MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 018 // **12 April 2021**

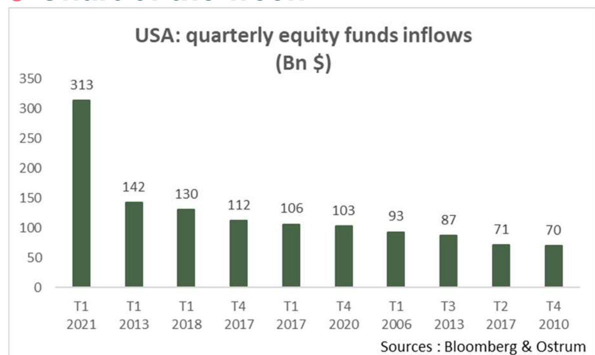
Topic of the week: SPAC, blank-check bets and financial mania

- **Excess liquidity always fosters financial innovation, that may turn out to be destabilizing;**
- **SPAC are blank-check investment vehicles set up to finance acquisitions of promising companies and list them rapidly in stock markets;**
- **SPAC are now drawing attention from regulators due to embedded risks stemming from information asymmetry between SPAC sponsors and investors;**
- **Recent SPAC price action may signal that investors have become more cognizant of risks of shareholder value destruction.**

Market review: Spring break

- **Equities off to strong start in 2Q**
- **Supply chain pressures and geopolitical risks weigh on the outlook**
- **Stable bond yields, some pressure on Italian spreads**
- **High yield outperformance continues**

Chart of the week



The volume of purchases in the United States on equity funds has largely beaten their record: 313 billion dollars in the first quarter of this year while the previous all-time high was «only» 142 billion.

A significant part of household savings has therefore been invested. This may be a signal that this savings will not be spent as much as some hope. It is also a signal of market overheating that echoes our theme of the week on SPACs.

Figure of the week

6.4%

Source : Ostrum AM

Sharp increase in US GDP growth expected by the IMF at 6.4% in 2021. That is +1.3 point higher than the Jan forecast. And +3.3 pp higher than the Oct one.
The Biden stimulus convinced the IMF.

Stéphane Déo
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Topic of the week

SPAC, blank-check bets and financial mania

Money must always go somewhere. It's no stretch to affirm that many corners of financial and real estate markets exhibit some degree of frothiness resulting from past monetary expansion. The Fed is only monitoring risks to financial stability it helped to create. Recent 'financial innovations' like non-fungible tokens, cryptocurrencies or indeed SPACs, i.e. *Special Purpose Acquisition Companies*, are prime examples of financial mania. In this piece, we review the latest developments in the US SPAC market.

The pitfalls of excess liquidity

Central banks responded to the pandemic by supplying reserves to the financial system. Repurchase agreements with banks and asset purchase programs resulted in unheard-of expansions of central bank sheets and narrow money aggregates. Money supply indeed rose well beyond transaction needs in the real economy so that excess liquidity built up. The Fed's total assets now amount to more than $ 7 trillion. Fed open market policy may have a direct impact on asset valuations, Treasury bonds for instance, or an indirect one as is the case for housing via MBS purchases. Central bankers certainly have great control on risk-free interest rates.

Yet policymakers should be wary of unintended consequences of excess money supply. To be sure, financial 'innovation' will always thrive on liquidity leaks along the alleged policy transmission channel.

Large amounts of liquidity are being diverted from macroeconomic objectives. Non-fungible tokens (NFTs), which offer a supposedly secure way to transfer "intellectual property rights," have seen prices skyrocket in recent times. Cryptocurrency investors have parked trillions of dollars outside the formal financial / economic system. SPACs also attract excess liquidity. Although SPACs are likely too small to pose a significant risk to financial stability, they also fall under financial folly.

An overview of SPAC: functioning and embedded risks

SPAC stands for Special Purpose Acquisition Company. These are investment vehicles designed to make acquisitions. SPACs are publicly traded shell companies with no operations. In fact, SPACs only hold cash to be used to purchase private (i.e. unlisted) companies. In the process, target private companies are instantly taken public.

SPACs go back a long way in the US where the tradition of private equity is more established than in Europe. The purpose of SPACs is close to that of private equity companies, albeit private equity funds tend to retire corporate equity from stock markets and may sell stakes in the marketplace years out. The main interest of SPACs is to enable the investment community to carry out private equity transactions via the stock exchange. Investors thus benefit from the guarantees of regulation and information offered by listed companies.

The SPAC life cycle

The life cycle of a SPAC is a three-stage process.

