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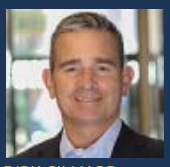
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Investment companies known as SPACs are the latest hot offering from Wall Street. We have been getting questions about how they work and whether they are a good investment. SPAC stands for Special Purpose Acquisition Company. It is a publicly traded shell company with a planned two-year life that holds only cash. Its purpose is to find a private company to merge with and thereby effectively take it public. The private company takes the SPAC's place on the stock exchange.

There are currently hundreds of SPACs either doing deals or hunting for companies with which to merge. Green energy, technology and electric vehicles are especially popular areas for SPACs right now. According to Dealogic, SPACs have accounted for about 70% of all IPOs in the first quarter of 2021 and have created renewed interest in IPOs in the last year or so.

A SPAC is created by a sponsor that forms a corporation and takes it public in an initial public offering (IPO). SPAC sponsors are typically a private equity firms or former company CEOs. Sponsors receive 20% of post-IPO equity (called the "promote") as compensation for work they do for the SPAC, as well as warrants and shares that they purchase concurrent with the IPO event. Going public through a SPAC is attractive to target companies because they can promote their firm's growth prospects and finalize their value with a small number of people in private negotiations, without the normal regulatory scrutiny and last-minute price fluctuations common in traditional IPOs.

SPACs have been around for decades and were once thought of as a "back door" method of going public. They have now become mainstream and promoted as a faster and cheaper way to go public. This might be good for private equity firm sponsors (who get 20% of a potential deal for next to nothing) and target companies, but what about the investing public?

As it is with many popular investment ideas, the investing public seems to get the worst part of the deal. The recent track record of SPACs illustrates the bottom line: according to Renaissance Capital, of the 107 SPACs that have gone public since 2015 and executed mergers, the average return on their common stock has been -1.4%. During the same period, the average return of companies that went public through IPOs was 49%, the firm says.

Some of the drawbacks of SPACs are highlighted in a March 2021 paper by three law professors at Stanford University and New York University, Michael Klausner, Michael Ohlrogge and Emily Ruan. First, they find that the cost structure of SPACs was much higher than traditional IPOs, with a median total cost (promote, warrants/rights and underwriting) of about 14%. The 25th percentile cost was about 10%, while the 75th percentile cost was about 21%, in all cases much higher than that of a traditional IPO.

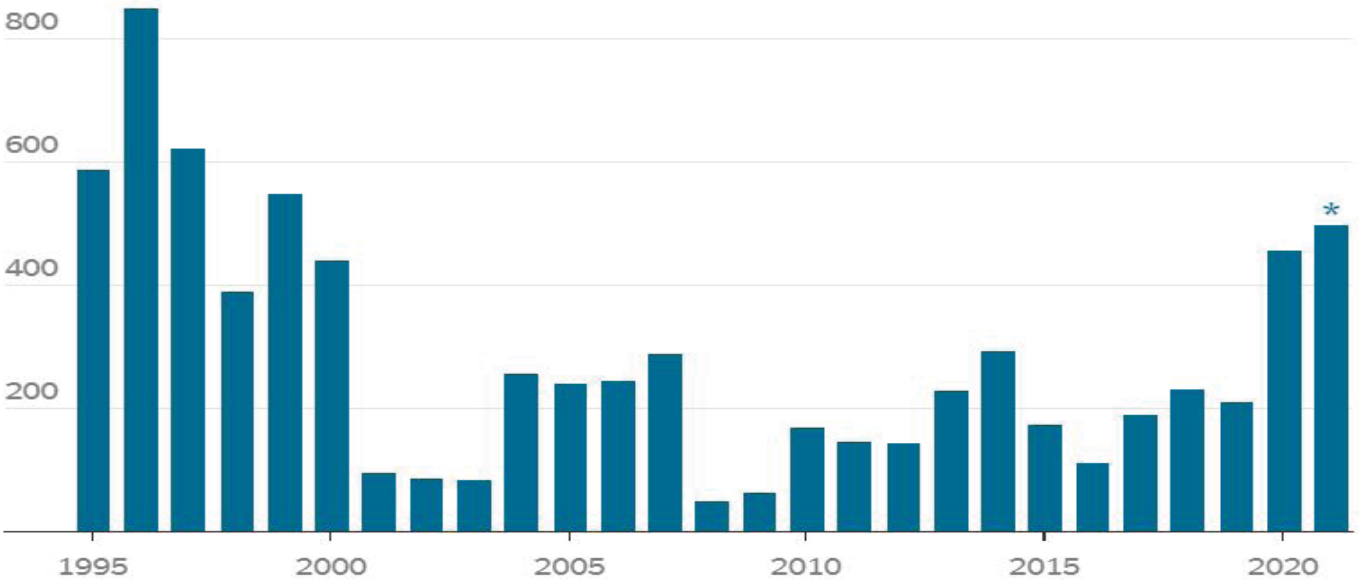
Second, the two-year life structure of a SPAC creates misalignment of incentives between the sponsor and investors. As a SPAC nears the end of its life, the sponsor has an incentive to enter into a deal that is unprofitable for investors rather than to liquidate and return investors their money. The fact that a sponsor's original investment is used to cover underwriting costs and expenses exacerbates the misalignment.

Third, reviewing SPAC returns back to 2010, there was never a year in which SPAC mergers outperformed the Russell 2000 index (the median post-merger market cap of firms in the 2019-20 Merger Cohort was $500 million, similar to the $580 million median market cap for firms listed on the Russell 2000 Index).

Klausner, Ohlrogge and Ruan conclude: "SPAC sponsors have proposed losing propositions to their shareholders, which is one of the concerns raised by the incentives built into the SPAC structure. Sponsors do quite well, even where SPAC shareholders have experienced substantial losses." They added: "It is difficult to believe that it is a sustainable arrangement. At some point, SPAC shareholders will become more skeptical of the mergers that sponsors pitch."

In April of this year, the Securities and Exchange Commission issued a bulletin and made comments about concerns they have about SPACs being too risky for individual investors. This has slowed SPAC IPOs in the last two months and it remains uncertain if any regulatory changes will be made. While it would be nice to see IPO volume recover to pre-financial crisis levels, we do not see SPACs being a sensible part of a prudent investor's portfolio.

Annual I.P.O. volume in the U.S.



* 2021 through June 10 • Source: Dealogic • By The New York Times

As always, thank you for you continued trust and confidence.

Warm regards,

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