SPACs – Their Purpose

SPACs are an alternative to traditional Initial Public Offerings (IPOs) for bringing private companies public. Whereas a traditional IPO is initiated to capitalize a specific company, a SPAC is formed to raise the capital first and then find an attractive operating private company to capitalize—either through acquisition or merger (the "deal").

SPACs are popular because they have the potential to offer valuable benefits to all parties involved:

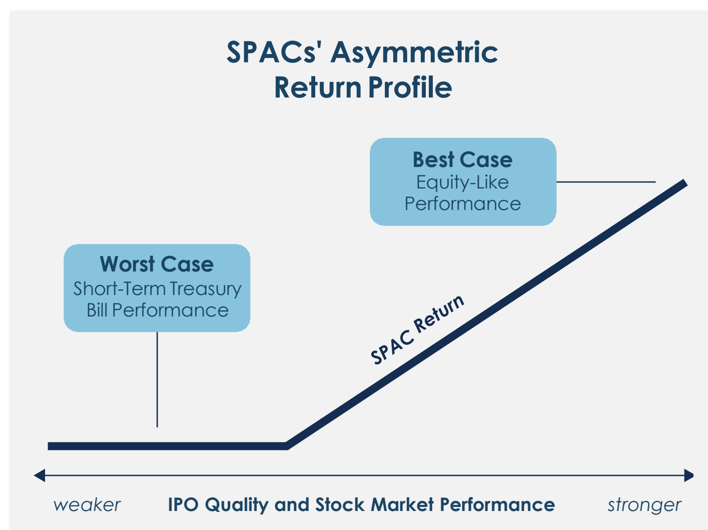
- For the private company—a quicker, cheaper way to access the public markets
- For the sponsor of the SPAC—access to ready capital for private-company deals, from which they can earn a substantial return on investment
- For investors—the opportunity to invest in a private equity-esque investment with strong checks and balances and attractive financial benefits

Short Term Interest Rate with Equity-like Potential– SPACs

Despite some recent bad press, we believe SPACs offer investors a viable way forward. A diversified portfolio of SPACs delivers an asymmetric risk/return profile:

- Baseline of short-term U.S. Treasuries with low risk of permanent loss of capital
- The optionality of equity investments
- Potential long-term tax treatment of realized capital gains

Additionally, SPAC returns are frequently positively correlated with rising interest rates.