In the first phase, SPACs raise capital via an initial public offering and other funds. As it goes through the IPO process, the main assets of a SPAC are its management team, the management team's strategy and the SEC's approval of the SPAC Form S-1 registration statement. Cash holdings are placed into a trust account (interest bearing) as management explore opportunities. The funds are used to make acquisitions in specific sectors, within the next 18 to 24 months. If no attractive deal in the targeted industry can be identified, SPACs must return funds to their shareholders. Additionally, SPAC investors receive warrants that allow them to buy additional SPAC shares at a preset price. Shares and warrants typically trade separately.

SPACs raise capital to make acquisitions, then merge with the M&A target. The combined entity then begins operations and trade publicly.

Phase two is the SPAC's business combination. When a M&A target is identified, shareholders have a say. Shareholders have the right to pull back and redeem their investments. Upon shareholder approval, SPACs announce a merger with a private company. The target company is acquired, and the combined entity begins operations and start trading publicly.

The third phase is operational. A business strategy is designed, full integration takes place with appropriate financial and compliance processes.

The principal-agent problem

SPACs embed a classic principal-agent relationship. Investor confidence is therefore key. Writing blank-checks to money managers or sponsors to run acquisitions of promising private businesses may be hard to process for most investors.

A principal-agent control problem arises as investors (principals) have incomplete information about managers' (agents') skills and willingness to align with investor interests.

To convince investors, SPACs must respect a few operating rules. Upon the IPO, investors must know the main features of the targeted acquisition such as the sector, the indicative size of the deal and its expected profitability.

This is the reason why SPACs are usually associated with celebrity investors or former business captains in the targeted industries. But there is a reason. SPAC backers reward themselves with large equity stakes in the resulting companies. Indeed, sponsors can buy 20% of SPAC shares at deep discounts. Once a merger is announced, SPAC shares start moving away from their net asset value made of cash holdings. Upon merger completion, share prices reflect the outlook on the new company's earnings. Much like any other stock indeed.

Target companies of SPACs are usually young fast-growing firms. The current wave of new technology in telecommunications, biotechnology, robotics or green energy areas offers such ground for M&A but requires deep industry knowledge to select corporate targets. The ability of SPACs to act swiftly given large cash balances is clearly an advantage compared to a situation where acquirers must first raise funding.

SPAC's underlying risks and D&O insurance costs

The principal-agent relationship induces litigation risks. As they go through their IPO and the subsequent M&A process, SPACs face many regulatory, legal, and business hurdles, including obtaining the appropriate amount and type of insurance for each stage of their life cycle. Risks may come from alleged misrepresentations or omissions of facts in the SPAC's S-1 registration statement or challenges of the completeness of information in relation with the SPAC's acquisition. Shareholders may sue after the merger transaction because they are unhappy with the resulting company. There can be forms of class action against the new company and likely many more instances of litigation risks. The costs of so-called Director and Officer Insurance (D&O insurance) and other liability insurance rates for SPACs are skyrocketing. Coverage of about $10 million to indemnify a blank-check company's directors and officers now costs more than $1 million on average. That's up from $250,000 to $300,000 a year ago.

The 're-equitization' fuss and SEC concerns about the SPAC boom

Supporters of the SPAC boom say it is pumping fresh blood into the public (US) equity markets, after a long period when promising technology companies were happy to remain private. New US equity issuance is off to a great start so far this year. The share of new listings in relation to the Wilshire 5000 market capitalisation is much higher than in previous years. New equity issuance indeed goes well beyond the SPAC phenomenon but both reflect a form of revival of equity listing. Corporate share buybacks, the occurrence of financial crises and population ageing had contributed to a decade-long shrinkage of equity market breadth.

However, investors should keep in mind specific risks associated with SPACs. Using a SPAC as the vehicle to take a company public exposes equity investors to greater risks than a traditional IPO. In a classic IPO, investment bank underwriters would do due diligence before signing off on the company being listed. In a SPAC IPO deal, the banks only underwrite the blank-check company. There are concerns that the level of diligence the SPAC sponsor and their financial advisers do on the SPAC's target business is not as robust. Forward-looking forecasts of the targeted business may be hot air. There have been cases of wildly optimistic assessments and inflated market valuations. It's no surprise that the SEC is worried.

Furthermore, investors may not be fully cognizant of their costs once SPAC sponsors' cuts are included, as well as not being aware of SPAC managers' potential conflicts from their other investments.

