

Analysis of Features, Risks, and Implications for SPAC

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Despite special purpose acquisition companies (SPACs) having appeared in the US as early as the 1990s, SPAC listing has not been a mainstream financing channel all along. However, it became popular in 2020, gaining attention from the Hong Kong SAR Government. This article discusses the major features and potential risks of SPAC and its implications for Hong Kong.

I. SPAC listing has become a mainstream approach in the US

A SPAC is a shell company without commercial operations. The only purpose is to acquire unlisted companies with rosy prospects using capital raised via initial public offering (IPO).

Compared to conventional IPO, SPAC listing has not been a major option for companies to raise funds all along. According to SPAC Research, the amount of funds raised via SPAC listing was less than USD 4 billion annually before 2017. The amount increased to more than USD 10 billion between 2017 and 2019. Nevertheless, such amount was marginal versus conventional IPO in the hundreds of billions of dollars.

In 2020, the outbreak of COVID-19 pandemic has brought tremendous shocks to the global economy. The Federal Reserve quickly cut the rate to near zero and resumed quantitative easing. Investors actively searched for good investment opportunities amid ample liquidity condition. Along with the support from professionals and celebrities, SPAC became popular in 2020. During the year, there were 248 SPAC listings which collectively raised USD 83.4 billion in the US, up 5.1 times and 3.2 times respectively compared with that in 2019. In terms of fund-raising amount and the number of listing, SPAC listing accounted for 47.9% and 50.2% of overall IPO activities. SPAC listing has been increasingly popular this year. As of March 10, 230 companies went public via SPAC listing, with fund-raising amount reaching USD 74.2 billion.

Exhibit 1: IPO amount in the US (in USD billion)



Exhibit 2: Number of new IPO in the US



Sources: Bloomberg, SPAC Research, BOCHK Financial Research Institute

II. Advantages of SPAC

Both companies and investors could share the benefits of a successful merger and acquisition (M&A),

making the SPAC model attractive among different stakeholders.

1. For companies

Compared with conventional IPO, the cost of SPAC listing is low and highly efficient. From the cost perspective, the SPAC sponsors typically contribute USD 2 million plus 2% of the fund-raising amount. Such 2% of funds is used to cover the feeds charged by the underwriter at the time of SPAC listing. According to Morrison & Foerster, the average contribution of the SPAC sponsors in the market at present is about 3.2% of the fund-raising amount. Therefore, SPAC listing has an advantage of low cost versus conventional IPO, which charges an underwriting commission of 3% to 8%.

In terms of listing procedures, after setting up a SPAC, a listing application could be filed with the U.S. Securities and Exchange Commission (SEC). The SPAC would be ready for listing with the approval of the SEC. It takes a few months to half a year for the whole listing procedure. In the future, the targeted company could complete listing via M&A transaction subject to approval of the SPAC shareholders, thus avoiding a series of conventional IPO procedures.

In addition, a SPAC does not need to deal with the problems left over from conventional “shell listing”. Most of the shell companies in “shell listing” have been willing to delist due to poor management. The successor may have to deal with debt and other problems from the original business first. On the contrary, a SPAC is a newly set up shell company solely with funds and without business, so it could focus on searching suitable targets for M&A.

2. For investors

First of all, the investment threshold is low. SPAC usually issue investment units, and the subscription price for each unit is USD 10. Each investment unit consists of common share and warrants. A general combination would be one common share plus one-half or one-third of warrants.

More importantly, the downside risks for SPAC listing investors are manageable but the potential return is high. The funds raised from the SPAC listing need to be deposited in an escrow account for the M&A transaction and relevant payments in the future. In general, a SPAC is required to complete the M&A within two years. If the M&A could not be completed within the required period, investors could redeem their invested funds and interest but only lose the time cost. Furthermore, there would be no lock-up period for investors. As a result, the downside risks for SPAC listing investors would be limited.

However, the potential return of a SPAC is high. Although the share prices of some SPACs, which have already completed the M&A transactions, have entered correction since late February this year, they could still achieve multiple times of returns. For the SPACs that have yet to complete M&A transactions, such as Bridgetown

Exhibit 3: Share prices and investment returns of several SPACs

Company name (stock code)	Post-merger business	Current share price (in USD)*	The highest share price (in USD)#	The largest growth#
Virgin Galactic Holdings Inc. (SPCE)	Space travel	29.59	59.41	4.9 x
DraftKings (DKNG)	Online betting	63.60	71.98	6.2 x
Bridgetown Holdings Limited (BTWN)	Not yet M&A	10.50	17.37	73.7%

Remarks: # The highest price in 2021, calculated with reference to the listing price of USD 10

* Share price as of March 26

Sources: Bloomberg, BOCHK Financial Research Institute

Holdings Limited, which was listed in October 2020, its return once exceeded 73.7% within half a year.

III. Potential risks of SPAC

There are pros and cons for SPAC listing. The potential risks to investors and financial markets cannot be neglected.

