Spring cooling for SPACs

Investment strategy insights

Authors: Jason Draho, Head Asset Allocation Americas, UBS Financial Services Inc. (UBS FS); Vincent Amaru, Investment Strategist Americas

- The SPAC market has cooled significantly over the past month, after exhibiting frothy conditions in February. New SPAC supply has slowed considerably, the number of acquisitions has moderated, and share prices are down collectively over 20%, with some prices down more than 50%.
- Pricing patterns around SPAC merger announcement dates suggest that the overheating in February was due to investor speculation, much of which appears to have been flushed out of the market. The result is healthier market conditions than a few months ago.
- The near-term outlook depends on investors' willingness to participate, SPAC share prices continuing to hover around USD 10, and the supply of acquisition targets, all of which are downside risks. But SPAC pricing is starting to reflect these risks. Still, we caution investors to become well informed about SPACs before investing in them.

Note: In this version, Fig. 1 and Fig. 2 now represent SPAC issuance based on those that are currently trading. The previous version had also included SPACs that had been priced but were still pending.

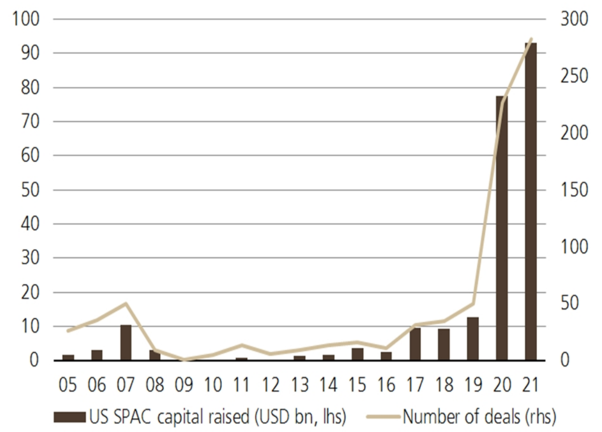
Temperatures are rising as spring blooms, but there's been significant cooling in the SPAC market in recent weeks after a torridly hot winter. Thus far, it's more moderation from unsustainable levels than it is falling off of a cliff. SPAC return patterns over the last six months also suggest fairly convincingly that speculation, not fundamentals, was driving prices. Consequently, SPACs—special purpose acquisition companies—became a quintessential "buy the rumor, sell the news" asset. But that phase appears to have passed and SPACs begin 2Q with more realistic expectations than at the start of the year. Such a sentiment reversal isn't surprising, as we outlined two months ago that SPACs were exhibiting bubble-like characteristics and growing pains were likely, although not necessarily this soon.

Taking out the market frothiness actually improves SPACs' investment outlook, which continues to benefit from a favorable equity market environment. But SPACs are vulnerable to additional challenges in the months ahead, including many that may be unable to complete a merger and poor returns for at least some that do. Investors should also be well informed about SPACs before investing, even if the share price has declined below the USD 10 redemption price. While that creates a tempting arbitrage opportunity, poor liquidity and deal uncertainty are risks that need to be closely monitored. Looking through this spring cleaning of the SPACs market, we continue to think that they will be a fixture in equity capital markets over the long term, but maybe only after experiencing more growing pains.

What happened?
In March there was a clear slowdown in the supply of new SPACs and merger announcements, and most notably there were steep declines in SPAC share prices, with many even struggling to stay above USD 10.

First on supply: New SPACs started coming almost immediately in January and maintained a scorching pace until mid-March. The 283 SPAC IPOs in 1Q raised USD 93bn, totals greater than for all of 2020 (Fig. 1).