Regarding underwriting activity, investment banks' lucrative takings on SPAC IPOs are indeed adding to the SEC's angst. It is estimated that bank fees totaled $ 37 billion in the first quarter of 2021. Disclosed fees for SPAC IPOs average at about 5.2% of gross proceeds (on Bloomberg data). For deals that require thin filing and little balance sheet risk, SPAC underwriting appears hugely attractive for Wall Street.

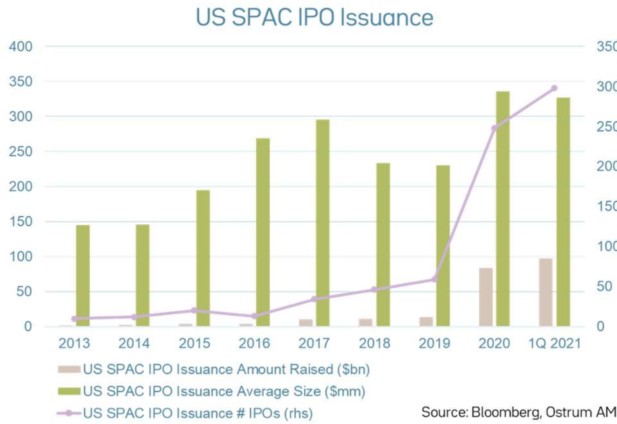
In December 2020, the supervisor urged SPACs to indicate in their prospectuses whether underwriters were due deferred fees once they complete a deal with a target company, and disclose potential conflicts of interest that may arise from additional services the underwriter may provide and get paid for.

The SPAC market

Overview of the US SPAC market

The SPAC market is now quite sizeable. On SPAC research data, there are 553 SPACs representing $178 billion in amounts held in trusts. In fact, 120 companies have announced a merger/business combination making up funding worth $ 38 billion. Almost 80% of all active SPACs are still seeking a target company. The idle cash held in trust funds amounts to $ 140 billion. Lastly 253 SPACs still have to hit the IPO market.

Active SPAC Summary		
Group	**# of SPACs**	**Amount in Trust**
Total Active	553	$178,333,687,555
Announced business combinations	120	$38,215,183,821
Seeking target	433	$140,118,503,734
Pre-IPO	253	$63,911,480,000*
		Source: SPAC Research, Ostrum AM



The recent SPAC issuance boom in numbers

Many SPACs launched in the first quarter on US exchanges, raising more funds than last year's total. Wall Street indeed underwrote $97 billion worth of SPACs with a total of 495 transactions in the three months to March 2021. Citigroup tops the league with 16% market share and $ 15 billion volume sold. Morgan Stanley tops the advisory credit league.

Top 10 SPAC Underwriter(2021)					
Underwriter	Bookrunner Volume ($MM)	Bookrunner Count	% Share	Volume Sold ($MM)	Deal Count
Citigroup	15 698	72	16.11%	14 817	72
Goldman Sachs	11 064	38	11.35%	10 033	38
Credit Suisse	8 626	41	8.85%	7 986	41
Cantor Fitzgerald	7 207	29	7.40%	6 219	29
Jefferies	6 040	31	6.20%	5 611	31
Morgan Stanley	5 869	26	6.02%	4 889	27
Deutsche Bank	5 489	29	5.63%	5 273	29
Barclays	4 639	27	4.76%	3 986	28
BofA Securities	4 633	25	4.75%	3 458	25
JP Morgan	4 223	23	4.33%	4 104	23
Total	**97 453**	**495**	**100%**	**87 097**	**634**

Credit for Bookrunner Volume ($MM) is based on the total amount of the offering sold, including over-allotment. Full credit is awarded to the sole book-runner or split equally among joint book-runners.

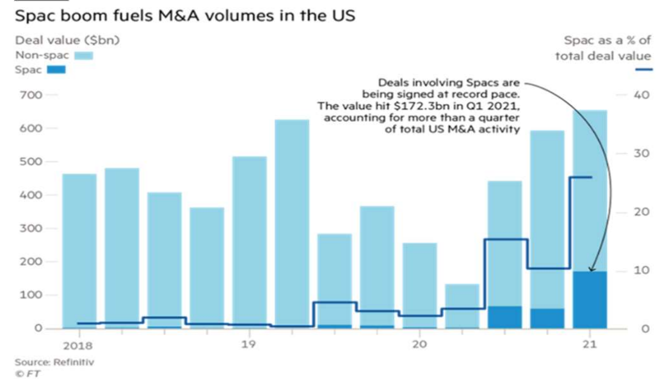
Source: SPAC Research League Tables, 2021