Firstly, less rigorous regulatory requirements imply that it could be easier to provide opportunities for information concealment and fraud. For registration statements provided to the SEC, in general, the statements provided by conventional IPO companies are more detailed, which include information of company business, market conditions of the industry, relevant regulations, etc. On the contrary, there are no such information disclosures by SPACs because they do not have commercial operations. As for the disclosure of potential risks of listing, such descriptions by SPACs are much less than that of conventional IPO.

Secondly, investors know nothing about the companies to be acquired in the future when the SPAC goes public. A SPAC is not authorized to target companies for M&A in advance. The prospectus would only indicate the industry and geographical place of the companies that the SPAC intends to complete M&A transaction. Investors will only know the companies they truly invest at the time they make the vote at the shareholders meeting after listing. Therefore, a SPAC is also called “blank check company”.

Thirdly, the performance of investment return among SPACs is mixed, and the quality of management team and sponsors is decisive. Many opinions in the market tend to emphasize the high potential return of SPAC investment. However, it largely depends on the quality of management team and sponsors. Michael Klausner and Emily Ruan of Stanford University, and Michael Ohlrogge of New York University studied 47 SPACs which carried out M&A between January 2019 and June 2020. They divided the sample into two groups. The SPACs were defined as “high-quality” (HQ) if they met either of the following criteria: First, the sponsors affiliated with a fund which had assets under management of USD 1 billion or above. Second, the sponsors or SPAC managers were former CEOs or senior officers of Fortune 500 companies. The study has shown that when the SPACs completed the deal, the overall sample and non-HQ sample reported losses after 3 months. However, HQ sample still registered positive returns within 6 months.

Exhibit 4: SPAC performance after M&A

Unit: %	Overall	HQ SPAC	Non-HQ SPAC
3 months	-2.9	31.5	-38.8
6 months	-12.3	15.8	-37.6
12 months	-34.9	-6.0	-57.3

Sources: Michael Klausner, Michael Ohlrogge and Emily Ruan, 2020, A Sober Look at SPACs

Fourthly, it is worth noting whether the SPACs in the market could complete M&A transactions on schedule. After the listing procedure, the next step would be searching for suitable unlisted companies for M&A. Although most of the SPACs in the past were able to complete M&A on schedule, the current round of SPAC listing fever has continued since 2020, and more than 470 SPACs have to complete M&A transactions by the first quarter of 2023. In other words, demand for the SPACs to find suitable companies for M&A would be much greater than before, or there may be insufficient supply of suitable companies in the market. Media reported that about three-quarters of SPACs listed in the US last year have yet to do a deal.

Besides, as investors could redeem the funds from the escrow account at any time, the amount of funds used by a SPAC for M&A in the future may be less than at the time of listing. The M&A capability could be weakened somewhat. Nevertheless, when a SPAC actually conducts M&A, it would usually raise additional funds from sponsors and third-party investors in order to fill the funding gap, but there are still uncertainties.

If there are large number of SPACs that fail to complete M&A on schedule in the future, they will face liquidation and return sizable amount of funds to investors. Market liquidity may tighten accordingly, bringing hidden concerns to systemic risks in financial markets.

IV. Development in Asia

The boom of SPAC listing in the US attracts some governments in Asia. The Singapore Exchange plans to consult on SPAC listing, targeting the first listing this year. The Financial Secretary of the Hong Kong SAR, Mr. Paul Chan, expressed that the Hong Kong Exchange and the Securities and Futures Commission were asked to explore suitable listing regimes to enhance the competitiveness of Hong Kong as an international financial center, while safeguarding the interests of the investing public.

It is worth noting that the SPAC listing mechanism has already been introduced to Asia. Nevertheless, the development of SPAC was slow, given insufficient depth and breadth of capital markets. In Malaysia, the first SPAC was launched way back in June 2011, followed by four listings between 2013 and 2015. Among these five listings, three of them had gone through the liquidation phase.

In Asia, the development of SPAC in South Korea is relatively mature, where SPAC listing mechanism has been introduced in 2010. According to S&P Global Market Intelligence data, 19 South Korean SPACs were listed in 2020. Furthermore, South Korea is one of the few Asian countries that has established a regulatory framework on SPAC, which mainly refers to the US framework. However, given the development of South Korean capital markets lags behind the US markets, especially given its large proportion of retail investors, South Korea's regulation is more rigorous in order to strengthen investor protection. For example, there would be higher requirements on the eligibility of sponsors, M&A approval threshold, etc.

Exhibit 5: Characteristics of a US SPAC versus a South Korean SPAC

	US SPAC	South Korean SPAC
Investor structure in SPAC IPO	Mainly institutional investors	Mainly retail investors
Composition of investment unit	Common share + warrants	Common shares
Qualification of sponsors	N/A	More than one of the SPAC sponsors should be an authorized dealer
Time limit for M&A	2 years	3 years
Approval threshold of M&A project	Approved by a majority of the shares of common stock	<ul style="list-style-type: none"> - Approved by the affirmative votes of no less than 2/3 of the voting rights of the shareholders present at the general meeting; and - At least 1/3 of the total issued shares

Sources: Korea Capital Market Institute, BOCHK Financial Research Institute

V. Implications for Hong Kong

In fact, Hong Kong has potential for SPAC development. As a leading international financial center, the capital markets of Hong Kong have sufficient depth and breadth. Combined with the advantages of large pool of institutional investors and professionals, as well as regulatory framework in line with international standard, such favorable conditions could facilitate the development of SPAC in Hong Kong.