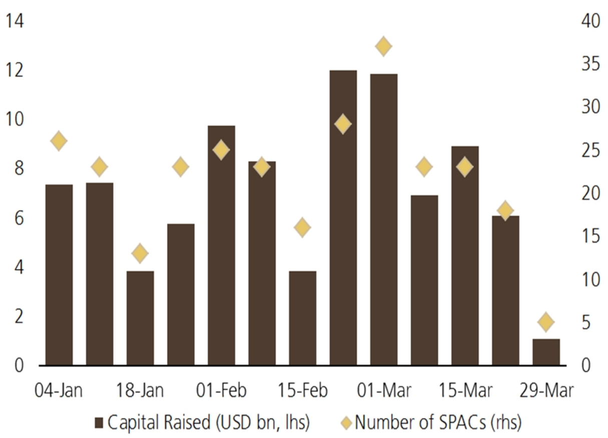
Fig. 1: SPAC supply in 1Q surpassed 2020 totals...



Source: Bloomberg, UBS, as of 31 March 2021

But starting in early March, the weekly number of new SPACs and the capital raised have trended down, with only five SPACs in the week of 29 March (Fig. 2).

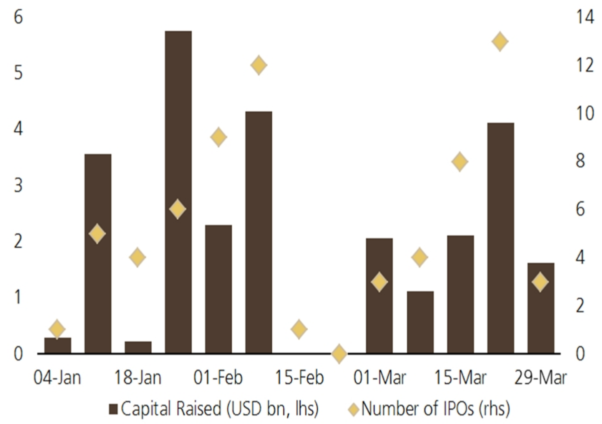
Fig. 2: ...but activity did slow into quarter end



Source: Bloomberg, UBS, as of 2 April 2021

Supply moderation was inevitable because the 1Q pace is unsustainable for a full year. By comparison, conventional IPO supply didn't have a clear trend in 1Q, which was strong with 69 IPOs raising USD 27.5bn (Fig. 3). But USD 3.6bn of expected IPO supply was withdrawn, one of the highest quarterly totals in recent years, highlighting that moderation in new equity supply was broad-based.

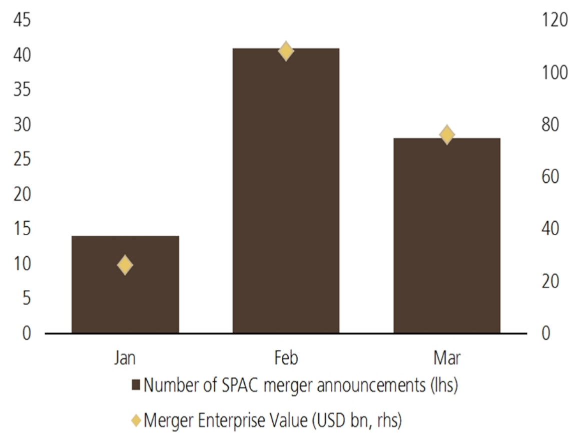
Fig. 3: IPO supply was significant and consistent



Source: Bloomberg, UBS, as of 2 April 2021

Merger announcements also slowed in March, with 28 new deals versus 41 in February (Fig. 4).

Fig. 4: SPAC merger announcements fell in March



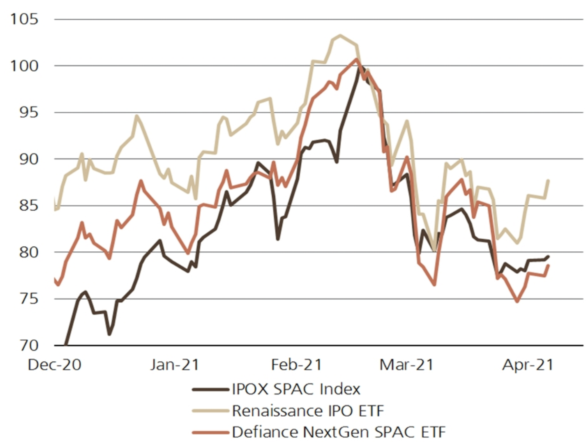
Source: Dealogic, UBS, as of 31 March 2021

