Make a Wish for a SPAC: industry overview and the peculiar case of Wish

Introduction to SPAC deals

A special purpose acquisition company (SPAC) is a company without any commercial operation that is formed to raise capital through an initial public offering to then merge with or acquire an existing private company. Generally, a SPAC is formed by an experienced management team or a sponsor with nominal invested capital, typically representing roughly a 20% interest in the SPAC, while the remaining 80% interest is held by public shareholders through "units" offered in the IPO. Each unit consists of a share of common stock and a fraction of a warrant (for example, ½ or ⅓ of a warrant). Following the IPO, proceeds are placed into a trust account and the SPAC typically has 18-24 months to identify and complete a merger with a target company, sometimes referred to as 'de-SPACing'. If the SPAC does not complete a merger within that time frame, it is liquidated, and the IPO proceeds are returned to the public shareholders.

A SPAC merger normally requires multiple steps of legal and capital restructuring that impact the tax status and considerations of the target company. Its annual and interim financial statements must be audited and reviewed based on PCAOB standards, which can add additional time and complexity to historical audits as compared to AICPA standards. Moreover, the target company must prepare an MD&A disclosure for all periods presented in the financial statements so that investors understand its financial condition and results of operation. MD&A disclosures usually require extensive data analysis and generally contain sensitive financial and operating information. Regarding investors' rights, once a target company is identified and a merger is announced, the SPAC's public shareholders may alternatively vote against the transaction and elect to redeem their shares. If the blank check company requires additional funds to complete a merger, it may issue debt or additional shares, such as a private investment in public equity (PIPE) deal. Generally, founder shares and public shares have similar voting rights, with the exception that the former usually have the exclusive right to elect SPAC directors, while warrant holders usually do not have voting rights and only whole warrants are exercisable. Overall, SPAC deals typically include favourable terms for their sponsors as they initially put up a small amount to cover expenses before the SPAC goes public and then get a 20% stake at a huge discount if the SPAC merges with another company. This makes it possible to earn returns several times the original investment even if the acquisition is not a good deal for other investors.

Also known as blank check companies, SPACs have existed for decades, but they became extremely popular only in recent years, with $83.4bn and $162.5bn raised by SPAC IPOs in 2020 and 2021, respectively. In comparison, only 59 SPACs had gone public in 2019, raising $13.6bn, which was more than four times the $3.5bn raised in 2016. One of the main factors that caused such a sharp increase in the popularity of SPACs was the global COVID-19 pandemic, as many companies chose to forego conventional IPOs because of market volatility and uncertainty. Moreover, the SPAC merger process with a target company may be completed in three to four months, which is significantly shorter than a typical traditional IPO timeline. Additionally, the owners of the target company usually have a high bargaining power because of the limited time to complete the deal, and thus, may be able to negotiate a premium price when selling to a SPAC. Furthermore, being acquired by a SPAC sponsored by prominent financiers and business executives provides the target company with experienced management and fuels investors' interest.

However, there are many risks associated with SPACs especially as during the boom of 2020-2021 there was a reduced degree of oversight from regulators and a lack of disclosure from blank check companies. Firstly, returns from SPACs may not meet expectations offered during the promotion stage: 70% of SPACs that had their IPO in 2021 were trading below their $10 offer price by the end of the year. Secondly, the deal may not end up being completed even if the SPAC has identified a company to acquire. According to industry reports, more than 55 supposed SPAC deals worth tens of billions of dollars ended up being terminated in 2022, with an additional 65 SPAC sponsors shutting down entirely. This happens when the SPAC's management team cannot negotiate favourable terms for the acquisition, such as the purchase price or the structure of the deal, or when the SPAC is not able to raise enough capital through the IPO to fund the acquisition. Finally, the SPAC deal can fail if the acquisition is not approved by regulatory authorities or by the SPAC's shareholders, who can pull their money out before the transaction closes if they do not like the chosen target or the terms of the deal. That can leave the newly public company with even less cash to grow and very few shares available for trading after a deal is completed, which gives rise to a liquidity problem. Last but not least, a target company in a SPAC merger needs to prepare itself for being a public company normally within a few months, which is a significantly shorter timeline compared to a traditional IPO for substantially the same preparation - complex accounting, due diligence, prospectus-drafting, SEC engagement and oversight. All the above-mentioned challenges have contributed to a decline in the popularity of SPACs since 2022.

