the 479 SPAC IPOs completed in 2021, for which the clock is winding down to complete a business combination. The number of active SPACs peaked at year-end 2021 at 694 and declined to 326 by October 2023. Half of the active SPACs today have live deals (*i.e.*, agreements to merge with a company in a de-SPAC transaction awaiting regulatory or shareholder approval). Looking at activity for 2021, 2022 and year-to-date 2023, some 362 SPACs have closed transactions, while 288 SPACs have been liquidated.[5]

The current post-deal stock market performance for the more than 300 de-SPAC business combinations larger than $100 million completed by SPACs between 2019 and 2022 have been evaluated, and their current post-deal market performance has been disappointing. This analysis indicates that four industry sectors accounted for 76 percent of these completed de-SPAC mergers, those being industrials (22 percent), health care (20 percent), information technology (18 percent) and consumer discretionary (16 percent). No other industry sector accounted for more than 7 percent of de-SPAC deals.

This makes sense, as SPAC investors expect returns akin to IPOs in bull markets from these business combinations. Targets in mature industries with modest growth potential, such as retailing or basic manufacturing, hold little appeal. Synergy opportunities or other deal-specific growth catalysts with SPACs are often minimal, so the deal target itself must provide the oomph.

Most SPAC sponsors look for targets with attractive narratives, high growth potential or business scalability that would appeal to SPAC investors, who are expected to approve a deal but may opt to redeem their shares for cash prior to a deal closing while keeping their warrants for upside

5 U.S. SPAC Monitor by SPAC Research, Dec. 27, 2021, Dec. 27, 2022, and Oct. 16, 2023.



potential. This would drain the SPAC of cash and potentially complicate or jeopardize deal completion if enough SPAC shareholders opted for redemption.

The ability to vote the merger, then redeem shares, represents a unique risk to de-SPAC transactions from a finance standpoint, forcing the sponsors to line up additional, more permanent funding through private investment in public securities (PIPES) to provide funding for the de-SPAC companies. Furthermore, the high redemption percentages by SPAC investors beginning in late 2021 highlighted another perceived imbalance from the effective dilution resulting from the substantial ownership by sponsors through their founders' shares and warrants, as well as SPAC warrants retained by redeeming shareholders, relative to the diminished remaining equity.

SPACs had a huge run prior to 2022. Many SPAC Class A shares traded well above their $10 IPO price within days or weeks of completing an offering on the basis of a having a prominent or high-profile sponsor, despite the fact that they were shell companies with cash at that point.

Moreover, bullish market reaction to some announced de-SPAC deals was often parabolic, especially for transactions in cutting-edge investment areas, such as electric vehicles and battery technology, satellite and space-related, AI-related, and biologics/immunotherapies. Some prominent companies that have been taken public via a merger with a SPAC since 2020 include DraftKings Holdings, 23andMe, SoFi Technologies and WeWork. More recently, VinFast Auto Ltd., an unprofitable Vietnamese automaker that combined with a SPAC in a reverse merger, made headlines when its stock price increased eightfold within two weeks of deal completion, only to crash below its IPO price the following month.

Most SPACs have provided investors with long-term financial projections supporting the bullish sentiment of investors. In mid-2021, a review of projections used by SPACs over the prior five years showed that the projected compound annual growth rates of revenues had more than doubled for de-SPAC transactions announced between the 2016 and 2021 periods, and included an increasing number of less-mature, zero-revenue companies being de-SPAC'ed.[6] Many of these early-stage companies also faced the need for additional rounds of capital-raising to fund their business plans, which the poor performance of their stocks precluded.

