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What Ted's Thinking

SPACs: Croupiers and Incentives

The croupier and one-off idea concepts from the last two weeks intersect with SPACs. I see unusually attractive dynamics in the nascent ecosystem. SPAC sponsors are the ultimate croupiers, and their sponsor equity investment is one of the most attractive risk-rewards I have ever seen. Sponsors provide working capital to do a deal and risk losing all of it if they fail. In exchange, they receive a share of the economics of a completed deal. It's roughly a 10x upside with 100% downside, implying a breakeven 10% probability of completing a deal. Sponsors have strong incentives to get a deal done, and my base case probability of deal completion is around 70% or more, multiples of the 10% breakeven.

The next croupiers at the table are participants in SPAC IPOs, who buy effectively a risk-free call option on a business. These investors put up \$10 to buy a unit of the SPAC stock (the \$10 of cash goes in a trust) and warrants. If no deal consummates, the IPO investors get the \$10 back and lose only their cost of capital (not much in a ZIRP world). If a deal gets completed, IPO investors can elect to receive their \$10 back and keep the warrant coverage (if the stock falls) or own/sell their shares and warrants. Even better, the market prices their securities well in advance of a deal, creating upside potential to exit along the way. The optionality of a deal and the warrants are worth more than \$0, so rational markets price the package above \$10 upon the IPO. It's all upside with next to no downside. No wonder credible sponsors have little difficulty raising money to fund a SPAC IPO.

I own a portfolio of post-IPO, pre-deal SPACs, which also offers an extremely attractive risk-reward with limited risk. Buying a SPAC (without warrants for simplicity) between \$10 - \$10.50 gives the potential upside of a deal with 0%-5% downside. I like the trade because some de-SPAC mergers incorporate an IPO pop, which more than covers the

potential downside. The trade resembles a low-cost option (not quite the free option bought by IPO investors). I started this in the fall and have had 2 post-IPO SPACs in my portfolio trade up over 20% in the aftermarket (which I exited) and 3 more announce deals, each of which rose between 10%-40% on the announcement. I think of it as 25% upside and 5% downside, a 5:1 risk-reward with far better than 20% probability of a deal getting consummated.

So, who loses?

Not the company getting purchased. Here's the back of the envelope math: a SPAC buys 20% of a private company, and the sponsor receives equity in the amount of 20% of their investment. The 4% dilution to the merged company (20% sponsor share * 20% of the company purchased) is less than the 6% the company would pay to an investment bank on an IPO. The company saves money, and there's a laundry list of additional reasons why companies might choose to go public through a SPAC.

Investment banks, but not entirely. The SPAC phenomenon arose because of a combination of a plethora of late-stage private companies and the opaque and inefficient IPO process. But not all banks lose out from their sticky 6% IPO banking fee. Those banking the SPAC IPO receive around 2-4% of the SPAC IPO proceeds and then can work with sponsors to receive a banking fee for the deal.

Secondary market investors. I've wondered how \$10 of cash, trading at \$10.50, can buy a piece of a company with \$10 and be worth \$15 overnight. Some of that may be froth in a hot market for hyper-growth concepts where shareholders eventually lose out. Massive valuations on concept companies with little revenue or earnings resemble public venture investments, many of which will fail. That said, some of value may be a discount private companies are willing to pay to enter the public markets - the democratization of the IPO pop. Incentives come into play here, as the larger the supply of SPAC sponsors and capital looking for deals (again, with massive incentives to do a deal), the more private company targets will have negotiating power. At the end of the day, the SPAC will become a listed company and the public markets will determine its price - with winners and losers just like always.

I expect that eventually markets will rationalize, and the sponsors, IPO investors, and post-IPO shareholders will earn less. Until then, expect this ecosystem to continue to grow. SPACs currently offer the combination of the croupier, aligned incentives, and attractive returns from IPO to de-SPAC merger.