SPAC's declining popularity

In 2022 SPAC fundraising has significantly slowed down as regulators questioned the model and financial markets cooled down because of higher interest rates. Only 31 SPACs completed their IPO to raise $3.8bn, compared to more than 860 SPAC listings that raised $246bn between 2020 and 2021. One of the main reasons for the cool-down was the strong regulatory push by the SEC. Policies issued in early 2022 were aimed at giving SPAC investors the same protections that investors in traditional IPOs receive, mainly by requiring more disclosures from companies and making executives liable. The SEC had also previously issued an Investor Alert in March 2021, cautioning investors not to make investment decisions based solely on celebrity involvement, as many entertainers and professional athletes heavily invested in SPACs in 2020 and 2021. Moreover, the poor performance of many SPACs and confusing statements about dilution in securities filings have contributed to the decline in capital raised by SPACs. Indeed, this information is often scattered in different sections, which makes it difficult for SPAC investors to determine whether they should go through with a merger or redeem their shares prior to the completion of the deal. Inferior performance of SPAC shares was in turn caused by the fact that their cash is heavily diluted by the time a merger takes place. Large investors that help to sponsor SPAC IPOs often buy "units" with a share, which can then be redeemed, and a right or a warrant, which are kept and can be exercised later. This allows large investors to minimise their risk while leaving the door open to high future returns. It also gives them an advantage over general investors, who buy and hold the SPAC shares and may suffer from dilution through the exercise of warrants and rights of large investors. After the sponsor's cut, bankers and lawyers' fees, and exercise of warrants, a SPAC might only have 50 cents to invest in the target company for every dollar contributed by shareholders.

Lastly, on January 24, 2024, the Securities and Exchange Commission adopted new rules and amendments to enhance disclosures and provide additional investor protection in SPAC IPOs and subsequent transactions between SPACs and target companies. Given the complexity of these transactions, the SEC seeks to enhance investor protection concerning the adequacy of disclosure and the responsible use of projections as SPAC targets, some of which had not yet begun operations, often made wildly optimistic forecasts about their revenue or market share, boosting future demand for their shares. Regulators worry that this encouraged investors to engage in SPAC deals without understanding them. New regulations will help to ensure that the rules for SPACs are substantially aligned with those of traditional IPOs, enhancing investor protection through disclosure, use of projections, and issuer obligations. The SEC hopes that these will protect investors by reducing information asymmetries and conflicts of interest in SPAC and de-SPAC transactions.

Contrasting SPAC journeys: VinFast and Lucid Motors in the electric vehicle sector

Even though the interest in SPAC mergers has fluctuated in recent years, the electric vehicle sector has seen notable examples of large deals being completed. Specifically, the cases of VinFast [NASDAQ: VFS] and Lucid Motors [NASDAQ: LCID] exemplify both the potential and pitfalls of this strategy, albeit in different contexts and circumstances.

On August 15, 2023, the Vietnamese EV powerhouse VinFast made a sensational debut on the Nasdaq, initially surpassing the market capitalizations of automotive giants like Volkswagen [FWB: VOW], BMW [FWB: BMW], and Mercedes [FWB: MBG], and doubling that of Ford [NYSE: F] and GM [NYSE: GM] at a staggering $85bn. However, the euphoria was short-lived, as the stock experienced a dramatic 46% decline in just two sessions at the end of August, bringing its market value down to $46.4bn, and aligning it more closely with the American relevant peers. Following this, VinFast's shares saw another significant and consistent fall, plummeting nearly 80% from their peak in just 11 trading days, and finally leading to a more stable stock price close to $5.9 (from a peak price of $68.77). This rollercoaster was partly due to the SPAC merger with Black Spade Acquisition Co, where over 90% of SPAC investors withdrew before the merger's completion, leaving minimal shares available for trading. The minimal float, adding to the fact that the founder retained control of 99% of shares, set the stage for volatile price movements. Despite such poor stock performance, the company persists in its global expansion efforts, including a significant investment in a North Carolina manufacturing plant scheduled to begin production in 2025.

