Reverse Mergers Went Bust. Will SPACs Follow?

Despite current exuberance, the signs don't augur well for "blank cheque" companies.

"Be fearful when others are greedy," wrote Warren Buffett in his annual letter to Berkshire Hathaway's shareholders. "And greedy only when others are fearful." Buffett's advice was meant for investors who try to **time the market** – a strategy that is a crapshoot at best – but it could be just as prescient for the financial frenzy of the moment: special purpose acquisition companies.

SPACs are shell companies that raise money in an initial public offering, typically attracting retail investors at US$10 a share, before finding private firms to merge with within a two-year deadline. Those firms that merge with SPACs thus become public without going through the paperwork and scrutiny entailed in a conventional IPO. SPACs have been around for years but exploded in popularity last year amid the global market exuberance, when 248 of them raised US$83 billion – six times the amount raised in 2019 and nearly as much as IPOs.

This year the phenomenon has only burned hotter. By the end of February no fewer than **188 SPACs had gone public**, amassing a total of US$60 billion. Famous founders or, in the jargon, "sponsors" ranging from billionaire hedge fund manager Bill Ackman, business magnate Richard Branson to football star Colin Kaepernick have only added to the allure of the so-called "blank cheque" companies, especially to retail investors who are often shut out of IPOs by more heavyweight players.

But history – if not Buffett's counsel – should give pause to would-be SPAC investors, as my recent **paper** shows.

Blast from the past

With its *modus operandi* of **an IPOdone backwards**, SPAC is a type of reverse merger, the subject of my paper, which was recently featured in the ***Harvard Business Review***. In a classic reverse merger, a private company hunts for a listed empty shell on whose back it could quickly go public without the fuss of an IPO. The controversial practice has existed for decades, mostly on the margins of financial markets. The most recent wave of RMs began in the mid-2000s and peaked in 2010 – before crashing in 2011.

Conventional wisdom, as INSEAD professors **Vibha Gaba**, **Henrich Greve** and I documented in a **paper** , is that when more people adopt a *non-controversial* practice, it will become increasingly widespread due to growing awareness and legitimacy. To understand how *controversial* practices propagate, **Edward Zajac**, **Peggy Lee** and I studied the boom-to-bust of reverse mergers. We found that, predictably, increasing adoption of RMs boosted awareness and, in turn, help spread the practice further.

However, the very same awareness also sparked and fuelled concern among third parties – media, investors and regulators. The controversial practice then became increasingly seen as a threat to existing institutionalised practices. That, plus the entry of low-status adopters, eventually stymied reverse mergers and caused them to wane. Similar factors have now converged in the froth of SPACs.

Too popular for its own good

We theorised that the popularity of a controversial practice has two opposing effects on its diffusion trajectory: a direct, positive effect due to increasing awareness among potential adopters of the practice and its potential desirability; and an indirect, negative effect stemming from greater third-party concern and scepticism.

These two effects are exactly what we found in our analysis of the RM boom during the 2000s in the United States. We collected data on reverse mergers' diffusion, market responses and firm characteristics, including market value, earnings, total assets and debt and exchange listing between 2001 and 2012.

We also studied how the media evaluated reverse mergers. Of the 267 articles published from the time period, 148 were neutral, 113 were negative and only six were positive. Finally, we gathered share price data to examine how stock markets valued reverse mergers.

Our analysis shows that, initially, as reverse mergers grew in number, the practice attracted even more adherents. It also drew scrutiny from the media and investors. Their scepticism intensified as the proportion of RM transactions involving firms with relatively low reputations and lacklustre market reception increased. This became a negative spiral which discouraged firms with good reputations from adopting the practice.

More trouble was to come. Both the Securities and Exchange Commission's 2005 disclosure rules for RMs and its 2011 warning to investors about investing in RMs amid an influx of Chinese players – a phenomenon studied in **another of my recent papers** – fanned negative market reactions.

In essence, investors, regulators and the media fed off one another's cues and evaluations. Negative media coverage weighed on stock market valuation and the subsequent diffusion of reverse mergers. By 2010, when RM activity peaked, 70 percent of media articles spoke of the practice in a negative tone. Cumulative returns on investment in RM firms neared -45 percent. The following year, in 2011, RM activity plunged by 35 percent.

Peak SPAC?

The SPACs boom has all the ingredients of the RM bubble: fast proliferation of a controversial financial innovation, poor-quality players, bad publicity and regulatory concern.

Scepticism has largely been fuelled by high-profile failures like Nikola, the **discredited** electric truck maker whose stock is trading at a fraction of the peak reached shortly after its merger with a SPAC last June. Poor shareholder returns from SPACs on the whole haven't helped. According to a **study** published last year by advisory firm Renaissance Capital, of the 313 SPACs formed since 2015, 93 had completed mergers and taken a company public. But these delivered an average loss of 9.6 percent and a median return of -29.1 percent, compared to the average return of 47.1 percent for traditional IPOs since 2015.

No surprise then that media coverage of SPACs is often negative and cautionary. "SPACs are oven-ready deals you should leave on the shelf" **warned** a *Financial Times* headline in December. Even David Solomon, chief executive of SPAC underwriter Goldman Sachs, has **cautioned** that the boom is not "sustainable in the medium term." The SEC signalled its concern in September, when then-chairman Jay Clayton said the regulator was watching SPACs closely to ensure their shareholders "are getting the same rigorous disclosure that you get in connection with bringing an IPO to market."

More than 300 SPACs need to secure private firms to merge with this year or face liquidation, with the money they raised returned to investors. SPAC founders, who typically take a 20 percent equity stake in the target company, thus have a strong imperative to close deals — even **at the expense of shareholder value.** SPACs may well end up in a negative spiral of poor quality/bad press/tighter regulation. That should make any investor afraid.

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