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INVESTMENT THOUGHTS

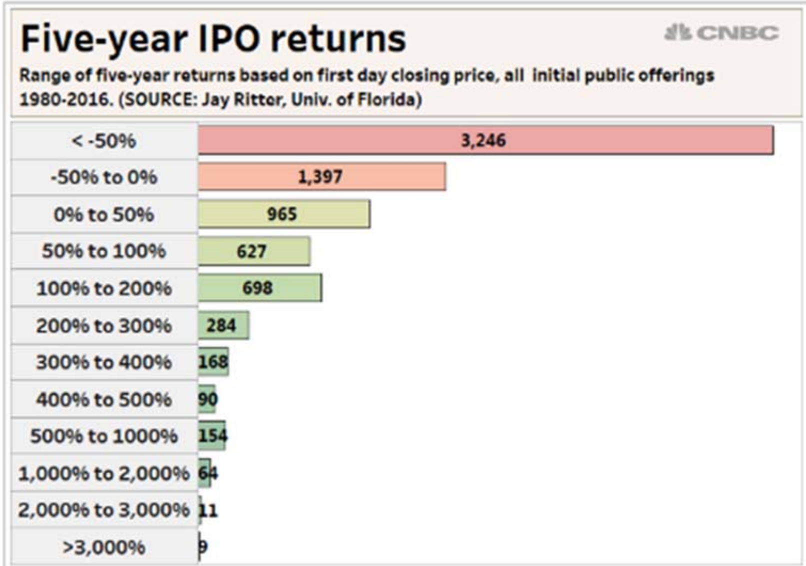
MAY 2019

THE RESURGENT IPO MARKET – LOOK BEFORE YOU LEAP

They're back! Private companies are once again selling shares en masse to the public through initial public offerings. These "IPOs" have been the subject of splashy headlines that have caught the attention of investors. A few examples: Beyond Meat, the maker of plant-based meat substitutes surged over 150% after listing its shares on the stock exchange. Video conferencing company Zoom gained over 70% on its first day of trading. Even Levi Strauss (yes, jeans) rose over 30% as soon as it hit the market.

More high-profile private companies plan to go public later this year including Airbnb, Peloton, WeWork and Slack Technologies. These companies provide innovative services and technologies that improve how we book lodging, exercise, share workspaces and collaborate with co-workers. Investors are eager to capitalize on these advancements and get in on the ground floor of what could be the next blockbuster investment. What they may not realize, however, is that the odds of success are stacked heavily against them. As a group, IPOs have performed poorly. Some IPOs, such as those by the ride-hailing companies Lyft and Uber, have already stumbled, highlighting the risks of investing in these newly public companies.

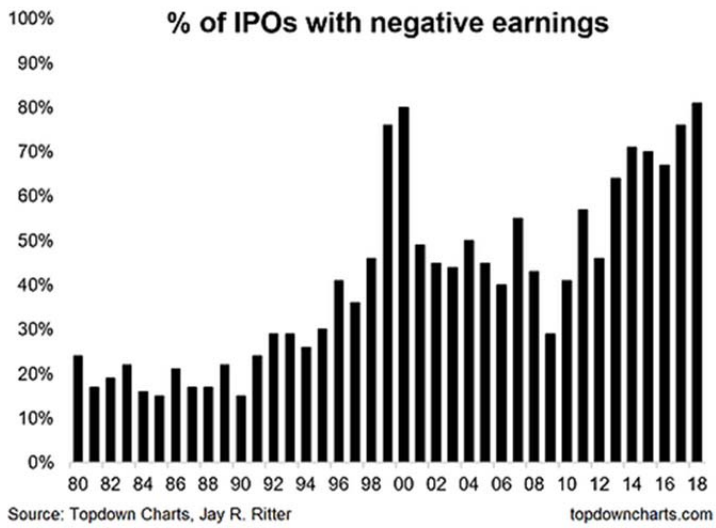
Jay Ritter, a professor at the University of Florida, has amassed an extensive amount of data covering more than 7,000 IPOs. His database shows that over more than three decades the average IPO underperformed similar listed stocks. The following table shows the five-year returns of IPOs during the period 1980-2016. While there were a handful of stocks that performed exceptionally well, 18% declined as much as 50% while 42% fell more than 50%.



