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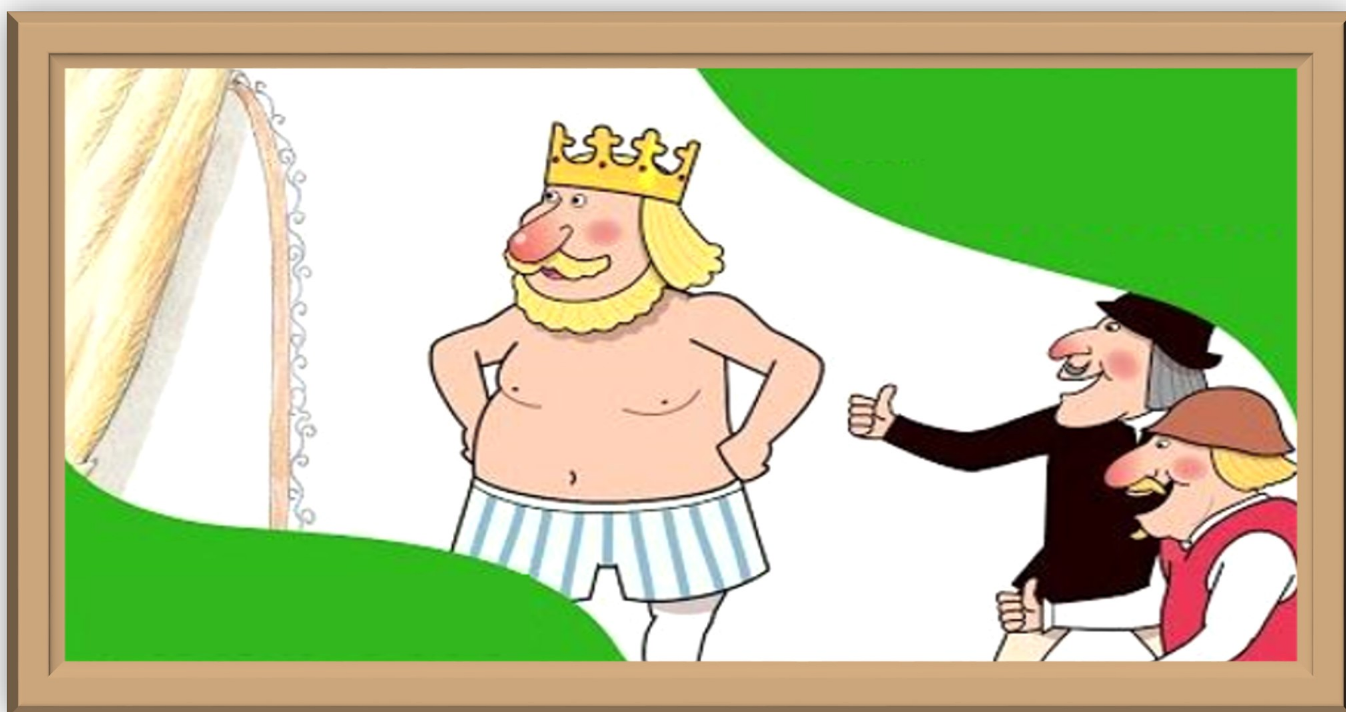
THE EMPEROR HAS NO CLOTHES!

ARE THE HOT UNICORN IPOS STARTING TO TURN COLD?



The last few years have seen an increasing amount of hype around the influx of initial public offerings (IPOs) of unprofitable companies. This may seem reminiscent of the IPO frenzy of 1999 and 2000 during the tech bubble. Do the names, Pets.com, Kozmo.com and WebVan ring a bell? These companies were losing massive amounts of money, had no solid business plan for generating future earnings and as a result, went out of business after going public. Goldman Sachs chief U.S. equity strategist, David Kostin, said in a letter to clients in mid-September that less than a quarter of companies going public this year will report positive net income in 2019. Sound familiar? This is the lowest level of profitable IPOs in their first year as public companies since the tech bubble. In 1999, 28% of IPOs reported positive net income in the first year as a public company, falling to 21% for companies going public in 2000[1]. Is history repeating itself? The moral of the fable "The Emperor's New Clothes" is that we should speak up when others are afraid or no one else will. It also shows the importance of proof in the form of empirical data, or information acquired by observation or experimentation.

Lessons From The Past

So have investors learned any lessons from these money-losing IPOs of the past and if so, will someone speak up? In recent weeks, money-losing unicorns (privately held startup companies with valuations over $1 billion) are beginning to fall out of favor with investors. Profitability is starting to become a concern to investors in companies entering the public market. On September 16, WeWork announced that its IPO was delayed. Does the weak demand for WeWork symbolize that growth-at-any-price is being questioned by investors? Are the public markets signaling that profitability might matter again?

This reminds us of Oscar Wilde's quote, "a man who knows the price of everything and the value of nothing." When IPOs go public, zealous investors can inordinately influence market prices as prices are set by supply and demand. IPO shares will sell for whatever price an investor is willing to pay for them. An investor should know both the price and value of a stock. All investors want to buy a stock that is worth more than what they paid.