On the other hand, Lucid Motors, operating in the luxury EV segment, pursued a SPAC merger with Churchill Capital IV Corp, historically one of the most popular SPACs, on July 26, 2021. Guided by Michael Klein, a seasoned Wall Street veteran, the merger positioned Lucid Motors as a formidable competitor in the EV sector, attracting investor interest and confidence. With a valuation of $24bn, the merger provided Lucid Motors with substantial capital, facilitating production scaling and product roadmap acceleration. While still encountering challenges, Lucid Motors' collaboration with Churchill Capital IV highlighted the potential of SPACs to facilitate significant transactions and support growth initiatives in high-growth sectors.

Despite varying outcomes, the SPAC journeys of both VinFast and Lucid Motors underscore key similarities and lessons. Both companies utilized SPAC mergers to access public capital and advance expansion plans in the competitive EV market. However, disparities in market sentiment, investor confidence, and operational execution influenced the trajectories of their journeys, resulting in differing dynamics in share prices in the short/medium term but ultimately yielding similar outcomes: a notable decrease in share price relative to initial value. VinFast's volatile journey serves as an instructive narrative for SPAC investors, emphasizing the risks associated with inflated valuations, trading liquidity challenges, and post-merger sell-offs. Conversely, Lucid Motors' initial triumph with Churchill Capital IV illustrates the potential for SPACs to catalyse growth by giving companies access to capital and strategic resources to execute business plans. The merger demonstrates the synergistic relationship between innovative firms aiming to disrupt traditional industries and seasoned investors skilled at navigating public market intricacies; However, the long-term result was still a decline in the share price of the company, with a value of around a third of the closing price in the first trading day.

An improbable SPAC? The case of Wish

Drawing inspiration from the model of SPAC deals, the board of e-commerce company Wish [NASDAQ: WISH] unveiled, earlier this year, a peculiar new strategy in a last attempt to generate value for its shareholder. Crucially, we believe that this plan perfectly exemplifies the importance of creativity in financial decisions and operations.

Wish, a San Francisco-based e-commerce company founded in 2010, gained widespread popularity because of its business model centred on a cost-over-quality principle. Offering an extensive choice of ultracheap goods, often with several weeks-long deliveries, the platform thrived thanks to bargain prices and an innovative customer-merchants matching system. Throughout 2018, Wish had been the most downloaded e-commerce application globally with $1.9bn in revenues; its IPO in 2020, albeit seeing its share unusually decline in a listing-friendly market at the time, valued the company at $14.3bn. However, Wish was yet to turn a yearly profit. As it continued to struggle to achieve profitability, it then faced a series of controversies surrounding the sale of counterfeit and illicit products on its platform which eventually caused it to be obscured in France. Moreover, increasing competition from other low-cost retailers such as Temu and Shein intensified pressure on Wish's financial performance. By 2022, the company was already in a financially critical position and had to carry out significant layoffs, of nearly 30% of its international workforce. As of 2023, it had accumulated net operating losses (NOLs) of $2.7bn

On February 12, 2024, it was announced that Wish's parent company – ContextLogic – had agreed to sell its operating assets and liabilities to Qoo10, a Singapore-based e-commerce entity. The deal had a gross acquisition price of $173m, below what Wish reported as its book value in October ($272m), but it still constitutes approximately $6.5 per share, a 44% premium on its stock price the day before the announcement. Pending shareholder approval, the transaction is scheduled for completion in the second quarter of 2024. Once finalized, Qoo10 will inherit Wish's brand and platform, integrating them into its existing businesses for what both companies have stated is a favourable outcome for Wish's customers and merchants. ContextLogic, meanwhile, will effectively become a shell company, continuing to publicly trade albeit under a different ticker symbol. Notably, the company will retain its substantial $2.7bn in net operating losses while also adding to its balance sheet the cash resulting from the asset sale. At this point, according to the company's management, the primary objective is to pursue a merger with a profitable entity to monetize the NOLs and also publicly list the target. This clearly resembles the functioning of a SPAC, while also leveraging the tax advantages stemming from previous losses to create what is commonly referred to as a 'NOL shell'. Additionally, the company is actively seeking a financial sponsor to inject additional liquidity, thereby enhancing its ability to acquire a suitable target. ContextLogic's chairman, Tanzeen Syed, has reassured investors of the fact that an analysis of all available strategic alternatives indicated this as the most effective mean of maximizing shareholder value. However, were it to prove unfeasible, all capital derived from the sale of Wish's assets would be returned to shareholders.