Top 10 SPAC Advisor (2021)			
Advisor	Advisor Credit ($MM)	Total Deal Volume ($MM)	Deal Count
Morgan Stanley	6 678	19 498	3
Goldman Sachs	5 520	24 417	7
Deutsche Bank	5 474	17 552	3
Credit Suisse	3 227	9 675	4
Moelis	2 521	15 125	1
Citigroup	2 285	8 165	4
JP Morgan	1 949	7 408	4
Cowen	1 354	3 326	3
Cantor Fitzgerald	1 130	2 942	3
Jefferies	1 034	5 645	4
Total	**38 708**	**143 327**	**66**

Advisor credit is shared equally among all advisors on a given deal, as a proportion of the enterprise value of the target company acquired by the SPAC. Firms with multiple advisory roles receive credit for each role.

Source: SPAC Research League Tables, 2021

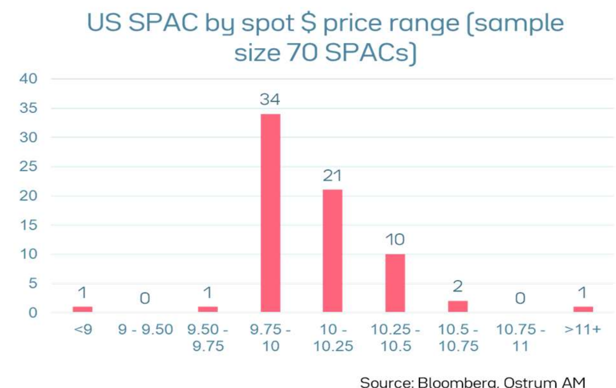
The SPAC boom is concomitant with increased M&A deals in the US and the rest of the world. On a global basis, there were more than 12k M&A transactions in the three months to March exceeding $ 1.3 trillion in value. In the US alone, M&A transactions involving SPACs accounted for $ 172 billion in the first quarter, more than a quarter of all US M&A activity.



The underwater SPAC puzzle

As stated above, SPACs eventually face a deadline to liquidate if they are unable to make an acquisition. At the end of March 2021, there were reportedly 300 SPACs trading for less than the cash raised in their public offering. The average discount stood at 1.22%, with some deals trading as low as 96 cents on the dollar. The market value of all those SPAC shares trading below their typical initial price of $10 stood at $81.4 billion at the end of the first quarter. In theory, the shares should be valued at least $10 plus interest (2-year UST yields around 0.15% at present). Hence a natural question for investors would be: is there a free lunch in buying undervalued SPAC shares? Probably not.

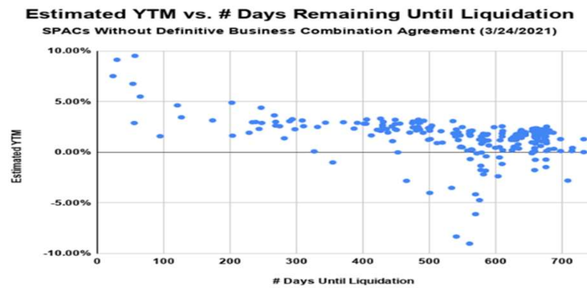
In our sample of 70 SPACs, we identify 37 instances of SPACs trading below $10. The market cap-weighted average stands at $10.10, an indication that investors expect little upside from potential acquisitions. A SPAC glut may signal that too much capital is chasing too few profitable merger opportunities.



Plenty of things can go wrong before those on-paper gains can materialize. SPAC sponsors always have an incentive to make a deal. Hence, managers may prefer to overpay for a company they purchase causing prospective losses of shareholder value than liquidate the investment vehicle. In addition, the deadline to acquire a company may be extended so that SPAC investors would have to wait before getting their money back.

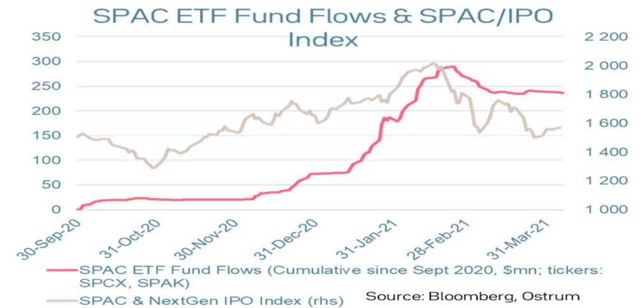
Given the glut in SPAC issuance, it could be the case that many SPACs indeed redeem. According to a study by Jay Ritter, a University of Florida finance professor, 15% of SPACs issued from January 2010 and May 2018 liquidated without a deal. This observation obviously pre-dates the SPAC boom. The discount may also reflect short-termism on the part of equity investors unwilling to wait a full two years to get the value of their investment moving. Early on this year, the retail frenzy on GameStop and other hyped-up names may have led investors to chase more juicy opportunities in single-name derivative space.

