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Special Purpose Acquisition Companies

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SPACs are all the rage right now in the finance world. What are they exactly … and how do they work?

A SPAC is a legal entity with minimal operations, created to identify and acquire or merge into an existing company. The SPAC entity facilitates the acquisition transaction. by raising capital, typically $75 million or more, through an Initial Public Offering (IPO) and then identifying acquisition targets. An underwriter is usually involved in this process.

SPAC founders are referred to as sponsors and work with management teams with a particular industry or market sector expertise. To get the SPAC started, the management team raises seed capital for the sponsor from various sources, including individuals or private equity funds. Capital raised at this initial stage is used to create the SPAC legal entity.

Shares and warrants sold are referred to as founder shares and warrants, respectively. The sponsor entity typically purchases 25% of the SPAC's total intended share capitalization and starts raising money for the SPAC IPO.

The SPAC has three distinct life cycle stages:

1. Initial capitalization stage through the IPO

2. Life as a public company with SEC 1934 Act reporting requirements, in spite of shell company status, while searching for target/merger candidates

3. The de-SPAC/business combination transaction, where typically the SPAC is merged with a target company, with the latter becoming a public company.

During the IPO stage, units sold are typically priced at $10 and consist of a share and a fraction of a warrant. The amount and terms of the warrants vary among SPACs. The IPO proceeds are typically placed into a trust and invested in money market funds or short-term U.S. government securities.

In Phase 2, the SPAC has a certain amount of time – usually 18 to 24 months – to finalize a deal. The SPAC searches for an appropriate target, typically a private company interested in completing an IPO.

In Phase 3, there are two possible outcomes. If a target company is identified and approved, the SPAC and target company merge, resulting in the target company becoming a public company. Alternatively, those SPAC shareholders who decide they do not like the intended target, can redeem their shares and have their initial investment refunded.

If an acquisition does not occur during the life of the SPAC, the SPAC is dissolved and capital is returned to remaining shareholders who are entitled to a pro-rated (based on ownership) portion after expenses are paid.

Implications for SPAC investors depend on the occurrence of a transaction. If no SPAC deal is closed, investors' capital is returned after two years. If a SPAC deal is closed, performance of the resulting operating company's stock determines investors' returns. Prominent New England companies that have gone public using SPACs include DraftKings and Ginko Bioworks.

As of January, SPACs have raised capital (many billions of dollars) and are still actively seeking deals. SPACs remain popular because they present an alternative to a traditional IPO; one that appears to decrease the time and cost associated with the underwriting process.

However simple the concept may appear, the mechanics of SPACs are complex, and any potential investment should be carefully considered.