Weekly Digest

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Lost In SPACs

We are back on "bubble watch" this week. You will no doubt have seen the news that Elon Musk's Tesla decided to "invest" $1.5 billion of its spare cash in Bitcoin, leading to what one commentator described as a "bubble within a bubble". This news elevated Bitcoin's value in dollars to a new peak.

You will note the use of inverted commas around "invest". They deliberately signal some scepticism about such a transaction. In many ways our thinking has not evolved massively since I last wrote about Bitcoin in detail in September 2017 (LINK PLEASE). It is no more a means of exchange or a unit of account than it was then. Perhaps a greater store of value. These are the three main criteria deemed to be required of a bona fide currency. But its dollar value has multiplied around twelve times since then, and there is no denying that.

Our Chief Investment Officer and I had a long discussion about cryptocurrencies back then, and concluded that it might not be totally idiotic to put a small percentage of one's net worth (say 0.5%) into Bitcoin, metaphorically bury it at the bottom of the garden for twenty years, and see how it plays out. We both had a feeling that there was going to be more to this story than traditional financial analysis could capture. Such a sum, while a bit more than the price of a one-way ticket on the Clapham Omnibus in our cases, would not have been missed in a life-changing manner had Bitcoin returned to zero, and today might have grown to become, let's say, 5% of net worth (allowing for a bit of appreciation in the rest of the portfolio).

Suffice to say, I didn't do it. As you might imagine, there are moments of regret. Those extra funds would have been nice to have. And yet I cannot guarantee that I would not have "dug up" a few of those Bitcoins and cashed them in along the way.

But I could almost equally regret not having bought shares in Tesla (+943% over the same period), or, say, Ceres Power or Nel (both involved in the production of hydrogen, possibly one of the world's green energy solutions) whose shares have appreciated ten-fold. There are any number of small-cap US stocks exposed to new and disruptive technologies that have done as well or better. None of them seem to exert the same power of FOMO over investors.

Bitcoin feels like more than just a prospective asset class. It is almost a movement. Whatever financial value we might think it does or does not have, it definitely seems to have some "social value", in that there are individuals who want to invest some of their social capital into it. What does that mean? Owning some Bitcoin is a badge of honour. It says things about you, ranging from rebellious and anti-establishment to tech-savvy and financially astute. (Trading it can also provide entertainment akin to gambling.) We can never prove this stuff, but I suspect there was a similar attitude driving many of the people who got into the GameStop game. And few of us are immune to this. Just look at the expensive cars that provide little more utility

in getting from A to B than something a lot cheaper. The same for fashion labels. Peloton exercise bike? Guilty as charged!

Perhaps the biggest game-changer in recent weeks has been the apparent blessing given to Bitcoin by a number of established, high-profile individual investors, as well as some well-respected investment houses. None of them are "betting the farm" on the outcome, but they see the same optionality that I noted and failed to act on in 2017. More recently we have had companies that handle financial transactions beginning to explore the possibility of embracing cryptocurrencies. The cynic in me asks "why wouldn't they?" They might as well have some skin in the game just in case. But this is very different from investing your money in something that might be worth nothing.

There are a few other things going on that demand some scrutiny. The IPO (Initial Public Offering) market is on fire. In the UK, shares of Moonpig, a company that offers greetings cards and gifts online, now trade 27% above the offer price. Dr Martens, maker of the eponymous boots, trades 36% above the offer price. At least both of these companies make profits. On the other side of the Atlantic we are faced with IPOs from all sorts of companies with no profits but lots of prospects.

Older readers might remember TV advertisements for Impulse body spray. The strap line was "When a man you've never met before gives you flowers… that's Impulse". So much for what was deemed acceptable in the 1980s. The gentlemen in question would probably be subject to a restraining order these days – that's assuming that he was allowed out of lockdown and could even find a flower-seller. Which, perhaps, are a couple of reasons why dating apps are so popular. Last week saw the US stock market debut of one called Bumble, which is different to its peers in that it requires the woman to initiate contact. Priced at $43, it now trades at $80, an 86% gain. This sort of pop is not unusual for current loss-making IPOs, as long as at least some part of their business is conducted online. But it does require a lot of faith in the ability to generate future profitable growth.

And if you think that is punchy, try Kuaishou, a rival to short-form video platform TikTok, which listed in Hong Kong at the beginning of the month at HK$115. Last price… HK$398. And we are talking big money here. Its market capitalisation is HK$1.65 trillion, which equates to £153 billion. That would make it the biggest stock in the FTSE100. It is currently loss-making too.

The final area to cover is SPACs, or Special Purpose Acquisition Companies. Despite being long-established investment vehicles which in many ways make a lot of sense, they are amongst the most vilified of instruments, and largely an American phenomenon. Very simply, they are pools of money assembled on public markets with a view to acquiring businesses out of private hands. Their advantage is that they provide ready cash to execute deals quickly without the long-drawn-out and costly process of an IPO. The argument against them is that they smell an awful lot like companies that were touted during the South Sea Bubble of 1720, the most egregious of which was created, according to folklore at least, to invest in "an undertaking of great advantage, but nobody to know what it is". You can imagine how that worked out for investors.

Today, though, these are stock-market listed companies, and therefore subject to due regulatory process. It should be difficult for the sponsor to waltz off with the cash never to be seen again. Certainly they are incredibly popular, with both issuers and buyers. According to data from Bank of America, there were more SPAC IPOs in January of this year (91) than in the whole period from 2010-2016 (86). And it's clear that the ramp up in issuance started in earnest in the summer of 2020.