SPACs – The Basics

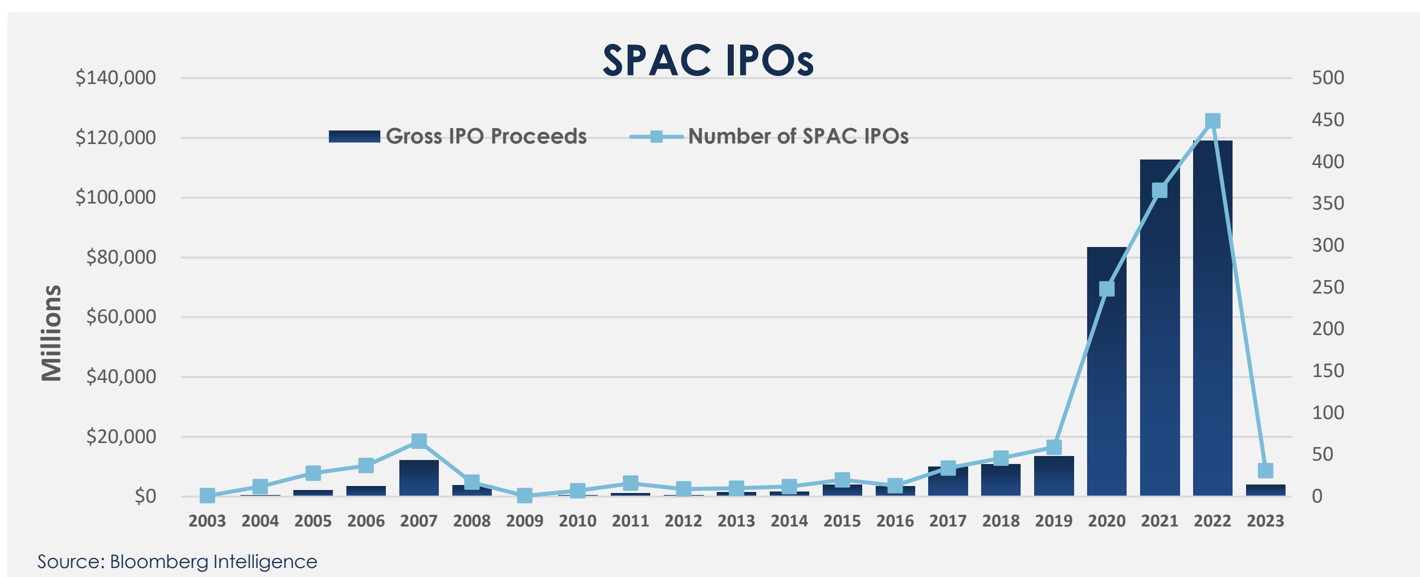
Their Mechanics

A SPAC issues shares to the public, typically at $10 per unit. Each unit is comprised of one common share and a combination of warrants and (sometimes) rights. Shortly after the IPO, the units split and the components (common shares, warrants and rights) trade separately. The proceeds from the IPO are placed in a trust account where they are invested in short-term U.S. Treasury Bills. Following the IPO, the sponsor typically has 18 to 24 months to complete a deal with a private company:

- If the sponsor is unable to complete a deal, the trust account is liquidated and funds are returned to investors with interest.
- If the sponsor is able to arrange a business combination with a private company, investors in the SPAC company vote "yea" or "nay" on the deal.
- If the deal is a good one, investors can remain invested, with the possibility of capital appreciation on their units.
- If the deal is unattractive (or there is no deal), investors can ask for their money back.

Their Scope

In 2023, there were 31 U.S. SPAC IPOs, with a total market cap of approximately $3.8 billion. This activity level was markedly lower than that in recent years, but there are encouraging signs for a pickup in activity and maturing space going forward.



Source: Bloomberg Intelligence

Definitions: An initial public offering (IPO) refers to the process of offering shares of a private corporation to the public in a new stock issuance for the first time. An IPO allows a company to raise equity capital from public investors. Common share shareholders in a publicly-traded company have certain rights pertaining to their equity investment, and among the more important of these is the right to vote on certain corporate matters. Rights offerings grant shareholders the right, but not the obligation, to buy new shares at a discount to the current trading price. Warrants gives the holder the right, but not the obligation, to buy common shares of stock directly from the company at a fixed price for a pre-defined time period.

SPACs – The Trust Account

The structure of the trust account is extremely important, not just to returns, but to the safety of principal as well.

If no deal with a private company is consummated, investors get back only their pro rata portion of the trust account. Accordingly, potential investors should examine the trust account structure very carefully, including how the account's funds are invested and how they're protected from creditors and any potential liabilities.

What to look for...

1. Where are assets custodied?

Cash proceeds from the SPAC company IPO should be custodied at a major and reputable financial institution and be overseen by an independent trustee as per the investment management trust agreement. No funds should be released unless a deal (business combination) is completed or the SPAC liquidates. Funds may be released for tax or working capital purposes if expressly stated in the trust agreement.

2. How much is initially invested in the trust account?

The amount of cash initially set aside for investors varies with each SPAC company. Lesser-known sponsors and smaller investment banks may entice investors with more cash. Other sponsors will promise a bump in cash if the sponsor seeks an extension of time permitted to complete a transaction.

3. How are the assets invested?

To protect principal, assets should only be invested per the guidelines in the trust agreement and under the supervision of the trustee. The assets are typically invested in short-term U.S. government securities with a maturity of 180 days or fewer. There is no credit or interest rate risk.

4. Who has access to the interest earned on the trust account?

Investors should be entitled to the interest earned on the trust account. This will ensure investors earn a competitive return in the event no deal or a poor deal is announced, and reduce the opportunity cost of investing in a SPAC versus holding cash in a bank account.

5. Are assets protected from claims against the trust?

If claims are brought against the trust by target businesses or vendors in the event of a liquidation, there should be a written guarantee from sponsors that they will pay claims so that the amount in the trust account is not reduced.

6. Does the trust pay the cost of dissolution?

If no business combination is completed and the SPAC is liquidated, it is important to know who is responsible for paying dissolution expenses, as this will impact the liquidation proceeds. Does the sponsor bear this expense? Or are funds released from the trust account? If expenses are paid out of the trust account, the amount should be made clear in advance and capped.

SPACs – The Redemption Feature

An important safeguard in the structure of a SPAC is the redemption feature, which allows investors to opt out of a poor deal and receive cash equal to their pro rata portion of the trust account—typically their initial investment plus interest.

