What happens when SPAC deals start failing?

Regular readers don't need a reminder, but I've been more than a little obsessed with SPACs recently. Almost all of my recent public posts and ideas have mentioned SPACs in some form, and I even did an interview with ReutersGMF entirely focused on SPACs.

The reason I'm so obsessed is simple: while, as a whole, the SPAC market will likely lead to value destruction for minority shareholders, from an event investors standpoint SPACs offer some of the best risk/rewards imaginable. An example might show this best: RTP is Reid Hoffman's SPAC. They announced a deal in late Feb with PIPEs from Uber, Baupost, and Baillie Gifford and structured the with a long term lock on the founders' shares (which should better align incentives with minority shareholders). Shares traded at $15/share in February before the SPAC carnage started. Shares last traded for $9.98, just below trust. That creates a really interesting risk reward: buy the shares today, and if the market suddenly gets excited about RTP again you could be looking at a lot of upside. If the market doesn't get excited, you can just redeem for trust value (~$10/share) and basically break even. As an added cherry on top, RTP is a small holding in the Ark Space Fund (ARKX) (alongside "definitely focused on space" companies like Netflix and Deere), so you don't necessarily need the market to get excited about RTP specifically to benefit; if the market went wild for ARKX for some reason, there's a decent chance RTP would benefit, and you're paying (less than) nothing for that optionality currently.

Personally, I find that type of "heads, you win, tails, you don't lose" risk-reward to be borderline unbelievable. While reminding readers that nothing on this site is investing advice, it just seems like the type of tilted odds that most investors / traders / gamblers dream of. For a while, Fortune's Formula made Kelly Criterion really popular with investors (it's still popular; it was just really popular for a few years there). Buying a SPAC below trust offers no chance of permanent loss (yes, you can mark to market up or down a few %, but eventually you can redeem or the SPAC will liquidate and you'll get trust back) and huge upside; plug that combo into Kelly and you're going to get a pretty high number for how much you should allocate to the investment (I say that while again reminding that absolutely nothing on this site is investment advice)!

Anyway, today I didn't want to focus on the "what happens if ARKX goes to the moon and takes RTP with it" type upside. Instead, I wanted to focus on the most likely outcome for SPACs trading at or below trust: what happens if their share prices don't rise above trust?

From an investor standpoint, it's pretty simple: if the SPAC never rises above trust, you redeem your shares for trust value when you're given the option. But what levers can the company pull if their stock is below trust?

Again, a typical SPAC has ~$10/share in trust. So if you see a SPAC trading below that price, in general it's because the market is expressing doubt about that SPAC. If the SPAC does not have a deal announced, the market is expressing doubt the management team will be able to find a deal that creates value. If the SPAC does have a deal announced, the market is saying the deal has not created value and expressing

significant doubt that shareholders will hold their shares through the deal (if a SPAC is at $9.98 and the company has $10/share in trust, the economic thing to do it redeem your shares when the vote comes around!). What happens then?

The most obvious thing that's going to happen if a SPAC is trading below trust is the company is going to go on a marketing blitz to better tell their story to shareholders. If the company can convince shareholders that the deal is great and the business's future is bright, maybe a few shareholders that would have sold hang on to their stock, or a few new shareholders buy into the stock, and the stock trades above trust and it's now makes more economic sense for shareholders to hold on to their stock versus redeem. That's why you're seeing SPAC sponsors make public relations drives that would make local politicians in the heat of primary season blush; from lengthy analyst days to "Mad Money" appearances to popping on podcasts to just a bunch of tweeting, SPAC sponsors and companies are trying to paint a good story / get their stock price up.

Why would the company care about painting a good story and how many shareholders redeem? Well, there are a bunch of reasons (what company doesn't want a higher share price?), but there are two big ones: the minimum cash closing condition and the desire to be public.

Let's start with the minimum cash closing condition. This is a pretty standard condition of SPAC mergers; it basically says that the merger will provide a certain amount of money to the company at closing. If enough shareholders redeem, the cash in trust can go below that minimum cash number, and the company the SPAC is merging with could call off the merger. An example might show this best: SmartRent is SPACing with Fifth Wall

(FWAA). If you flip to p. 66 of the merger agreement, you can see the merger has an "available funds" / "minimum cash" condition of $250m. That minimum cash includes $155m from a PIPE (lead by some pretty good investors), so the SPAC trust needs to have $95m ($250m minimum cash less $155m PIPE) post-redemption in order for the minimum cash condition to be met. That's probably a pretty good bet; the SPAC has $345m in trust and is trading well above trust value currently (~$10.60 versus trust of $10), so something would have to go pretty wrong for enough redemptions to come in that the minimum cash condition to be an issue, but you could certainly imagine a world where the stock market takes a really bad turn or some bad press comes out on Fifth Wall and it becomes an issue.