The total enterprise value of these mergers is roughly USD 211bn, already exceeding the 81 "de-SPAC" mergers in 2020 worth USD 148bn in value. Some of this slowdown is due to time constraints among SPAC merger advisors, as there are limits to how many deals they can work on at any point in time. But the pace of SPAC mergers is more likely to hold up compared to the supply of new SPACs because there are already over 400 SPAC sponsors searching for acquisitions, and they are incentivized to close deals.

Share price performance is where SPACs have experienced the biggest tumble. For the SPAC market overall, the decline began in mid-February, with the SPAK and IPOX indexes both down over 20% peak-to-trough, and they're barely off their lows over the past month (Fig. 5). Within this cohort of post-merger SPACs, there are some down over 40%. Conventional IPOs also fell over 20% from their February peak, measured by the Renaissance IPO ETF, but have rallied modestly off the lows.

Fig. 5: SPACs are still down over 20% from their February peaks

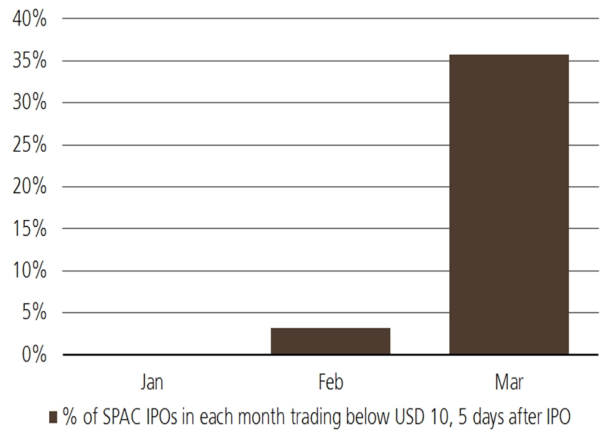
Indexed to 100 at IPOX SPAC Index peak on 17 February 2021



Source: Bloomberg, UBS, as of 6 April 2021

Price weakness has extended to pre-merger announcement SPACs. Most striking is that many are trading below USD 10, the price at which SPAC shareholders have the option to redeem their shares prior to the merger, thereby presenting an arbitrage opportunity. Yet 36% of all SPAC IPOs in March were trading below USD 10 five days after their IPO, compared to none and 3% of SPACs in January and February, respectively (Fig. 6). The bulk of these SPACs were issued later in March, with 15 of the 18 SPACs issued the week of 22 March closing that Friday at or below USD 10.

Fig. 6: Over a third of SPACs that IPO'd in March were trading below USD 10



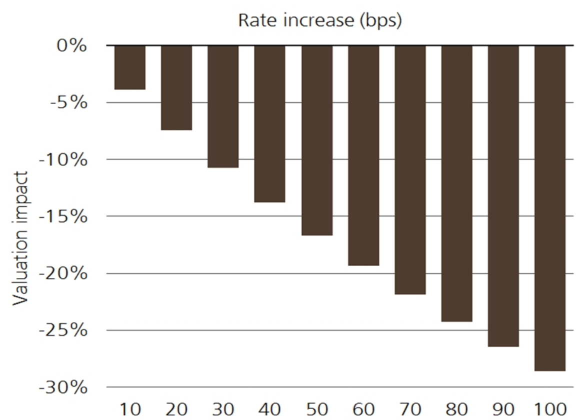
Source: Dealogic, Bloomberg, UBS, as of 31 March 2021

Why did the SPAC market cool?