How are deals approved? How do investors opt out?

When the management of a SPAC finds an attractive merger target, it is required to seek approval of the merger from investors. This is done in two ways.

- **Tender offer:** In this instance, the SPAC will commence a tender offer to purchase all shares from investors that wish to exit the company for cash, at a price equal to their pro rata share of the trust account.
- **Vote:** In the second (more common) method, a shareholder meeting is held and shareholders vote on the transaction. At this time, investors who choose not to stay in the deal may follow procedures to redeem their shares for cash.

Investors must take several steps to ensure they don't lose their right to redeem their shares…

a) Make sure that you are a shareholder of record.

Shares purchased after the record date for a shareholder meeting are not entitled to vote and are not entitled to redemption rights. Therefore, it is extremely important that you be a shareholder of record. If not, in the event of a poor deal, you will be left holding shares of stock that may perform poorly, possibly resulting in loss of principal.

b) Shares must be voted.

Shareholders of SPACs must vote their shares. They can vote for or against the business combination, but shares must be voted and the proxy card checked off correctly. Otherwise, redemption rights will be lost.

c) Shares should be held in a cash account.

Shares purchased in a margin account can be lent out by a broker's stock loan department. If that happens to SPACs that you own, you will lose the ability to vote your shares and lose redemption rights.

d) Shares must be delivered to the transfer agent by the deadline.

To complete the redemption request, shares must be delivered by the brokerage firm to the transfer agent by the deadline, which is usually two business days before the meeting date. If shares are not received by the transfer agent in a timely manner, they will not be redeemed.

CASE STUDY – EVALUATING SPONSORS AND UNDERWRITERS

In addition to the structure of a SPAC, an investor needs to evaluate the capabilities of the sponsor and investment bank bringing the company public.

Not All Sponsors Are Created Equal

The intent of a SPAC sponsor is to find undervalued private companies, bring the companies public by tapping into capital provided by the public securities markets, and then grow the company.

The end goal for sponsors is to make money for themselves and their investors. Sponsors have their own capital invested in the blank check company, and they will lose their money if no deal is announced. However, if they complete a successful deal, they stand to receive returns many times greater than what they initially invested.

While sponsors are highly incentivized to get deals done, it is important for an investor evaluating a blank check company to also assess sponsors' strengths and weaknesses:

- Their experience, reputation, skill and networking capabilities.
- Their "skin in the game"—i.e., the size of their capital investment in the SPAC.
- Their potential to not only complete a deal in the limited time allotted, but also to achieve a well-regarded business combination likely to increase the price of an investor's common shares, warrants and rights.

Underwriters – Large vs. Small

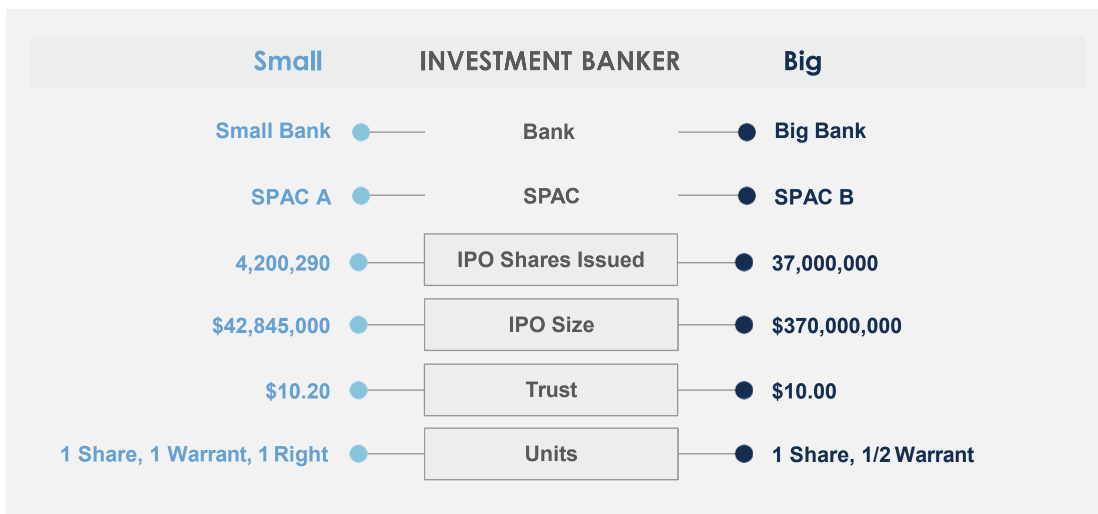
Investment bankers play several important roles. The first is during the IPO stage: Bankers help design the structure of the SPAC and sell shares to the public.