But what happens if the company and SPAC can't change the narrative and shares continue to languish under trust value? Well, then they're probably in for a wave of redemptions that takes the company to under the minimum cash condition. At that point, it'll be up to the company and SPAC what to do. The easiest thing would be to just waive the minimum cash condition; for example, RPLA last month was merging with Finance of America (FOA). Their deal had a $400m minimum closing cash condition; when it became clear redemptions would take them well under that number, the company and SPAC simply agreed to waive that condition. In the end, RPLA had ~75% of their shares redeem and closed with ~$342m (the vast majority of which was from their $250m PIPE).

If the company and SPAC can just agree to waive the minimum cash close condition, why does any of this matter? Well, for SPACs without a PIPE, a wave of redemptions would mean that they're delivering almost no cash to their merger partner. Even for SPACs w/ a PIPE, a wave of redemptions could effectively turn the stock into a super illiquid, highly concentrated stock, which doesn't make anyone happy (it

reflects poorly on the company, means they'll have trouble raising financing in the future, and the PIPE shareholders will be unhappy because they'll have a lot of trouble unloading the stock when their lockup expires and they're ready to sell). At the extreme, you could have a SPAC that waives its closing cash condition and sees 100% redemption... and then the PIPE shareholders and company have basically created a private market company that has a ticker but no trading stock (and a boatload of pissed off PIPE investors!).

There are other options for SPACs facing a wave of redemptions. The two main ones would be letting the deal get voted down or recutting the deal.

Let's quickly go into "letting the deal get voted down." This has happened before; basically what happens is the current merger ends and the SPAC sponsors can now search for a new deal. If they find one, they can bring it to shareholders and try to have them vote that through. However, it's generally a tough process; remember that SPACs eventually have to wind up if they don't find a deal, and given how much time and effort goes into a deal that fails, the SPAC sponsors won't have much time to find a new deal. In addition, shareholders have basically told management "you came to us with a deal you said was great and we didn't believe you," so any future deals are probably going to face a pretty high bar to getting cleared / going through. And any company negotiating with that SPAC will know that shareholders have already voted one deal of theirs down; it's going to make it tough for any but the most desperate of companies to commit to a merger knowing shareholders have already rejected that SPAC team once.

So let's turn to "recutting the deal." This process is actually the reason I wanted to write this article: I think

we're going to see a waive of recuts going forward, as both SPAC sponsors and companies recover from the euphoric valuations of February and look at how to get their deals through in a way that benefits everyone. And I think investors today who are buying SPACS below trust value are getting a free option on a deal recut.

A deal recut can take several forms. The simplest is the company and target agree to just cut their valuation; for example, Aersale (ASLE) announced a deal to be acquired/SPAC'd for $430m in late 2019. Then the pandemic hit, and in September the company agreed to cut their valuation down to $300m. But there are other things that can be done to cut a deal price; for example, when HOF Village was having trouble getting their merger through in early 2020, the SPAC sponsors agreed to significantly reduce their founders shares so that minority shareholders would get more of the combined company.

I suspect that both types of recuts will be in play going forward. Some of the valuations that SPACS placed on more speculative companies at the start of the year look insane with hindsight (actually, they looked insane in real time, but they look even more insane today!). These SPACs are going to be facing a wave of redemptions if they don't recut their deals; I think they'll recut their deals to a lower price point and to better align sponsors with shareholders (either by putting longer lock ups on the sponsor shares or by giving shareholders some of the sponsor economics in order to nudge the deal over the finish line) in order to get their deals done. Investors buying below trust are getting a free look into a potential recut: if the sponsor gives up enough economics or the companies recut the deal to the point where the market likes the deal, shares could go up substantially. If not, investors could just redeem.

An example might show this best. Consider SOAC. They announced a deal to merge with DeepGreen in early March. Shares have fallen in line with the SPAC market since then and currently trade under trust value (~$9.92 versus $10 in trust). I think it would behoove everyone to try recut this deal. DeepGreen has huge cash needs to fund their exploration and production ramp; so cutting the deal price to ensure maximum cash in their trust would be a big win for them (and, given SOAC has already done DD and has them under contract, even a recut deal w/ SOAC is probably, by far, the lowest cost of capital option for SOAC). The SOAC sponsors are on the shot clock; the SPAC expires in ~November, so if this deal falls through they probably won't have time for a second shot. And shareholders could benefit from a recut deal in that the shares might actually trade above trust! Win/win/win for everyone by recutting the deal. Shareholders get the chance at some upside, the sponsors can keep their promote alive, and DeepGreen gets access to much needed financing at what will still be very attractive terms.

Anyway, I'm going to wrap this post up here. It got a little longer and more winding than I initially thought it would, but there are a ton of SPACs trading below trust and I get questions all of the time asking what will happen to them. I wanted a place to put what I think will happen (i.e. no guarantees, just what I think makes sense) and to delve a little further into why I think SPACs below trust represent such an interesting opportunity.

I've said it before and I'll say it again: SPACs are an event investor's dream playground, and as long as the opportunity set is this interesting I'll be spending more time writing / researching / thinking about them.