Before investing in an IPO, it is important to consider who is selling and why. Companies typically sell shares to raise capital to fund growth initiatives. The sellers are generally the founders and executives of these companies or private investors such as venture capital firms. They are the "smart money" because they are the most informed about the company's prospects. They seek to sell when the timing is advantageous to them. As a result, the sellers gain can come at the expense of the unwary buyer. Moreover, the seller is not the only party that gains from this process. The investment bankers, which the seller hires to facilitate the transaction, earn a fee that can be as high as 6% of the deal's value. They provide information on the offering but have a conflict of interest. Consequently, they are not in a position to provide objective advice.

Public offerings tend to come and go in waves. Renaissance Capital estimates that private companies will raise over $100 billion in 2019, more than the prior three years combined. The last time IPOs hit this mark was the year before the Dot-com bubble popped 20 years ago leading to substantial losses. Fortunately, the market is in a better position to absorb this new supply of stock than in the past. The amount of publicly traded stock on the major U.S. stock exchanges has shrunk considerably since 1997 due to corporate buybacks and mergers and acquisitions.

Nevertheless, investors can still lose money investing in some of these newly public companies, as they did during past IPO booms. What is different this time is that many of the companies that are going public stayed private longer and are older and larger than those that issued stock in the past. The press refers to these start-ups valued at $1 billion or more as "Unicorns. " Because they are more seasoned, some believe they are safer and more likely to succeed. These attributes, however, have not translated into a better profitability for the current crop of IPOs. As the following chart shows, 80% of companies that went public last year had negative earnings. This trend continued in 2019. We have not seen this many unprofitable new companies hit the market since the late 1990s.



In the absence of profits, some companies are touting more creative metrics to impress investors. WeWork, which plans to go public later this year, measures its success using a proprietary measure called "community-adjusted EBITDA." EBITDA stands for earnings before interest, taxes and depreciation. It is a legitimate and helpful measure of cash flow. The "community" part, however, should raise some eyebrows. It ignores the impact of basic expenses such as marketing, general and administrative and development and design costs associated with growth initiatives. The use of inventive measures like this is reminiscent of the late 1990s when unprofitable companies cited alternative measures such as "clicks" and "eyeballs" to entice investors.

One simple way to value these companies is to look at the price-to-sales ratio. Beyond Meat and Zoom Video went public at 50 and 60 times sales respectively. Pinterest had a price to sales ratio of 20x sales. Uber was a relative bargain at 7x sales. These measures are well above the 2.2x sales of the average stock. The reason these multiples are so high is that investors expect these companies to grow very rapidly. Some companies are able to meet such high expectations. Facebook, for example, went public in 2012 at 26x sales and went on to be very successful. However, many will struggle to live up to such lofty expectations. In another study, Jay Ritter tracked the performance of nine IPOs that went public with a price-to-sales ratio above 30 between 2001 and 2018. He found that as a group they underperformed the market by 20% the following three years.

Although there are many reasons to be wary, we are very mindful that IPO booms such as the one we are experiencing now often coincide with periods of significant advancements. When the Dot-com bubble popped in 2000, numerous companies that issued shares to the public did not survive. Nevertheless, many of their inventions did, and the Internet went on to have a profound influence on our lives. The evolution of technologies is inherently Darwinian. Many businesses will struggle and/or fail, but entrepreneurs will find ways to adjust and improve over time. It is through this often-tortuous process that good ideas grow stronger and give birth to business models with more enduring prospects. Consequently, we spend a lot of time thinking about how the innovations that result from these periods will affect the investment landscape and disrupt current businesses.

Rather than rush to invest in IPOs as soon as they are available, we believe it is advantageous to wait for the dust to settle. This provides time for companies to demonstrate they have a viable business model that can produce a growing stream of profits. This approach means that we will inevitably miss some of the big winners that surge right out of the gate. Our goal, however, is to always invest for our clients in a manner that increases the probability of their success. Unfortunately, the odds are clearly stacked against IPO investors. Thankfully, many companies can compound significantly in value and meaningfully contribute to portfolio returns even if we invest later in their life cycle. When it comes to IPOs, waiting is usually the best strategy.

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