Playa-ing around with SPACs (Part 1) $PLYA $PACE

- Pace Holdings (PACE), a SPAC, is buying Playa Resorts in a deal scheduled to close this month.
- Despite the history of SPACs, I find the deal and company attractive
- Due to post size, I split my overview into two pieces: part 1 (below) covers why I'm so negative on SPACs, and part 2 (see here) covers why I like Playa.

In the wake of the tech bubble, there were plenty of stories of retail investors losing huge chunks of their net worth. As a value investor, the story that resonated most with me was probably the “prudent investor caves and gets burnt”. The story went something like this: Chad and Joe live next to each other and have similar jobs working for the same company. One day, Chad tells Joe about this hot tech stock he’s investing in. Joe, being a hardworking and prudent investor, looks the stock up, sees it has 100x P/E, and ignores Chad. The stock goes up 50% in three days. Rather than kick himself, Joe thinks something cliché like “even a broken watch is right twice a day.”

The next week, Chad tells Joe how he’s rolling his profits from the first company into a new, even hotter tech stock. Joe looks this stock up and sees that its P/E is infinite (the company was burning money like crazy). If we’re being honest, Joe likes Chad, but Joe can’t help but having a little premature Schadenfreude thinking of Chad’s speculation failing when the stock crashes and burns. Instead, Joe watches in horror as the stock triples over the next two weeks.

A month later, Chad tells Joe about his latest tech stock idea. Joe sees that this one is trading at a “reasonable” 50x P/E. Sick of missing out on all this easy money, Joe thinks to himself “ok, this isn’t as cheap as I normally would like. But it’s way cheaper than the other two. I’ll swing hard at this one and make some money.” Trying to catch up to Chad, Joe puts half his net worth into the stock. The stock drops 95% over the next two weeks, and Joe is ruined.

Anyway, I recently dipped my toes into the SPAC space for the first time in a

while by buying Pace stock and warrants (PACE; soon to be PLYA, disclosure: long a bit of stock and warrants), and as I was doing it couldn't help but feel a little bit like Joe.

Let me go through some background. A special purpose acquisition vehicle (SPAC) is a company that raises a bunch of money in an IPO. That money then sits in a bank account while the SPAC looks for a company to buy. Eventually, they find an acquisition target, and the SPAC then takes that deal to their shareholders. If shareholders approve the merger, the SPAC buys the target and the common stock switches from owning the cash in the bank account to an ownership interest in the company (just like a normal stock). If shareholders don't approve of the merger, the deal breaks and the SPAC needs to try to find a new target. If the SPAC can't find a target / get a merger approved in ~2 years, they have to return all of their money to shareholders.

There's no two ways around one fact: the history of [SPACs is awful](). There are two main reasons for that historical underperformance:

1. The incentives encourage the SPAC's sponsors to do any deal. If the SPAC ends up liquidating, the sponsors are out 2+ years of time in addition to any of their out of pocket expenses for setting the SPAC up, looking at deal targets, etc. However, if the SPAC successfully completes a deal, the sponsors are given a significant amount of equity (called "founder's shares") and warrants in the new company for basically nothing. Getting 10%+ of the company plus a ton of warrants for almost nothing is pretty typical; given the SPACs are generally raising hundreds of millions of dollars, that free equity is incredibly valuable.
2. This is somewhat related to the incentive to do a deal at any price, but SPAC investors can be assured they are paying top price for any company they are buying. SPACs are financial buyers with no synergies; in general the only way they're successfully buying a company is if the company is at an auction and the SPAC is the highest bidder. Not exactly the recipe for finding undervalued companies. And SPAC common stock holders are actually hit with a double whammy: not only did the sponsor buy the company for top price, but the common shareholders effectively pay a 10%+ premium on top of that after you adjust for the free dilution given to the SPAC manager as a reward for successfully completing a deal.

Ok, so SPAC's have an awful history and investors in them are effectively paying a premium for any company they buy / deal they do. So why do investors keep funding them?

The answer is in the way an SPAC IPO is structured. At an IPO, SPAC investors pay $10 for one unit. Each unit consists of one share and one warrant to buy a share, generally for ~$11.50/share. The investors are promised the option to redeem their shares for $10/share (plus any interest that accrues on those funds while they're sitting in a bank) if they want to. So investors at the IPO effectively are parking their cash in a bank account and given a free

warrant in exchange. Everyone likes getting something for free; for investors with too much cash or a super low cost of capital, it makes too much sense not to take advantage of that offer.

The arb for initial IPO investors should look something like this: hand over your $10 and get a share and a warrant. Sell the warrant to immediately collect your profit, and then hold on to the shares until a deal's announced. If the stock trades above $10, sell it then and take a nice profit. If the shares trade below $10, redeem your stock to the company and get $10. Either way, the warrant represents pretty much risk free profit.

But that whole process does present one interesting dynamic- the initial IPO investors are pretty insensitive to the deal itself. Obviously, if it's a bad deal, they'll have to vote against the deal and collect their $10 in cash. They're looking to sell their shares and warrants and collect a risk free profit, not hold on to the shares or warrants if the deal is actually a good one. In effect, they are forced sellers, so if the announced deal is actually a good one it gives investors an opportunity to buy up virtually unlimited shares and especially warrants at prices just above the $10/share IPO price. And that forced selling is quite the lure, particularly when you add in the leverage that a warrant gives an investor: if you can identify one good deal in the sea of SPACs, you can buy the hell out of the warrants from relatively price insensitive sellers and make a massive profit when the stock / warrants go up.

That sounds incredible in theory. I love forced / uneconomic sellers. But it's really tough to execute. Remember, an SPAC is generally paying 10%+ the highest price a slew of sophisticated investors were willing to pay. With that as a starting point, you basically have to think 1) every singly sophisticated investor who passed at a price effectively 20%+ lower despite inside information was a complete dummy or b) there was some type of deal dynamic that so heavily incentivized going with an SPAC over some other type of structure that the SPAC managed to overcome the awful incentives to produce a fantastic deal. Color me skeptical on both ends; finance types with hundreds of millions on the line are very through in inspecting every nook and cranny for value, and there's a reason we've come up with the term "winner's curse". I also can promise that every advantage of an SPAC can be topped by a private structure without SEC compliance and minority shareholders ten times over; there's a reason more and more companies prefer to be private over public.

But perhaps my skepticism that is a bit too cynical. I know several investors who participated in just two SPACs last year: TWNK and LMB. TWNK is at ~$15.50 and LMB is ~$14, so the stocks have been huge home runs and the warrants have been absolute grand slams. I looked at both and ended up passing for one reason or another; chief among them was the hesitancy for investing in any SPAC's mentioned above. Maybe those investors got lucky. Or maybe there is value in the slew of awfulness that is SPACs, and those

investors were just able to see it more clearly than I am.

Pace is in a deal to merge with Playa Holdings. There are a lot of things about the deal I like. There are also a lot of things about the deal I don’t like. I have a small position in the stock and warrants now, but it’s tough for me to wonder if my position is because I actually fundamentally like the company or if I’m acting like Joe and trying to catch up to Chad after seeing the success of TWNK / LMB.

In part 2 of this post, I discuss what I like / don't like about Pace / Playa.