PRIMEIRO PARTNERS

The Daily Dispatch

Weekly Special Feature

July 23, 2021

Reverse mergers went bust; will SPACs follow?

By: Ivana Naumovsk – The Business Times *(Published on July 21, 2021)*

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. *[BT FILE PHOTO]*

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." Mr 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 Mr 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 IPO done 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 & 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 per cent of media articles spoke of the practice in a negative tone. Cumulative returns on investment in RM firms neared -45 per cent. The following year, in 2011, RM activity plunged by 35 per cent.

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 per cent and a median return of -29.1 per cent, compared to the average return of 47.1 per cent 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 per cent 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.

The writer is an assistant professor of entrepreneurship and family enterprise at INSEAD. Her research examines the diffusion of practices and the consequences of corporate fraud, with a focus on financial markets. This article first appeared in INSEAD Knowledge.

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TODAY'S TOP NEWS

Gov't to enforce 60-40 oil sharing deal with China

The Department of Energy is preparing to implement the 60-40 ownership rule in the planned joint exploration with China over the West Philippine Sea, an official said Thursday. Energy Undersecretary Felix William Fuentebella said the Philippine and Chinese governments were in talks for the joint exploration.

BPI's net income climbed 28% to P6.8B in 2Q

Bank of the Philippine Islands, the third-largest lender in terms of assets, said Thursday net income jumped 28.8 percent year-on-year in the second quarter to P6.8 billion, its highest quarterly profit since the start of the pandemic.

ABCI to offer P1.5-B preferred shares

ABCI expects to raise up to P1.5 billion from the offering, which will be used to "support the development of pipeline real estate projects, land banking initiatives, funding requirements of subsidiary Irradiation Solutions Inc. and other general corporate purposes."

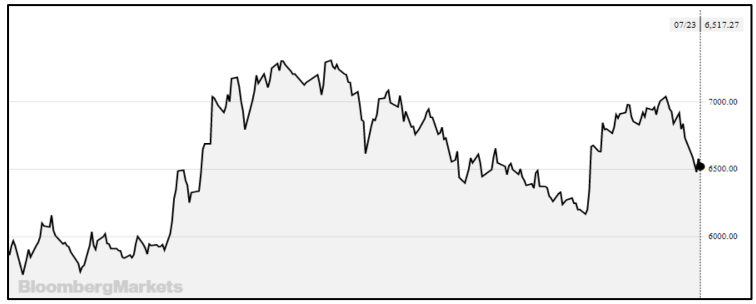
PNR Calamba receives 34 bids for railway project

The Department of Transportation (DOTr) said on Thursday a total of 34 bids were submitted for the contract packages of the Philippine National Railways (PNR) Calamba Project. The 34 were from six Filipino companies and 17 foreign firms. They were bidding for six packages of the railway project.

PHL non-life insurers to accelerate digitization

THE country's non-life insurance companies are expected to accelerate developing their digital infrastructure and product offerings as the industry continues to adjust to the "new normal" arising from Covid-19 pandemic, according to insurance credit ratings agency AM Best Co.

Philippine Stock Market Update



Previous Close:
6,576.62

1 Yr Return:
9.80%

Open:
6,600.88

YTD Return:
-8.90%

52-Week Range:
5,691.74 - 7,432.40

Source:
Bloomberg

Foreign Exchange

As of July 22, 2021

US Dollar	Philippine Peso
1	50.14

BVAL Reference Rates

As of July 22, 2021

Tenor	Rate
1Y	1.633
3Y	2.382
5Y	3.011
7Y	3.502
10Y	3.927
20Y	4.871

Daily Quote

"To play without passion is inexcusable."
-- *Ludwig van Beethoven*

MORE LOCAL NEWS

Million users seen to switch network providers

TELECOMMUNICATIONS Connectivity, Inc. (TCI), the company put up by the country's dominant mobile network operators to facilitate mobile number portability, expects "a million" subscribers to switch network providers during the initial phase of the implementation.

AC Health breaks ground for specialty cancer hospital

AC Health, the healthcare unit of Ayala Corp., broke ground for the country's first specialty cancer hospital on Thursday. Located at the FTI Complex in Taguig City, the Healthway Cancer Care Center is aimed to be completed by July 2023.

Lopez firm builds three microgrids in Camarines Sur

FIRST Philippine Holdings Corp. is preparing microgrids for underserved communities, its chief executive said on Thursday, as he disclosed Camarines Sur to be the location of the first batch.

