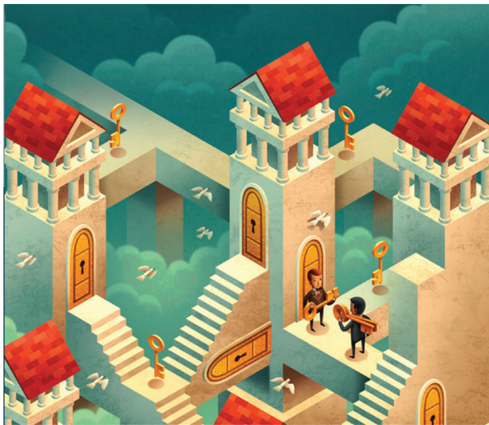

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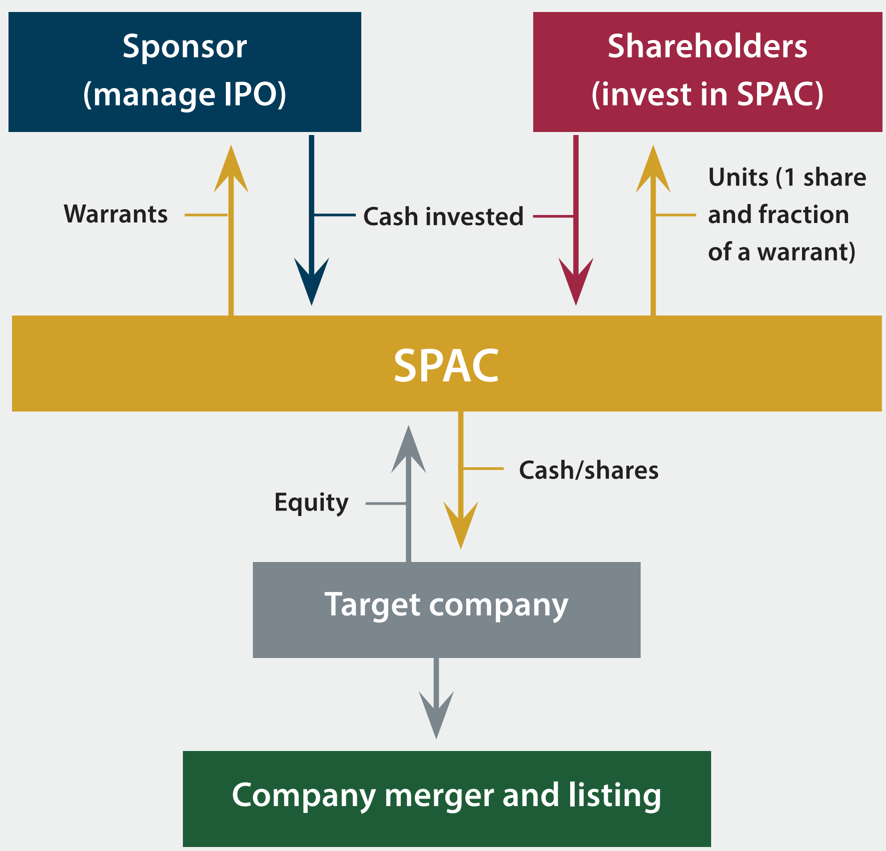
Great ExSPACtations: A Look at Special Purpose Acquisition Companies

There is no shortage of cryptic acronyms for investments and investment vehicles. These include terms like "SMA," or separately managed account – a portfolio of separately managed securities. They also include security classes, like the term "REIT," short for real estate investment trusts – companies that invest in income-producing real estate. These, and many other acronyms, have become part of an investor's everyday vocabulary. Some acronyms, however, may be less well-known, referring to less widespread, or more specialized investment categories. One that has been getting a lot of attention recently is the Special Purpose Acquisition Company (SPAC).

SPACs defined

So just what is a SPAC? A SPAC is a shell company, with funds typically raised through an IPO, which is set up for the purpose of acquiring a different, and initially unknown, private operating company. The SPAC has no other assets, no functioning operations, and does not produce or sell a "product" of any sort. It is sometimes called a "blank-check" company because when you invest in a SPAC, you do not know what company the SPAC will eventually target for acquisition.

SPAC Structure



Source: UBS, as of September 22, 2020

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SPACs are generally created by professional institutional investors or individuals with significant industry expertise. They have become an increasingly popular and easy way for a private company to go public (get listed on a stock exchange). The publicly traded SPAC merges with the acquired private company, and the merged company then becomes the listed company – with a new ticker symbol to signify the change. Some well-known recent examples include Virgin Galactic, DraftKings, and Nikola Motor Co., all of whom went public through a merger with a SPAC. WeWork is rumored to be following the trend in the months to come. According to Renaissance Capital (Renaissance), around 200 SPACs went public in 2020. KPMG reports SPACs raised a record $76.2 billion in 2020, more than the total raised through traditional IPOs in the same timeframe.

Why are SPACs so popular?