Business schools teach that when an investor determines the value of a stock, the investor discounts the future cash flows of a business. So, how can an investor value unprofitable companies when they have no concrete plans for earnings in the future? Earnings matter and they are an indication of a company's profitability and long-term strength. Investors can try to sort through IPO fundamentals in order to determine a fair value but, at some point, a business needs to become profitable to keep investors. Traditionally, investors pay very close attention to earnings-per-share as steady increases in earnings-per-share generally result in rising prices for a company's stock.

How Do Hot IPOs Convince Investors To Buy?

Investors have always been taken with the idea of IPOs. The thought of making a quick fortune through a disruptor (companies that change the landscape of an entire industry or sector) is enticing. However, investors are having difficulty determining when the likes of an Uber, Lyft and WeWork will be profitable and by how much. After debuts of unprofitable unicorns earlier this year, Uber, Lyft and Slack, have all seen dismal performances. Since the beginning of October, Lyft has fallen 46% since its March IPO, while Uber, which debuted in May, has dropped 34%. (WeWork, as of this writing, has shelved its plans for an IPO and replaced its top executive, Adam Neumann.)

Investors being lured by the possibility of growth in these companies should compare current IPO metrics to Salesforce, which debuted in June of 2004, and at the close of its first day was valued at a little under ten times revenue. It was considered very pricey at the time. Investors are now paying even greater sky-high multiples for growth in companies-especially the enterprise technology names that are trading at 25-30 times projected current year **revenues**, not earnings. Earnings seem a thing of the past in this IPO market.

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Many IPOs are bleeding cash, but trying to convince investors of their value with "creative new accounting measures" that mimic profitability. Uber uses a metric called "core contribution platform," and WeWork focuses on "community profit." It is déjà vu: these types of creative accounting methods were used during the dot-com bubble when companies used "revenue per eyeball" as a measure of performance. Great, industry-disrupting products should not be mistaken for solidly profitable businesses.

No Profit, No Problem?

In the long-run, large, unprofitable and transformational companies like Uber and Lyft need to provide a roadmap for investors on how they will achieve profitability. It seems many of these companies have no plans for future profitability. In May, Uber lost more money and destroyed more shareholder value in its first two days of trading than any IPO in history[2]. Nelson Chai, Uber's finance chief, said in April of 2019, that the company is "setting the foundation for attractive long-term margins." But the company's current plans will take decades of investment, and there is virtually no map to profitability.

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A Wall Street Journal article on September 22, noted, "Investors are starting to demand profits, or at least profits in the near future, from richly valued tech companies when they go public." The article goes on to note that while these companies are private, it is much easier to make their finances look attractive. However, once they go public, they have to report based on standard accounting rules, which reveal their losses[4]. The CEO of Peloton, another unicorn, noted in a CNBC interview before the company's IPO that the company was profitable. However, after reviewing its audited financial statements, Peloton was only making money on **gross** profit. According to its regulatory filings, the company expects to incur **net** losses for the foreseeable future.

Finally, investors are starting to see through the hype. Garrett Black, an analyst at financial data firm PitchBook, said, "companies will be forced to be more disciplined with their capital when it comes to spending, as well as scrutinize their balance sheets and growth paths much more closely[5]."

Finding Profitable Disruptors

There are many established, profitable companies becoming disruptors in new markets that do not involve the risk associated with IPOs. The best long-term factor for success is looking at whether a company can sustainably grow and profit. To do this, investors are beginning to realize that they can find exciting growth opportunities in companies other than hot new IPOs.

Target, for example, is a well-established company that has become a disrupter. It is turning the tables on Amazon by using its existing brick and mortar stores to supplement and reinforce online retailing. Shoppers are ordering online and picking up merchandise in stores in order to avoid shipping fees and to save time, especially in the case of groceries. Target also offers Shipt service which will deliver a purchase to your home the same day. It thus has something Amazon doesn't have–a network of stores in every suburban area. In fact, Target shares are up nearly 60% since the beginning of 2019 and continue to trade at a reasonable valuation.

The Emperor Has No Clothes

In summary, in the last few weeks, investors are speaking up and showing their concern with IPOs of unprofitable companies as evidenced by falling stock prices and canceled IPOs. We believe it is a good thing when unicorns start to lose their magic on Wall Street as growth-at-any-price gives way to time-tested fundamentals. Although all investing contains risks, there is a clear correlation between profitability and stock performance, and investors once again are remembering that profitable companies are the best investments.

Footnotes

[1] https://www.cnbc.com/2019/09/18/this-years-ipo-class-is-the-least-profitable-of-any-year-since-the-tech-bubble.html

[2] https://www.forbes.com/sites/lensherman/2019/06/02/can-uber-ever-be-profitable/ #7526d1475785

[3] https://www.wsj.com/articles/unicorns-pre-ipo-profit-claims-get-scrutinized-11569172817

[4] https://techxplore.com/news/2019-09-unicorns-wowed-investors-hard-road.html

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