Manila Mining board approves capital increase

MANILA Mining Corp. announced that its board of directors has permitted the increase of its authorized capital stock to P4.6 billion as part of efforts to settle liabilities. In a stock exchange disclosure on Thursday, the company said the board approved on July 21 the capital increase from P2.6 billion.

First Gen to supply clean energy to Menarco Tower

THE Lopez group's power generation arm First Gen Corp. announced on Thursday that it will be supplying clean power to the Taguig-based Menarco Tower of Menarco Development Corp. The deal, which was completed this month, will last for two years.

NGCP seeks ERC approval for interconnection proje

The National Grid Corp. of the Philippines (NGCP) is seeking regulatory approval to build 2 interconnection projects worth over P22B. Based on applications filed with the Energy Regulatory Commission (ERC), NGCP is proposing to put up the Batangas-Mindoro Interconnection Project and the Quezon-Marinduque Interconnection

Gov't eyes more reforms to fast-track telco permits

The government is eyeing more reforms to expedite the release of permits for the telecommunications sector, particularly for poles and cables, the Anti-Red Tape Authority (ARTA) said.

PayMaya, Smart to integrate digital wallet

PLDT's wireless arm Smart Communications Inc. has teamed up with digital financial service firm PayMaya to improve and make seamless the loading experience on the GigaLife App through a new feature called GigaPay.

Self-employed, voluntary SSS members up 20%

The number of self-employed and voluntary members (SEVMs) of the state-run Social Security System (SSS) rose 20 percent to 8.43 million as of end-May, making up one in every five members of the provident fund's 40.52 million membership base.

Fruitas puts up processing line in Cebu

Fruitas Holdings Inc., the listed food and beverage kiosk chain, is expanding in the Visayas with the establishment of a processing line in Cebu. The commissary marks the beginning of an aggressive expansion of Fruitas community stores and e-commerce hubs in the Visayas, said Fruitas president and CEO Lester Yu.

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TODAY'S TOP ASIAN NEWS

SGX to buy FX trading platform MaxxTrader for $125m

SINGAPORE Exchange (SGX: S68 +0.25%) will acquire single-source and direct-to-market FX trading platform MaxxTrader, for a cash consideration of US$125 million, the bourse operator said in a filing on Friday.

Japan boosts renewable energy targets

JAPAN will raise its target for renewable energy in the country's electricity mix for 2030 as it pushes to cut emissions to meet commitments under international agreements on climate change, according to a draft of its latest energy policy.

GIC increasing focus on sustainable investments

GIC has, in recent months, been investing in technologies geared towards reducing food waste and transitioning towards electric vehicles. The sovereign wealth fund launched its Sustainable Investment Fund last July, as it seeks to identify sustainability-related opportunities amid shifts towards a lower-carbon economy.

US PE fund Lone Star lays off most of its Asia staff

Texas-based private equity firm Lone Star Funds has laid off most of its investment team in Asia outside Japan in a major retreat from the region, three people familiar with the situation told Reuters.

China weighing unprecedented penalty for Didi

Chinese regulators are considering serious, perhaps unprecedented, penalties for Didi Global after its controversial initial public offering last month, according to people familiar with the matter.

TODAY'S TOP GLOBAL NEWS

Uber buys trucking software firm for US$2.25b

[SAN FRANCISCO] Uber on Thursday announced a US$2.25 billion deal to beef up its freight unit with the acquisition of a firm specialising in logistics management software.

Star Entertainment withdraws bid for Crown Resorts

[BENGALURU] Star Entertainment Group said on Friday it has withdrawn its all-stock proposed takeover of Crown Resorts, valued at A$9 billion (S$9 billion), over worries Crown may lose its licence to run its Melbourne casino.

Daimler to develop electric vehicles

[LONDON] Mercedes-Benz maker Daimler plans to invest more than 40 billion euros (S$63.9 billion) between 2022 and 2030 to develop battery electric vehicles (EVs), and be ready for an all-electric car market by the end of that period.

Chipotle, Starbucks, Domino's stocks hit highs

Domino's Pizza, Chipotle Mexican Grill and Starbucks hit all-time highs on Thursday as investors shrugged off any concerns about the delta Covid variant. On Monday, stocks fell sharply over concerns about a resurgence of Covid cases tied to the variant.

Carlyle seeks to raise as much as $27b for fund

Private equity firm Carlyle Group Inc (CG.O) is looking to raise as much as $27 billion for its latest flagship fund, Bloomberg News reported on Thursday.