Pearl in the shell? Special purpose acquisition companies should embrace uncertainty with investors

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When it comes to filing an initial public offering for a typical company, there's a long list of things for prospective investors to know.

With a special purpose acquisition company IPO, it's more of a case of you don't know what you don't know.

New research published in *Strategy Science* from Derek Harmon, assistant professor of strategy at the University of Michigan's Ross School of Business, shows that when filing a SPAC-IPO, being honest about—and leaning into—the uncertainty may be key to funding success.

Unlike a traditional initial public offering, SPAC-IPOs are not selling a company; they are selling a shell company and its founder's ability to assess the market and acquire a company.

The goal of a SPAC-IPO is to raise funding for acquisition and give investors the opportunity to get their money back if the shell company cannot acquire another company within 24 months.

There has been a proliferation of SPAC-IPOs in the past few years, primarily because of the U.S. Securities and Exchange Commission's rules on their vetting. SPACs don't have the same SEC vetting process as traditional IPOs. This was partially what attracted Harmon to the subject.

Because of the uncertainty of their acquisition targets, SPACs are in an awkward position to communicate how they will be successful in the market. Harmon's study asked, "When you can't clarify uncertainty, what is the best strategy?"

The study found that the more a shell company recognizes uncertainty in its communications to investors, the more likely they are to earn the trust of investors.

"What we're arguing, which is consistent with research in communication studies on studying cancer, studying earthquakes, studying rare weather events, is when you don't know what you don't know—if you communicate your uncertainty—it actually makes people trust you more," Harmon said.

Because SPACs don't go through the traditional vetting process, the companies were raising more money than traditional IPOs between 2010 and 2020, he said. With the promise of returning funds, if they do not source a company and low vetting by the SEC, SPACs could be a dream for industry-savvy founders and investors.

Still, SPAC-IPOs are disadvantaged because it is illegal for them to know the company they are acquiring or the industry they are participating in beforehand.

Despite the research showing that communicating uncertainty can be beneficial, SPACs can use other strategies to increase investor confidence. The background experience and human capital of the founders can make an impact on funding. It's one part of a communication strategy that the founders don't want uncertainty around.

"To claim that you don't know much about your own founding team is suspect. And so, the more you can share about the reputation, the education, the expertise of your founders, the less uncertainty there will be, and that has a better outcome," Harmon said.

"There are founders who have been really successful with SPACs, so when you see a SPAC founder a second or third time, that level of trust kind of overrides because you know they've done it before."

Even with the expertise of founders or the status effect of celebrities like Shaquille O'Neal, who participated in Forest Road Acquisition Corp. II, a clear outcome of the research is that the ability to communicate uncertainty gives SPAC-IPOs a strategic advantage to raise funding.

More information: Ivana Naumovska et al, Communication under Uncertainty and the Role of Founders' Information Advantage: Evidence from SPAC IPOs, *Strategy Science* (2024). DOI: 10.1287/stsc.2022.0043

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