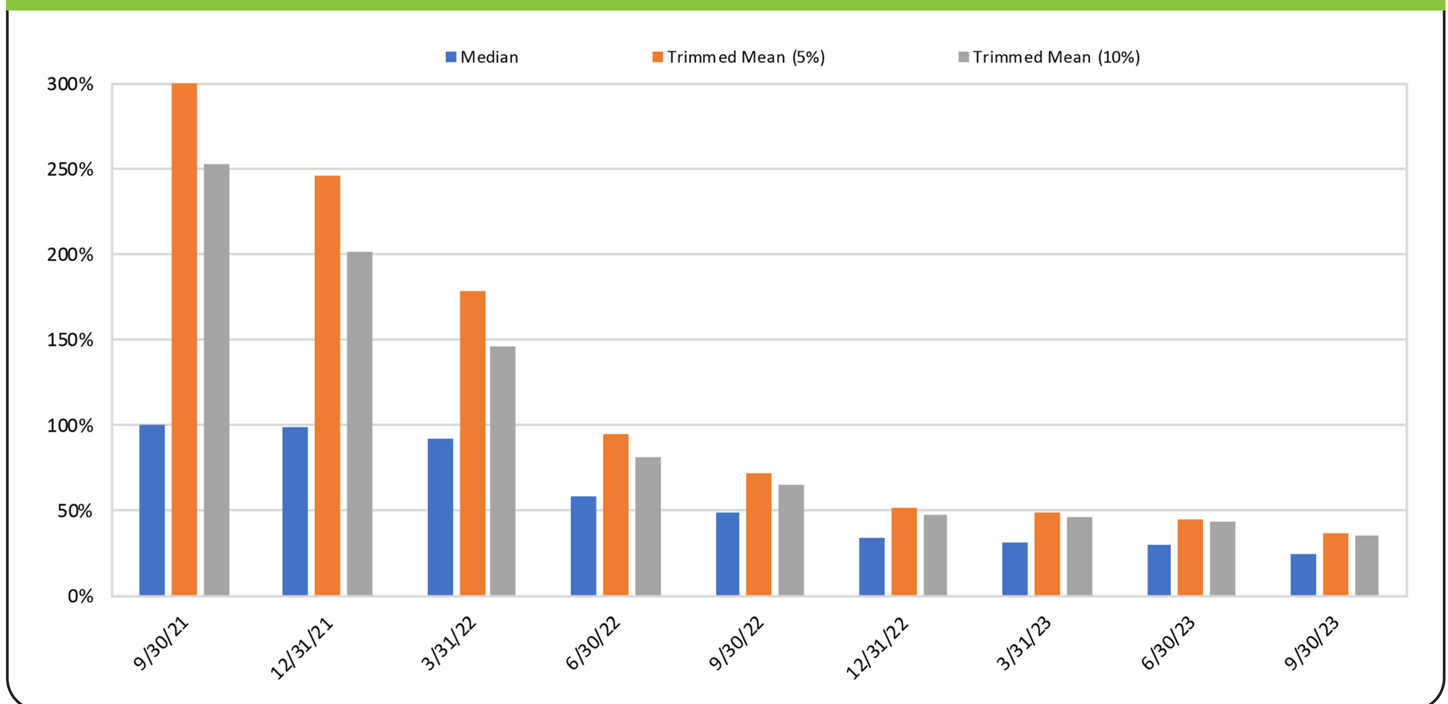
A broad composite of equity market valuations of SPACs on a post-business-combination basis is a reasonable proxy for evaluating post-deal performance, at least from a market perspective. For each of the 300-plus de-SPAC mergers that have been completed since 2019, post-deal monthly closing market prices per share relative to the SPAC IPO prices (or first trading price after the IPO) from the closing date of the business combination (*i.e.*, the reverse merger) were tracked, then computed for a monthly *price relative* ($\text{Market Price}_{\text{Month End}}$ / $\text{Market Price}_{\text{IPO date}}$) for each SPAC through Sept. 30, 2023. (A *price relative* of 100 percent would indicate that the post-merger entity is trading at the same price as its SPAC IPO price, meaning that there has been no price appreciation relative to the IPO date. A *price relative* of 200 percent would indicate that the post-merger entity has doubled in price compared to its IPO price, etc.) Monthly summary statistics of these hundreds of price relatives for the entire group of de-SPACs were compiled in Exhibit 2.

Post-merger SPAC market prices generated large positive returns from the third quarter of 2021 through the first quarter of 2022 — more than doubling on average[7] in the second

6 Stuart B. Gleichenhaus & Bill Stotzer, "Why Have SPAC Valuations Skyrocketed?," *FTI Journal* (Aug. 3, 2021), *available at* fticonsulting.com/insights/fti-journal/why-have-spac-valuations-skyrocketed (based on a client alert, "A View on Projections Used by SPACs" (July 2021)).

