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SPACs Revolution Turns Into Public Equity Market Transformation

Apr 18, 2021 | By Alex Gavrish, Etalon Capital Ltd; author of "Story Investing"

2020 had taught us an important lesson. The lesson being that we should base our decisions and actions on reality instead of religiously adhere to certain models or modes of thought.

Current wave of SPACs is an interesting case. Once a small market niche, SPAC deals turned into a mainstream trend. According to Alex Gavrish from Etalon Capital, since 2018 over 650 SPAC companies raised a total of more than $180 billion of capital. Lately, SPAC activity has picked up even more: in the first three months of 2021 alone more than 298 SPAC companies raised more than $86 billion of capital.

What is interesting is that most market participants still look at these transactions as a niche segment when in reality they are becoming something different.

According to Etalon Capital estimates, an average SPAC raises about $300 million of capital. If you assume that it merges with a target company at an Enterprise Value to SPAC capital ratio of x5, this means that $200 billion of SPAC capital will bring public more than 650 companies with a combined enterprise value or market capitalization of $1 trillion dollars.

If SPAC issuance trend will continue, it is possible that in a year from now (cumulative since 2018) SPAC issuance will reach 1300 companies with a possible influx of more than $2 trillion in the combined market capitalization of new companies.

To put this into perspective, current market capitalization of S&P MidCap 400 companies is $2.38 trillion while market capitalization of S&P SmallCap 600 companies is $1.1 trillion.

There are few reasons why successfully investing in these companies is hard. First, the SPAC structure mechanics gives an edge to initial participants while warrants create certain amount of dilution going forward. Second, as is often the case with regular IPOs, many companies that merge with SPACs are growth companies and the risk level is high. Third, because SPAC transaction is an easier and quicker route to market than a regular IPO, disclosures and information available to investors are of lesser quality. Fourth, some companies are not only growth companies but come from very dynamic and risky sectors such as electric vehicles, for example.

However, despite all this SPAC companies share many characteristics similar to spin-offs. It is a natural assumption that interesting investment opportunities could be found in this market segment.

Merger or acquisition by SPAC vehicle of an operating business represents an important corporate event. Similar to spin-off it becomes an important turning point in company's story.

Many companies that merge with SPACs try to sell investors a growth or transformation story for the next three or five years.

Because of this, when valuing SPACs, the degree of insight investors can have by focusing only on fundamentals and accepted valuation principles might add limited value. The key, on the other hand, might be understanding the story of company and what story market participants tell themselves and others.

And here, one might have no choice but to turn to narrative mode of thinking and try to formulate these stories: stories of company's business, story market participants tell, story that sell-side analysts promote, etc.

Jerome Bruner, a famous cognitive psychologist, explains that narrative mode of thinking leads to conclusions not about certain absolute truths, but about varying perspectives that can be constructed to make experience comprehensible. By telling stories, we formulate these different perspectives. Pablo Picasso said: “Art is a lie that makes us realize the truth”.

It seems that similar to 2020 crisis, current SPAC trend provides investors an excellent opportunity to take a step back from ETFs, passive investing, algo and quantitative trading, roll up their sleeves and reap rewards of an exciting active investment research and management process.