SPAC research data suggests that the discount to SPACs nearing their liquidation date, say within 100 days of liquidation, does exhibit the fear of a late bad deal as annualized yields hover about 5-10%. Amongst SPAC deals with liquidation 500-600 days away, there also appears to be a clear majority of positive yielding SPACs. This is testimony of the risk of shareholder value destruction.



Source: SPAC research, As at March 24, 2021

To gauge investor enthusiasm for SPACs, it may be worth looking at ETFs tracking this market. The fund flow into two ETFs (SPCX US: SPAC & NEW ISSUE ETF; SPAK US: DEFIANCE NEXTGEN SPAC DERIVE) is informative of investor demand for this corner of the equity market. ETF amassed inflows at a staggering pace from September to mid-February before recording modest outflows. That being said, the recent decline in the SPAC market index hints at a continuation of fund outflows.



Another way to gauge investor optimism regarding the asset class is to track warrant prices. SPAC Research produces an index which measures the market capitalization of public warrants without a deal announcement, divided by the initial trust account values for those SPACs. The trust account representing cash holdings varies little. The chart below suggests that average prices for warrants without a deal has fallen by more than 50% in a month's time.

Conclusion

Parts of financial markets exhibit frothiness at present. When too much money chases too few good opportunities, there must be shareholder value destruction. SPACs may be one such example. SPACs are blank-check investment vehicles whereby investors make funds available for managers to make acquisitions. SPAC proponents argue that these vehicles may revive equity investing. The current M&A backdrop in green energy, biotech or telecom is supportive so that SPACs are in a favorable position to raise money. However, given the financial risks arising from conflicts of interests, information asymmetry and potential winner's curse in a bidding war, SPAC enthusiasm may prove misguided financial mania.

Axel Botte

Market review

Spring break

Low volumes hint a possible correction on equities

Stock markets have remained quite upbeat since the start of the second quarter. The major US indices hover near their all-time highs. The Fed, which still sees the glass half empty despite strong evidence of economic improvement, is undeniably supporting the rise in prices. The S&P 500 climbed 3% in April, with growth stocks firmly dominating, taking advantage of a lull in US bond markets. The UK's FTSE equity gauge also gained 3% whilst the euro rebound towards $ 1.19 seems to limit performance in Europe (1.5%). However, reduced trading volumes around the quarterly close and the Easter break raise questions about the continuation of the upward movement.

The macroeconomic backdrop is difficult to decipher in Europe. Entrepreneurs are optimistic as evidenced by the PMI manufacturing surveys for March (62.5 for the euro zone) even as new lockdown measures were implemented. However, industrial production contracted sharply in February, in Germany (-1.6%) and even more so in France (-4.7%). The hope of a way out of the crisis, made possible by the acceleration of vaccination, seems to run up against supply constraints and tensions along global production chains. The semiconductor shortage, which is expected to continue through the end of the year, is hampering activity in several industries. This shortage has become a major issue in international politics, but it is not the only one.

The Iranian situation is at the center of concerns. The lifting of American sanctions remains conditional on the withdrawal of Iranian nuclear plans. The Israeli attack on an Iranian ship in the Red Sea already portends an escalation. As China approached Iran to strike an oil deal, a new conflict broke out with the United States. The oil market is indeed paying attention to the ongoing recovery in Irian oil output (+ 300k since the beginning of the year). The barrel of Brent fell below the threshold of $ 63. At the same time, the first part of the US $ 2,250 billion infrastructure plan requires a sustained increase in corporate taxation. In this context, Janet Yellen calls for international harmonization of corporate income taxation. For the US Treasury, it is above all a matter of repatriating the profits of multinational companies. A zero-sum battle for the global corporate tax base seems inevitable.

The evolution of taxation does not seem to be fully priced in by equity markets. In addition to the increase in the corporate income tax, reduced goodwill amortization (GILTI tax) will weigh on bottom lines, especially in sectors such as technology where M&A activity has been robust. The earnings per share projections have yet to take the fiscal tightening into account. The accretive effect of share buybacks funded by the generosity of the previous Administration may wane. The earnings forecasts imply 14% EPS growth in 2022. In this context, valuations will remain a point of attention. Flows into US equity funds were unprecedented in the first quarter and the SPAC craze is a symptom of current excesses as is the unexplained drop in implied volatility or subpar trading volumes over the past few weeks. Europe follows the US market yet the appreciation of the euro resulted in some underperformance. The high weighting of "value" cyclical stocks is nonetheless a factor of underperformance as the T-note yields now stand below 1.70%.