There is potential for SPAC development in Asia from a macroeconomic perspective, and Hong Kong could seize the opportunities. There are a large number of startups with great prospects in Asia. However, they have difficulty in financing with high funding cost. In this regard, SPAC listing could solve the financing problem given its features of low funding cost and high efficiency. Therefore, startups are ideal targets for SPACs to acquire. The introduction of SPAC listing in Hong Kong could provide more diversified financing channels for startups, facilitating their business development. Meanwhile, the introduction of SPAC listing will have positive impact on promoting Hong Kong's function as an innovation and technology financing platform, and its status as an innovation and technology center.

In addition, SPAC listing could be an option for Chinese enterprises to carry out secondary listing in an efficient way. After the US passed the "Holding Foreign Companies Accountable Act", it is expected that there would be Chinese enterprises to delist from the US market as they could not meet the requirements of the US authorities. As a result, they need to look for other places for secondary listing, becoming resources for competition among exchanges. Hong Kong has attracted a batch of Chinese enterprises for secondary listing since the introduction of listing rules on weighted voting right structure. Nevertheless, some of those Chinese enterprises may want to complete the secondary listing procedure in a short time. While the procedure of conventional IPO is complex and lengthy, SPAC listing could be suitable for their needs.

However, as SPAC's investors have to face certain degree of risks, it is important to safeguard the interests of investors. Regarding areas such as information disclosure, quality of SPAC's management team, and qualification of sponsor, etc., the authorities could refer to overseas experience and proactively consult different stakeholders in the market, in order to formulate the most suitable scheme. Meanwhile, as a lot of domestic retail investors do not have deep understanding on SPAC, it is necessary to think about how to promote investor education properly.

The SPAC boom is likely to extend from the US to Asia. As a leading international financial center in the region, it is worthwhile for Hong Kong to explore the pros and cons, opportunities and risks of SPAC listing, in order to be well-prepared for competition in the future.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	2019	2020	2020/Q3	2020/Q4
總量 (億元) GDP(\$100 Million)	27,997	26,277	6,728	7,018
升幅 (%) Change(%)	-1.2	-6.1	-3.6	-3.0
二. 對外貿易 External Trade			2021/2	2021/1-2
外貿總值 (億元) Total trade(\$100 Million)				
總出口 Total exports	40,961	39,275	3,111	6,989
進口 Total imports	45,714	42,698	3,258	7,388
貿易差額 Trade balance	-4,753	-3,422	-147	-400
年增長率 (%) YOY Growth(%)				
總出口 Total exports	-5.6	-1.5	30.4	37.6
進口 Imports	-8.1	-3.3	17.6	28
三. 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	2.9	0.3	0.3	1.1
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數 (宗) No. of agreements	74,804	73,322	7,561	13,773
年升幅 (%) Change(%)	-5.5	-2.0	71.3	68.2
五. 勞動就業 Employment			2020/11-2021/1	2020/12-2021/2
失業人數 (萬人) Unemployed(ten thousands)	139	259.1	25.3	26.2
失業率 (%) Unemployment rate(%)	2.9	5.5	7.0	7.2
就業不足率 (%) Underemployment rate(%)	1.1	3.1	3.8	4.0
六. 零售市場 Retail Market			2021/1	2021/1
零售額升幅 (%) Change in value of total sales(%)	-11.1	-24.3	-13.6	-13.6
零售量升幅 (%) Change in volume of total sales(%)	-12.3	-25.5	-14.5	-14.5
七. 訪港遊客 Visitors			2021/2	2021/1-2
總人數 (萬人次) arrivals (ten thousands)	5,590	356.9	0.5	1.0
年升幅 (%) Change(%)	-14.2	-93.6	-97.2	-99.7
八. 金融市場 Financial Market			2020/12	2021/1
港幣匯價 (US\$100=HK\$)				
H.K. Dollar Exchange Rate (US\$100 = HK\$)	779.3	775.2	775.2	775.3
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	2.6	30.1	30.1	78.4
M2	2.8	5.8	5.8	15.2
M3	2.7	5.8	5.8	15.1
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	2.9	5.4	5.4	15.8
港元存款 In HK\$	2.5	6.2	6.2	24.6
外幣存款 In foreign currency	3.2	4.6	4.6	6.8
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	6.7	1.2	1.2	12.4
當地放款 use in HK	7.1	1.7	1.7	17.7
海外放款 use outside HK	5.8	0.1	0.1	-0.1
貿易有關放款 Trade financing	-0.7	-6.2	-6.2	-2.2
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	28,189	27,231	27,231	28,284