Understanding SPACs' Hidden Capital Costs

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Over the past year, we have witnessed a boom in special purpose acquisition companies, with the SPAC method of going public seeing a meteoric rise in popularity as an alternative to the traditional initial public offering.

In 2020 alone, there were more than 200 SPAC IPOs, and that number is expected to be much larger in 2021.

Even though this method is gaining steam and has been utilized for decades now, there are still plenty of misconceptions about SPACs and their perceived cost benefits.

As the anatomy of the SPAC process reveals, there are, in fact, hidden costs of capital associated with SPACs that should be fully understood, and as with any kind of boom, we could be headed for a bust.

A SPAC involves a blank-check company, or shell company, raising money from investors in a public offering and then later merging with a target company. That merger results in the target raising money and becoming a publicly traded company.

Years ago, the target companies involved in these transactions were typically companies that were seen as not ready to go public, but today, the targets are much more sophisticated firms.

SPACs have become particularly popular today in the tech industry, as venture capital investors view them as a better liquidity solution that eliminates the pricing and timing inefficiencies of a traditional IPO.

However, while SPACs are perceived to have many benefits in terms of cost and speed, they are not always the best option. The many costs and complexities must also be taken into consideration before choosing the SPAC method.

One widely held misconception is that SPACs are faster and less expensive than the traditional IPO process. While this can prove to be true in some cases, it is not always the case.

In order to more accurately measure the total cost, various factors must be taken into account. First, the cost of capital is very high for the retail investor.

There is also the fee the SPAC would pay to the investment bank, which is a percentage of the money it raises. Total costs should also include the cost of the initial IPO for the blank check company, the money that sits in escrow for years, and the cost of the actual M&A transaction as well as its review.

In addition, the target company may incur costs associated with going public on an accelerated timeline, e.g., increased accounting fees due to financial reporting complexities.

There is also a massive overhang of sell-side supply with a SPAC. Everyone involved with a SPAC is looking to sell.

There are those with the initial purchase in the SPAC IPO, the sponsors who select the target company also receive 20% ownership and want to monetize it, and then there is the SPAC target, which has long-term shareholders.

All of these stakeholders are looking to sell, creating the need to find a new universe of long-term investors looking to buy. As SPACs are typically overhyped and end up underperforming, this creates a problem in securing those long-term buyers.

SPACs also involve lockups that can last anywhere from one to five years. As we are about to hit the one-year mark of this SPAC boom, that also means that the one-year lockups will start to roll off in the coming months, and this has the potential to bring the SPAC boom to a bust.

There is already evidence that a crash could be starting already as several high-profile SPACs declined well below their highs in February, and many are now selling for less than their cash holdings.

This kind of crash would undoubtedly be followed by a regulatory response, particularly since SPACs bypass some of the U.S. Securities and Exchange Commission's regulatory safeguards, one of the aspects that makes them a more attractive option.

As outlined above, there are myriad hidden costs spanning from the cost of the initial IPO to the final merger and everything in between. Despite these added expenses, a SPAC could still be a viable option for companies to go public.

As signs of a crash are becoming increasingly evident, it is more important than ever to fully understand the real costs of a SPAC and the implications a crash could have on the market moving forward.

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