Another database from Goldman Sachs (dated 15th December 2020) cites that since August 2018 272 SPACs had raised $88bn of equity. Of these, just 31 had completed a merger, 47 had mergers announced but not completed, 1 had been withdrawn, and the other 193 were sitting on $63bn of dry powder looking for a target. And this is cash burning a hole in the issuers' pockets, as the general rule is that a deal must be completed within two years – otherwise the cash has to be handed back to investors. Another very strong incentive for sponsors to find a target is that they will often (but not always) receive a "promote" worth 20% of the equity on completion of a deal.

You might well be viewing this as a very one-sided transaction so far – free money with an equity kicker for doing a deal. But the beauty of these vehicles are the incentives for investors, especially those who can participate at the IPO stage. For putting up the initial cash, they also receive a warrant to subscribe for a fraction of a further share for every share they buy. These warrants usually have a strike price 15% above the IPO price. (These operate in a similar fashion to a call option. Let's say the shares go from $10, which is the usual issue price of a SPAC, to $15. The owner can exercise the warrant at $11.50, sell the shares at $15 and pocket the difference). Warrants acquired in the IPO are thus very valuable, and much sought after by hedge funds in particular. They normally have a five-year term, and must be exercised if the share price rises to $18. The merger size is not limited to the size of the original IPO. More capital can be raised once a suitable target is located.

Investors also get a put option, in that they are invited to vote on the merit of any deal that is announced, and to reject it if it is unattractive, sending the sponsor back to the drawing board. The risk of investing, then, is deemed to be asymmetric – there is a lot of potential upside if the sponsors find the right deal, but turkeys should be avoided. In market jargon, there is limited left-tail risk, and a lot of right-tail risk. I should note that European-listed SPACs do not have such safety nets: they really are "blank-cheque" companies. Therefore they are not as attractive or popular.

The proof of the pudding is in the eating, as it were. Of those 193 SPACs sitting on the runway, only one was trading "below par" for the combined equity and warrant value – and that was at $9.99! Many were trading at substantial premiums. Unsurprisingly, many of them are tapping into the zeitgeist of disruptive, technology-driven industries, with the majority of issuers targeting the IT, Healthcare and Consumer Discretionary (think online retail and self-driving cars, not shopping malls) sectors, whereas a few years ago the trends tended to favour "old economy" Energy, Industrials and Financials. 31% of the class of 2020 do not specify any industry target.

The performance of the 47 SPACs that have announced but not completed deals illustrates the optimism and excitement that finding the right target can deliver. Again, all but one of these trade at a premium to the IPO price, although on average the premiums are now larger than for those still in search mode. Finally, there are the 31 that have completed a merger. This is where the optionality starts to work both ways, and rigorous analysis of the new entity becomes much more important. Of those 31, 13 are underwater, with the worst having lost around 80% in value. But had you held a portfolio of all of them, the gains would still be substantial. The biggest winner is now quoted as Draftkings (involved in online sports betting), and has returned more than 500%.

There is a common thread that runs through all of these areas of the market, and that is the perceived asymmetry of making substantial gains versus limited losses. Bitcoin could become the de facto online currency of the world (a subject to which I still promise to return, but it's such a wide-ranging, important and contentious subject that I want to do it justice); IPOs (with notable historical exceptions) tend to be priced in a way that leaves some upside to ensure a successful entry to the market; and SPACs, as one major investment bank puts it, are "all right-tail risk".

And much of this is enabled and encouraged by the fact that the cost of money is effectively zero. If there is no opportunity cost from not holding safe assets, then riskier assets become more valuable. Add in retail demand (retail is a big player in the SPAC secondary market), more than ample liquidity, strong positive risk asset trends and a sprinkling of hype, and nothing comes as a great surprise. But, as we often comment, ultimately there has to be some intrinsic value to back these investments up.

I want to be clear that I am not trying to pass a firm valuation judgment on these assets, and certainly not a moral one upon people who invest in them. The key point here is to provide some sort of description of what is going on in certain areas of financial markets at the moment. And just because these things are currently in vogue does not mean that we are forced to invest in them. We continue to judge everything on its own merit to the best of our capabilities. There's always going to be something going up that we don't own.

Finally, though, and more reassuringly, although we do believe that there are pockets of the market that display signs of unsustainable speculative activity, and also that a period of consolidation or even a bit of a pullback would not be entirely surprising or unwelcome, that does not necessarily mean that we are in the grip of an all-embracing bubble of 1999/2000 proportions. As my erudite colleague and IT sector analyst Simon Lapthorne puts it with respect to the large capitalisation technology stocks: in 2000 there was an awful lot of froth and not much coffee; now the situation is reversed, with the sector dominated by big companies that have strong businesses and fortress balance sheets. Contrast that with many of the highly leveraged leaders of 2000 who were borrowing money to lend to their clients to buy their products (known as vendor financing). That did not end well.

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Last week's Economic Highlights

FTSE 100 Weekly Winners

Prudential PLC	8.9%
Anglo American PLC	7.2%
Rio Tinto PLC	5.6%
Pearson PLC	5.5%
DS Smith PLC	5.4%
AVEVA Group PLC	5.2%
Entain PLC	5.1%

FTSE 100 Weekly Losers

Ocado Group PLC	-6.7%
JD Sports Fashion PLC	-5.7%
International Consolidated Airlines	-5.2%
Barratt Developments PLC	-4.2%
Kingfisher PLC	-3.6%
Intercontinental Hotels Group PLC	-3.6%
Land Securities Group PLC	-3.4%

FTSE 100 Index, Past 12 Months

Source:FactSet

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