Second, they utilize their resources and networks to bring potential merger targets to the attention of the sponsor. Also, they help in completing deals and obtaining shareholder approval.

Larger investment banks are thought to have better resources than smaller banks, so smaller banks will entice SPAC investors by providing more generous structures (better terms on warrants, higher amounts held in trust, etc.) than larger banks.

Alignment of Interests

To align the interests of the bankers with sponsors and investors, bankers' compensation is based on both IPO success and deal completion. Partial compensation is received at the time of the IPO, and the balance is deferred to when a deal is completed. Because investors have the right to redeem shares if they do not like the deal, bankers' compensation should also be tied to the number of public shareholders that opt to remain in the deal.



This chart is for illustrative purposes only and highlights some of the quantitative differences between blank check companies underwritten by large and small investment bankers.

CASE STUDY – LANDCADIA HOLDINGS II (LCA) ACQUISITION AND ASYMMETRIC PAYOFF RATIOS

Equity-like potential with principal protection

IPO Terms

- Landcadia: 31.6 million units at $10
- Unit = 1 Common Share and 1/3 Warrant with $10 per share deposited in the Trust Account invested in short-term treasuries
- SPAC Deal Window: 24 months
- Underwriter: Jefferies
- SPAC Management Team: Led by well-known dealmakers Tilman J. Fertitta (owner of Houston Rockets, Landry's and the Golden Nugget Casinos) and Richard Handler (CEO of Jefferies Financial Group)

Deal Highlights

- Transaction valued the combined companies at an anticipated pro forma Enterprise Value of $745 mm, or 6.1x Golden Nugget Online Gaming's estimated 2021 revenue of $122 million.
- Landcadia II will assume $150mm of GNOG debt and pay down at closing an additional $150mm of debt at closing.
- GNOG will become only the second publicly traded pure online casino company in the U.S.

Asymmetrical Return Profile

This example clearly illustrates the asymmetric return profile of SPACs, and how it can be skewed toward the upside.

On the downside, one's risk is limited to the cash in the trust account and the interest earned.

However, the upside potential is as high as that of equity investments.

Important Disclosures: Prior to a merger transaction, common shares of a SPAC often trade at a discount to the cash held in the trust and may decline in value. It should not be assumed that the performance of any specific investment or investment strategy will be profitable or suitable. It may, in fact, result in a loss. Sources: Bloomberg (pricing data); SPAC Research (IPO data)

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Associated Risks of Pre-Combination SPACs. "Pre-Combination" SPACs are SPACs that are either seeking a target for a Combination or have not yet completed a Combination with an identified target. Pre-Combination SPACs often have predetermined time frames to consummate a Combination (typically, two years) or the SPAC will liquidate. The Fund invests in equity securities including common stock, rights and warrants of SPACs, which raise cash to seek potential Combination opportunities. Unless and until a Combination is completed, substantially all of the cash raised by a SPAC is deposited in a trust account that generally invests its assets in U.S. government securities, money market securities, and cash. Because SPACs have no operating history or ongoing business other than seeking Combinations, the value of their securities is particularly dependent on the ability of the entity's management to identify and complete a Combination that investors find attractive. There is no guarantee that the SPACs in which the Fund invests will complete a Combination or that any Combination that is completed will be attractive to investors. Some SPACs may pursue Combinations only within certain industries or regions, which may affect the volatility of their prices. **New Fund Risk.** The Fund is a recently organized investment company with no operating history. As a result, prospective investors have no track record or history on which to base their investment decision. **Non-Diversification Risk.** Because the Fund is "non-diversified," it may invest a greater percentage of its assets in the securities of a single issuer or a lesser number of issuers than if it was a diversified fund. Investing involves risk, including the possible loss of principal. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV and are not individually redeemed from the Fund. Brokerage commissions will reduce returns. The Fund's investments in securities linked to real assets involve significant risks, including financial, operating, and competitive risks. Investments in securities linked to real assets expose the Fund to potentially adverse macroeconomic conditions, such as a rise in interest rates or a downturn in the economy in which the asset is located.

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