While the SPAC structure has existed for well over a decade as a way for smaller companies to raise capital, there has been significant growth in use in the past year. There are several explanations for this recent rise in popularity. Many believe it is the result of pent-up uninvested capital from the first half of 2020 (as many traditional IPOs were postponed and professional investors "sat out" the volatile period). Another explanation is the perception of an attractive risk-free rate of return for SPAC investors (during the early, pre-merger phase). For sponsors, the SPAC is an attractive way to raise funds and take a company public relatively quickly (versus a protracted and costly process for a "traditional" IPO). Finally, as we saw earlier this year, the rise of short-term traders, and their desire to find

How SPACs work

The "typical" SPAC has a lifecycle of approximately 24 months, which can be divided into three phases:

Phase	Timeframe	Description
Phase I Initial formation and IPO	8+ weeks	• Outside counsel and auditors engaged • SPAC incorporated and initial shares sold • Documents prepared and filed with SEC • SPAC terms negotiated • Shares priced and sold and fund closed
Phase II Identify and negotiate target acquisition company	Up to 19 months	• Periodic SEC filings • Identify target and conduct due diligence • Negotiate acquisition terms and agreement • Documents prepared
Phase III Approval and closing	Up to 5+ months	• Announce agreement • File preliminary documents • Obtain shareholder approval (if not approved, process begins again) • Redeem shares in original fund (with shareholders either choosing to invest in newly merged companies or take their cash) • Raise additional investment capital from institutional investors • Close SPAC merger

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new securities to trade, can support trends like this for a significant amount of time. But the biggest winners in a SPAC are the founders – also called the sponsors. They manage the IPO and look for the deal – and in return they usually get 20% of the SPAC shares! It is an attractive setup, but only if they can make a good deal. Which means their interests are at least somewhat aligned with investors.

Potential benefits and risks

For investors, a SPAC can provide access to investing in IPO-like investments, since IPOs themselves are often difficult for individual investors to access. In addition, if a target is not found in two years or investors don't like the selected target once announced, they can redeem their shares and get their initial investment back. This feature gives investors the flexibility to decide whether they want

> *A type of blank-check company is a "special purpose acquisition company," or SPAC for short. A SPAC is created specifically to pool funds in order to finance a merger or acquisition opportunity within a set timeframe. The opportunity usually has yet to be identified.*
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to invest in the newly merged public company or, simply, walk away. But there are risks associated with investing in a SPAC, including potentially less rigorous due diligence around the eventual acquisition target. Lloyd Blankfein, former CEO of Goldman Sachs, had this to say on a CNBC Squawk Box interview in January of this year: "When the initial SPAC goes public, you are scrutinizing a shell company, possibly the reputation of the sponsor. When that company then de-SPACs and merges, it is a merger, as opposed to an IPO that carries with it a lot of diligence obligations." Sponsors are under time pressure to find a target within the 24-month period, which may lead to selection of lower quality companies, just to get a deal done before time runs out. Lastly, investors enter into these deals based in large part upon faith in the sponsor, without knowledge of what the target will be. This attribute is the impetus for the moniker "blank-check" investment. A sponsor may rely on name recognition to raise the initial capital to create the SPAC. These can be anyone really, ranging from wealthy public company founders/CEOs who have since left their previous company to a famous celebrity or athlete.

Traditional IPO and broad market performance historically exceed SPAC post-merger performance

Data from Renaissance indicates that overall performance of SPACs post-merger lags that of traditional IPOs. According to Renaissance, as of third quarter 2020, 2015 to 2020 post-merger SPACs underperformed IPOs, although performance is trending in an upward direction, with 2019-2020 SPACs outperforming 2016-2018. Analysis from Goldman Sachs corroborates this conclusion. Goldman Sachs' equity strategy group looked at 56 SPACs that merged with target companies since the beginning of 2018. While most SPACs outperformed for the post-deal announcement to deal closure period, performance then tended to lag broad market indices. This means, on average, these deals can sometimes "pop" around deal announcements, then fade or fall behind the broader market on investment returns in the period thereafter. It is important to point out, however, that there is a wide variance among deal results (winners can be "big winners," and losers can be "big losers,") similar to the IPO market. Sponsor and target quality are incredibly important, particularly in a crowded market, where competition to attract the best potential target companies is fierce. Beyond that, according to Renaissance, larger SPAC deals have outperformed smaller ones, and, consistent with broad market equity performance, healthcare and tech-focused SPACs have outperformed, while energy has underperformed.

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Should you invest in SPACs?

At KF Advisors, we believe in a highly customized approach to developing each client's investment strategy. The foundation for this is a thorough understanding of what you are trying to accomplish with your assets, as well as your unique circumstances and needs. Once we have developed your personalized asset allocation, we can determine what types of investment solutions are most appropriate, while also carefully evaluating how these investments work together in a portfolio. Depending on your goals, liquidity requirements, and other criteria, we may utilize an array of public and private investments. Your wealth advisor can help you understand the potential risks and rewards of different solutions and determine which solutions are most suitable for you.

Conclusion

Interest in SPACs has grown substantially over the past few years. 2020 was a particularly active one for new SPACs, driven in part by pent-up demand after the first half of the year. While there are potential return rewards from investing in SPACs, they do carry risks, and there is a wide variance in performance among SPACs. If you are interested in learning more about SPACs and other investment solutions, KF Advisors is here to help.

For questions regarding SPACs and other investments, please speak with your Advisor or contact us at 212.492.7000 or info@klingenstein.com.

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