7 Exhibit 2 utilizes a trimmed mean summary statistic, which is an average that controls for outliers. A trimmed mean (10 percent) excludes the top 5 percent and bottom 5 percent of returns, then computes the arithmetic average of the remaining 90 percent of observations.

Exhibit 2: SPAC Prices Post-Reverse Merger Transaction (as a Percentage of the IPO Price)



half of 2021 — although these returns diminished steadily in each successive quarter. Not surprisingly, price returns of the composite group deteriorated sharply after first quarter 2022 and are currently deeply negative, with the *average SPAC trading at 35 percent of its IPO price — or a negative return of 65 percent from inception* (see Exhibit 2).

Moreover, the early high returns of the SPAC composite averages in 2021 through early 2022 were misleading, as it was dominated by a relatively small number of big outperformers, as evidenced by the median return (literally, the return for the middle value of the composite group) consistently trailing the trimmed mean returns by a wide margin, even in the best of times. The wild success of some high-profile de-SPACs in 2021 undoubtedly helped attract new capital to the SPAC space, even though these huge returns were not representative of the wider composite group. Subsequently, these outliers have come back down to earth since mid-2022, with the difference between median and trimmed mean returns having narrowed considerably since then (see Exhibit 2).

Lastly, when tabulating the number of de-SPACs trading above or below their IPO prices on a monthly basis (ignoring the amount of the return), it is evident that even in the best of times the number of de-SPACs trading above their IPO price (*i.e.*, a positive return) only slightly exceeded those trading below their IPO price (*i.e.*, a negative return) — underscoring the impact of high performers on overall return averages in the third quarter of 2021 to the first quarter of 2022 — before turning lopsided since mid-2022. *Currently, 90 percent of SPACs that have completed reverse merger transactions are trading below their IPO price* (see Exhibit 3), *a clear indicator of negative market sentiment toward SPACs at the moment*.

As for the operating results of companies acquired in a de-SPAC transaction, the data are hardly encouraging. In fiscal year 2022, 116 of the 306 de-SPACed companies (37.9 percent) with reported financial results had annual revenue of less than $50 million, including 34 companies (11.1 percent) with zero reported revenue, while 253 companies (82.7 percent) reported operating losses in fiscal year 2022. The results were negligibly better in the most recent 12-month period (LTM), with 120 of 329 de-SPACed companies (36.4 percent) with reported financial results having LTM revenue of less than $50 million, including 35 companies (10.6 percent) with zero reported revenue, while 272 companies (82.7 percent) reported LTM operating losses.