The March FOMC minutes suggest that the Fed still has some time to act. The market now seems to reflect a high degree of monetary policy inertia and barely reacts to improving employment data or accelerating producer price inflation. In fact, monetary policy remains conditioned by the US Treasury's capacity to finance successive stimulus plans other than by borrowing. Asset purchase tapering will require significant improvement in fiscal deficits. In Europe, the ECB maintains its policy of micro-management of the bond markets. Its weekly asset purchases have halved amid low trading activity pending a deluge of redemptions from next week onwards. Bund yields fluctuate around -0.30% with little amplitude and its sensitivity to the T-note is weakening. However, sovereign bond issuance weighed on spreads. The € 5bn syndication of BTP 2072 received investor demand worth more than € 60bn but surrounding BTP bond prices had to adjust lower. The Italian 10-year spread is back above 100bp. The € 40 billion budget extension linked to the extension of aid measures in Italy is also weighing on market. After a € 4 billion 10-year deal, Portugal has carried out more than half of its annual program. The pressure on spreads should ease. Note that the United Kingdom should launch a first green loan in the second quarter.

On European IG credit markets, primary activity is shrinking ahead of the earnings season. New corporate bond issuance is down compared to 2020 in the non-financial sector (€ 112 billion) but net issuance is higher than expected at € 53 billion. Financials borrowed € 28 billion in net terms (excluding covered bonds). The ECB increased its corporate bond purchases somewhat in March to 10% of the APP. Spreads are narrowing to some degree. The spread compression theme seems to be easing.

High yield markets were not very active last week except for a few buying flows in sectors linked to tourism. Bond supply is also larger than expected with € 26 billion net so far this year. Despite this, European high yield spreads narrowed by an additional 8bp this week to 305bp vs. Bund. The US high yield performed well despite continued fund outflows.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	12-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.71 %	+0	-2	-1
EUR Bunds 10y	-0.30%	+3	+1	+27
EUR Bunds 2s10s	41 bp	+3	+3	+28
USD Treasuries 2y	0.16 %	-1	+1	+4
USD Treasuries 10y	1.67 %	-3	+4	+76
USD Treasuries 2s10s	151 bp	-3	+3	+72
GBP Gilt 10y	0.79 %	-1	-3	+59
JPY JGB 10y	0.11 %	-1	-2	+9
€ Sovereign Spreads (10y)	**12-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	26 bp	+1	+2	+3
Italy	103 bp	+7	+10	-8
Spain	68 bp	+4	+5	+6
Inflation Break-evens (10y)	**12-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	130 bp	+4	+17	-
USD TIPS	233 bp	-2	+5	+34
GBP Gilt Index-Linked	348 bp	-11	+3	+48
EUR Credit Indices	**12-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	87 bp	-2	-2	-5
EUR Agencies OAS	39 bp	-1	+0	-2
EUR Securitized - Covered OAS	31 bp	-2	+1	-2
EUR Pan-European High Yield OAS	303 bp	-10	-19	-55
EUR/USD CDS Indices 5y	**12-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	51 bp	+0	+4	+3
iTraxx Crossover	248 bp	+2	+5	+6
CDX IG	51 bp	+0	-2	+1
CDX High Yield	293 bp	-3	-8	-1
Emerging Markets	**12-Apr-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	349 bp	-6	-23	-3
Currencies	**12-Apr-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.191	+0.81	-0.34	-2.56
GBP/USD	$1.376	-1.04	-1.19	+0.78
USD/JPY	¥109.33	+0.7	-0.27	-5.52
Commodity Futures	**12-Apr-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$63.7	$1.6	-$5.0	$12.0
Gold	$1 738.7	$10.4	$11.6	-$155.7
Equity Market Indices	**12-Apr-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 129	2.71	4.70	9.92
EuroStoxx 50	3 974	0.71	3.67	11.86
CAC 40	6 177	1.21	2.15	11.27
Nikkei 225	29 539	-1.83	-0.60	7.63
Shanghai Composite	3 413	-2.05	-1.16	-1.73
VIX - Implied Volatility Index	17.06	-4.75	-17.54	-25.01

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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