Rodney's Take

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Attack of the SPACs

Warren Buffett famously said that he didn't buy tech companies because he wouldn't invest in something he didn't understand. There's logic in making sure you understand a business before you hand over your hard-earned money for shares in the company. That way, you can assess how the company will fare in the months and years ahead, or at least try to.

Before that can happen, the business has to exist. While that might sound basic, there's an entire industry now built around issuing shares for companies that do absolutely nothing. Ironically, they're called "special purpose acquisition companies," or SPACs. The firms have no operations and no equipment. They exist for one purpose: to merge with an as-yet unidentified private company.

If this sounds odd, it is, but it makes sense when you look at the steps required to go public.

When a private company wants to go through an initial public offering (IPO), it must file an S-1 with the Securities and Exchange Commission (SEC). For an individual, this would be like a college application wrapped in a mortgage application inside of a life insurance application, with the added bonus of being very expensive. It takes forever and the company has only modest control over when the shares hit the market. To avoid the hassle, expense, and drawn-out time frame, sometimes growing private companies merge with small, listed companies, and then the previously private company becomes the dominant business. This sort of reverse merger, where the acquired firm becomes the lead, used to be frowned upon as a backdoor way for a company that might not get approved by the SEC to hop onto a stock exchange without going through the normal channels.

But that was before investment banking firms figured out a better way to handle reverse mergers and to still make their fees. Wall Street is taking a page from Hollywood, where studios sign up executive producers to finance films, with one catch: the producers don't get to pick the film. They just get the next one in the pipeline. In this instance, investors are the executive producers.

Investment firms now create SPACs, which they duly list with the SEC through an S-1 filing and sell shares, and then they market the SPACs as available partners to merge with private companies that would like to hop onto a stock exchange in a relatively short amount of time. When that happens, the SPAC must file a disclosure statement, so there's still a bit of paperwork, but it's nothing like an S-1.

There is a catch. If a SPAC doesn't find a suitable partner within two years, it must dissolve and send all funds back to the shareholders. Those who bought at the IPO are likely to get back most of their money, but anyone who bought shares at a premium over the IPO price is likely to lose money. Remember, once the SPAC shares are issued, they trade on a stock exchange, even though the company is nothing but a shell with some cash, looking for a merger partner.

Investors who buy shares in SPACS are betting that the investment firm that created the entities will successfully merge them with quality companies that the investors would like to own. The benefit of buying SPAC shares is that investors get involved with companies at pre-IPO prices, but they take the gamble that the companies are worth buying at all.

This is a big business. So far in 2020, more than 50 companies valued at more than $22 billion have merged with SPACs, compared with 59 companies at $13.6 billion in value through all of 2019. The companies getting SPAC-ed this year include fantasy football giant DraftKings and electric-hydrogen big-rig maker Nikola. Vehicle-battery maker QuantumScape just announced that it will merge with a SPAC later this year. Charging-station maker ChargePoint also announced a deal, although it's not quite finalized.

While investment firms wine and dine institutional investors to get them to invest in SPACs, individual investors can hop along for the ride simply by searching for a list of outstanding issues available for purchase. Generally, they trade around $10 per share. You can think of them as expensive lottery tickets, since investors rarely buy one share of anything. Just like movie producers, you might make a fortune by owning the next installment of the Avengers, but you also might end up with Ishtar or Gigli.

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Got a question or comment? You can contact us at info@hsdent.com.