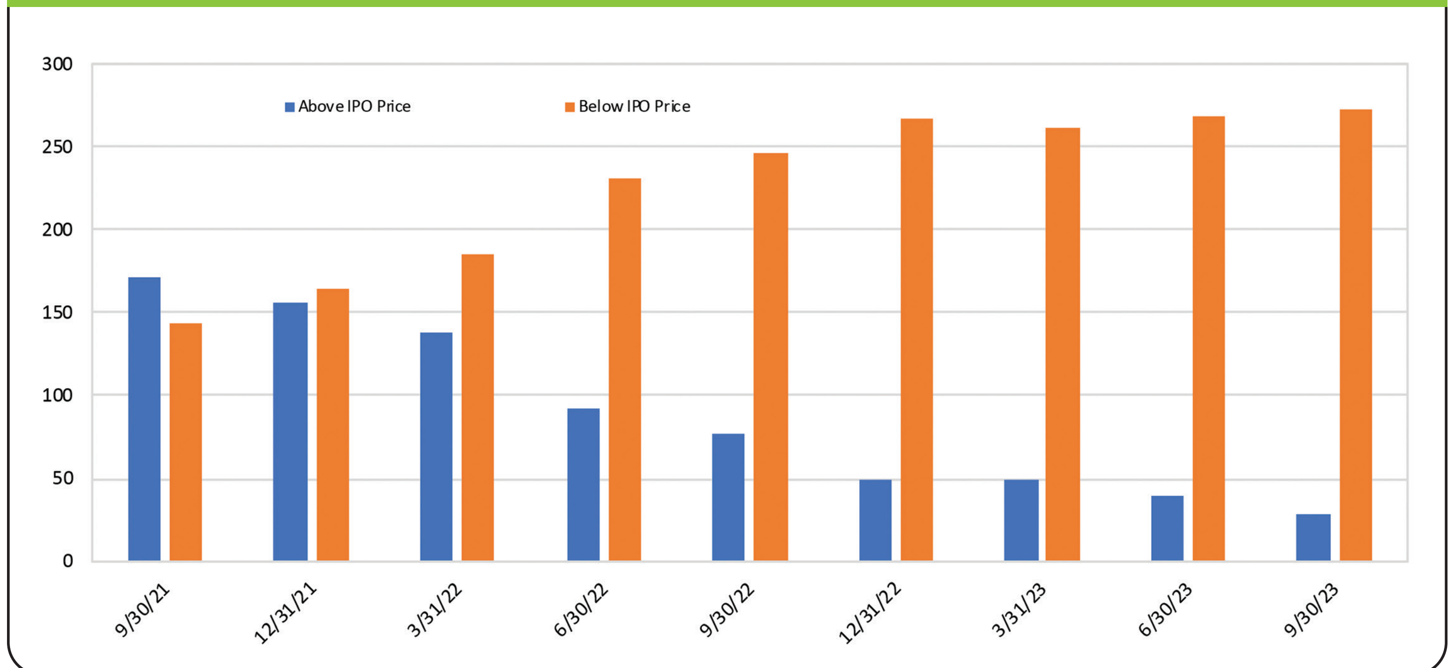
Fifteen companies that went public via a reverse merger with a SPAC already have filed for bankruptcy since late 2022.

Some observers have opined that many of these targets were not IPO-ready companies; they were more akin to middle- to late-stage venture capital-funded companies. The prevalence of modest revenues and deep operating losses for so many of them likely supports that argument.

Fifteen companies that went public via a reverse merger with a SPAC already have filed for bankruptcy since late 2022, including Lordstown Motors, Shift Technologies, Virgin Orbit Holdings, Core Scientific, Pear Therapeutics, AppHarvest, Cyxtera Technologies and Proterra. This is a high failure rate for recently public companies within a short time period. Moreover, it might only be the beginning, with 84 SPACs that have completed reverse mergers currently sporting a share price of less than $1.

SPAC skeptics were cautionary voices throughout the SPAC boom period, and their criticisms were mostly leveled at the "back door IPO" nature of the de-SPAC transac-

Exhibit 3: SPAC Prices Post-Reverse Merger Transaction (Number Above or Below the IPO Price)



tion, which lets targeted companies avoid the full scrutiny of a traditional underwritten and marketed IPO process. Some critics contend that the financial forecasts and underlying assumptions presented in proposed de-SPAC transactions were often aggressive to "sell the deal," although such commentary is anecdotal and difficult to demonstrate empirically. Other common criticisms of SPACs include the very wide latitude and discretion that sponsors have in selecting a target company to combine with, as well as potential conflicts of interest for SPAC sponsors — which are abundantly disclosed in standalone sections of offering memoranda — and the strong financial incentives for sponsors to get a de-SPAC deal done even when attractive deals are in short supply.

SPAC defenders may say that there were just too many SPAC IPOs in 2020-21 and not enough attractive deal targets, but that the inherent nature of SPACs had little to do with the many disappointing outcomes. Moreover, these deals — both the SPAC IPO and de-SPAC transaction — have to meet all regulatory filing requirements and stock exchange listing requirements, with ample disclosures and caveats for investors to consider. Furthermore, SPAC investors have the opportunity to get out whole before a reverse merger is consummated if they do not like the deal. Whomever you agree with, it seems unlikely that "that old SPAC magic" will be returning to equity markets anytime soon, while restructuring activity among struggling de-SPAC'ed companies will be picking up considerably in the year ahead. abi

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