Perhaps, one of the most intriguing aspects of the deal is the potential tax benefits that could be transferred from Wish's shell to a target company. Under US regulations, in fact, companies with net operating losses can deduct them from future profits, up to 80% of net income in any subsequent year, until the balance expires or is exhausted. With the US federal corporate tax rate standing at 21%, the theoretical value of the resulting future tax shield would approximate just under $600m – notably, only $886m of the $2.7bn in NOLs have a carryover expiration date, which falls between 2030 and 2037. However, it is also essential to note that tax rules impose restrictions on the utilization of NOLs in the event of a change of control, such as when a shareholder acquires the NOL shell company too rapidly or in overly significant proportions under other specific circumstances. Nevertheless, there are no such limitations on NOL shell companies making acquisitions and utilizing those NOLs, as in this case. Furthermore, the acquired companies are not required to operate within the same business line as the NOL shell company. To safeguard its strategy, ContextLogic's board has then introduced a 'Tax Benefits Preservation Plan', which entails the distribution of currently non-exercisable share purchase rights to existing shareholders via a dividend. This mechanism allows the board to mitigate the influence of any hostile acquisition of more than 4.9% of Wish's shares, by significantly diluting the position as it makes the distributed purchase rights redeemable at a discounted price.

Although quite unusual, the case of NOL shell companies is not entirely unprecedented, with one of the most significant examples being Washington Mutual. A US regional bank that collapsed due to the Great Financial Crisis, it resulted in its $6bn NOLs being transferred to a publicly traded entity established in 2012, known as WMIH. Thanks to a KKR investment in the shell, WMIH eventually merged with Nationstar Mortgage in 2018 at a valuation of $3.8bn. Despite this success, similar operations still consist of risky bets that often do not lead to the intended result; after all, even for WMIH several years and a substantial investment from KKR were needed to make the plan work. The case of Amigo Holdings [LON: AMGO] is a recent example of a similar endeavour having an opposite outcome. The UK subprime lender - which collapsed after interest rate hikes turned insolvent many of its debtors - had sought to leverage its public listing in a reverse takeover with three entities in the music and film streaming market, led by Swedish entrepreneur Catos Crogh. However, last December, Amigo Holdings was forced to terminate its attempt as the deal's unusual complexity discouraged the counterparties.

Outlook of the SPAC industry

In essence, the journey of SPACs has unfolded in a wave-like manner, marked by rapid expansions succeeded by contractions, as highlighted by the fundraising slowdown observed since 2022. This is the result of a combination of factors, including increased oversight from regulatory bodies and shifts in market dynamics. Initially hailed for their ability to navigate market volatility and accelerate the public listing process, SPACs faced hurdles driven by concerns regarding transparency, underperformance, and the dilution of stakeholder equity. We are currently experiencing a critical period for SPACs, with the Securities and Exchange Commission's implementation of new regulations, signalling a move towards bolstering investor protections and aligning the regulatory framework with that of conventional IPOs. By tackling prevalent issues like information asymmetries and over-optimistic forecasts, these regulatory actions strive to foster a deeper sense of trust among stakeholders, augment protections for investors, and uphold the integrity of SPAC transactions.

In the near future, the performance of SPACs is uncertain, as there are doubts regarding their sustainability compared to traditional IPOs. The success of regulatory changes in guaranteeing enhanced investor protection might even renew enthusiasm for SPACs, depending on how well the industry adjusts to changing regulations, addresses inherent weaknesses, and provides concrete benefits for both sponsors and investors. Consequently, the next few years will be crucial in determining the trajectory of SPACs, as they navigate through a landscape marked by heightened regulatory scrutiny and changing market conditions, thereby impacting the framework of capital markets and corporate financing.

TAGS: SPAC, Wish, NOL shell, Industry overview, SEC