There are both fundamental and investor-sentiment reasons why the SPAC market has cooled so notably and quickly, with the latter being the most significant. The fundamental factor is higher rates—the 10-year Treasury yield is up 77 basis points year-to-date, with the majority (47bps) occurring over four weeks in February and March. During this period, the Nasdaq 100 fell nearly 11% peak-to-trough, while the SPAC and IPO indexes were down over 20%. These declines make sense because expensive stocks are very sensitive to even small rate changes.

Fig. 7: Small rate increases matter a lot for expensive stocks

Estimated valuation impact from higher rates for a stock with a 40 P/E multiple

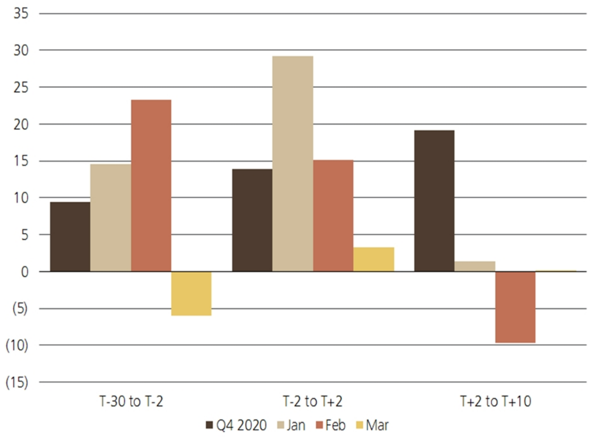


Source: Bloomberg, UBS, as of 6 April 2021

A 10bps rate rise should cause a 4% price decline for a stock with a 40 P/E multiple, all else equal, based on a simple perpetuity formula. The higher the rate rise, the bigger the price hit: A 30bps rate rise lowers the value by 10%, whereas it falls 22% after a 70bps increase (Fig. 7).

The rate rise may have triggered a sell-off in SPACs, but investor euphoria and rampant speculation made them especially vulnerable. The evolving patterns of SPAC share prices around merger announcements illustrate this point. Absent any news about a potential target, SPAC share prices shouldn't rise much above the USD 10 offer price until the merger is announced. Yet in 4Q the average SPAC price rose nearly 10% in the period from 30 to two days prior to the merger announcement (Fig. 8). But then this pre-announcement run-up increased to nearly 15% in January and then peaked at 23% in February before turning negative in March.

Fig. 8: SPACs were rising on merger rumors, selling on actual news



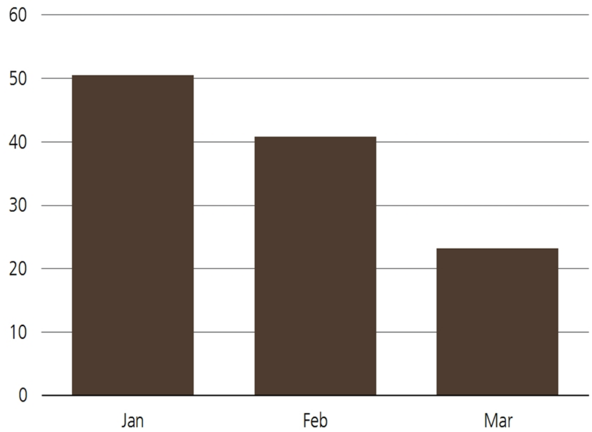
Source: Dealogic, Bloomberg, UBS, as of 6 April 2021. T = merger announcement date

In effect, investors were buying on rumors of a deal, which is why the average announcement "pop"—the return right around the announcement—was actually higher in January (29%) than it was in February (15%). This buying on rumor pulled forward returns, leaving less reason for the share price to pop on announcement. But there was also selling on the news in February, as SPAC shares were down nearly 10% on average in the two weeks after the pop. This selling the merger news is in contrast to the almost 20% average return post-announcement for deals in 4Q.

All told, these merger announcement return patterns show how investor enthusiasm for SPACs started growing late in 2020, accelerated in early 2021 to the point of exuberant speculation, and then cooled very quickly once prices came down sharply over a short period. At this point, sentiment toward SPACs has chilled, but interest could easily pick up again.

To that point, pricing for conventional IPOs has also eased, as evidenced by their first-day returns averaging 50% in January, 40% in February, and 23% in March (Fig. 9). This decline in the monthly averages toward the long-term average first-day return shows that the IPO market has pulled back from its hot status to start the year, but it is still a strong market.

Fig. 9: IPO first-day returns moderating, but still high



Source: Bloomberg, UBS, as of 31 March 2021. Only includes US IPOs greater than USD 100mn on offer

What's the outlook?

The cooling of SPACs from their white-hot status in February to something more temperate is a healthy correction from a long-term perspective, but there is a risk of a deeper market chill in the near term. In our "SPACs in 2021" report, we identified a number of aspects of the market that would influence how it evolved. Three that are most pertinent right now are: the risk of investors not willing to participate in SPACs, the SPAC share price around the merger date, and the supply of potential acquisition targets.

Investor participation: The ultimate determinant for investor participation in SPACs is performance—if expected risk-adjusted returns are poor, investors won't participate, bringing the market to a halt. The three main investor types in SPACs have been hedge funds and arbitrage investors in the IPO, institutional investors participating in PIPEs (private investments in public equity) at the merger, and retail investors buying shares or warrants after and increasingly before the SPAC merger announcement.

The economics are still attractive for arbitrage investors in the IPO, but institutional and especially retail investor appetite for SPACs is at risk. The exuberance for SPACs evident in the merger announcement returns is largely attributable to retail investors. Thus, the recent cooling suggests diminished retail interest. But it’s not just SPACs that are being impacted by shifting retail activity. Overall retail trading in single stocks and options on single stocks has declined over the last six weeks. This may be temporary, but as the economy fully opens, retail participation may revert closer to pre-pandemic levels. Interest from institutional investors is less fickle, but their constraint may be the amount of capital they have committed to PIPEs is less than what SPAC sponsors will require to complete every potential merger.

Share price at the merger: SPAC share prices hovering below, or even just above, USD 10 is a risk for the long-term success of SPACs post-merger. With share prices that low, the redemption rate for pre-merger investors will likely be higher, depriving the sponsor and post-merger company of that capital and increasing the need to attract new investors, whether institutional via a PIPE or retail investors. That will be a harder sell given recent performance. This type of dynamic can create a negative feedback loop that perpetuates poor SPAC performance.

Supply of potential targets: There are currently 432 SPAC sponsors searching for acquisition targets. For comparison, there were 56 completed SPAC mergers in 2020 and so far in 2021 there are 24 completed mergers and another 83 deals announced but still pending. In other words, the amount of deal activity has to more than double over the next 12 to 18 months in order for all of these SPACs to do a deal. Many won’t as the supply of desirable targets that are ready to be public companies is likely lower than the demand. The rising risk of not completing a deal should weigh on their share prices, as already appears to be the case.

These factors together imply downside risk in the near term, but current SPAC pricing is starting to more accurately reflect these risks, and as a result the risk-return for SPACs has improved. A continued slowdown in new supply would also help the market to work through the existing glut of SPACs searching for deals, alleviating some of the downward share price pressure. None of this changes our long-term view that SPACs will remain a lasting vehicle in equity capital markets. The maturation and institutionalization is the key to this outlook, and this process hasn’t been impacted by the euphoria and cooling that the market has experienced over the past six months.

The takeaway for investors is to remain cautious and become well informed about SPACs before investing in them. The past two months have demonstrated that investors can lose a lot on SPACs, even when they have the redemption option. We still think that investing in a diversified portfolio of SPACs at the IPO offers the best risk-return trade-off because of the redemption option and upside optionality through warrants. Investors who don't participate in the SPAC IPO should wait until the merger target is at least announced and can be evaluated, and now perhaps also wait until the “selling on the news” is complete.

Appendix

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