That was Then, This is Now – *Contrasting Today's IPO Market with the Tech Bust of 2000*

After a sluggish IPO market last year, 2019 has witnessed a wave of "unicorns" going public.

Lyft led the pack by listing its shares on March 18th, followed by Pinterest and Zoom on April 18th. Many other notable startups are expected to follow suit – the noteworthy list of companies includes: Uber, WeWork, Airbnb, Slack and Postmates.

The heightened activity in this nascent IPO market has raised concerns about the bull market reaching its peak. We disagree with this view mainly because increased IPO activity is not necessarily a leading indicator of future market direction – especially not standalone.

Many financial reporters and research analysts have been comparing the current IPO market with that of the dot-com era, which became a bubble and burst in 2000.

While some similarities are visible on the surface, such as the investor fear of missing out on the next big thing and the lack of profitability in some of these companies, the two are different market environments.

In this Thinking Man we expand on why that is the case.

That was Then – *The Tech Bust of 2000*

In the late 1990s, markets saw many new technology companies go public and then go bust. Investors were keen to bet on any company with a ".com" after its name given the hopes of overnight success.

These companies seemed attractive, and many of them were the first to offer services of their kind through the Internet. A good example of this is "Pets.com", an online retailer selling pet supplies to consumers, which gained momentum as a result of its innovative nature and aggressive marketing campaigns. Although it was highly unprofitable and had an unsustainable business model, the company succeeded to go public on the NASDAQ in February of 2000. Nine months later, the firm went bust, with its IPO share price of $11 falling below $1.[1]

Companies like "Pets.com" had managed to create euphoria around the ".com" concept, creating a "hot" IPO market with outsized valuations and nonexistent profits. At the height of the dot-com bubble in 2000, 81% of IPOs were companies

The Thinking Man's Approach

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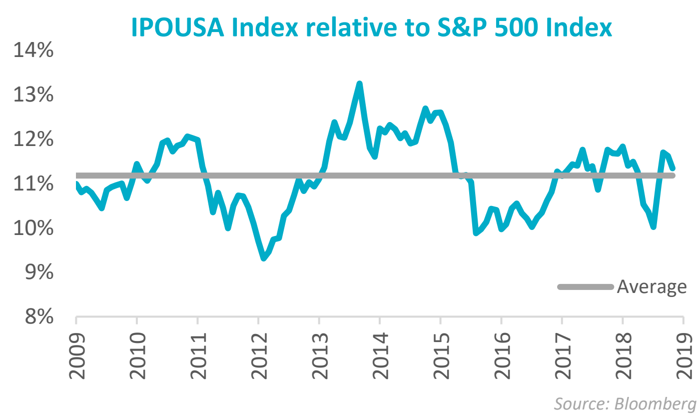
- Although companies currently listing in the public markets are more mature in terms of age and size than listings of the dot-com era, the probability of another bubble forming is not out of the question
- While many "unicorns" and "decacorns" are overvalued in our view, we do not foresee them triggering a recession in the short-term, as it is still too early in this IPO cycle
- Bubble risks will be created by companies that don't have a clear path to profitability, and by those that lack platform effects needed to maintain dominance in their respective fields
- We expect to see a highly volatile IPO environment and a scattered distribution of outcomes for these newly listed equities

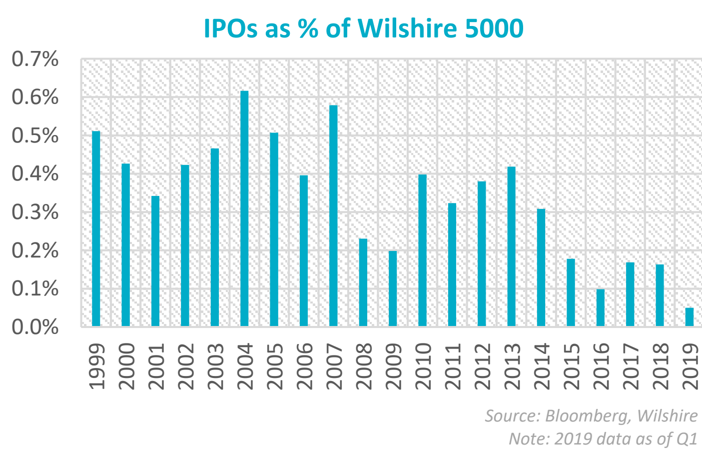
For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com with negative earnings – the highest rate since 1980. To certain analysts and investors, 2019's IPO wave seems like a throwback to these darker times, pointing to Lyft's recent public listing as an example given that the company is unprofitable and experienced a "hot" IPO that quickly fizzled out.

This is Now – *Today's IPO Market*

Our belief is that today's heightened IPO activity is a coincidental indicator of a strong equity market, and not a leading indicator of a market downturn. While similarities between the current IPO market and that of the dot-com era exist, there are also key differences that suggest the current market environment is not indicative of excessive euphoria.



The companies going public this year are expected to collectively surpass the record $107.9 billion raised in 1999. While that is the case, it is important to analyze the IPO market relative to the overall stock market's value. Valuation multiples for equity markets are lower today than they were back then, and the share of IPOs relative to the total equity market capitalization is also materially lower.



The top graph shows the ratio of the Renaissance IPO index (IPOUSA)[2] to the S&P 500 Index, which is slightly above the 9 year average – a sign that IPO activity is in line with historical patterns.

Given that the Renaissance IPO Index only dates back to 2009, we conducted a second analysis to explore the share of IPOs relative to the overall market, represented by the Wilshire 5000 Index. The bottom graph shows our findings: the aggregate value of IPOs relative to Wilshire 5000's market cap is much lower today than during the years leading to the previous equity market bubbles (1999-2000, 2007), suggesting there is not excess in the IPO market, which has been relatively muted over the past 10 years.[3]

Staying Private for Longer

Today's tech unicorns seem better prepared for the public markets given their increased size and age.

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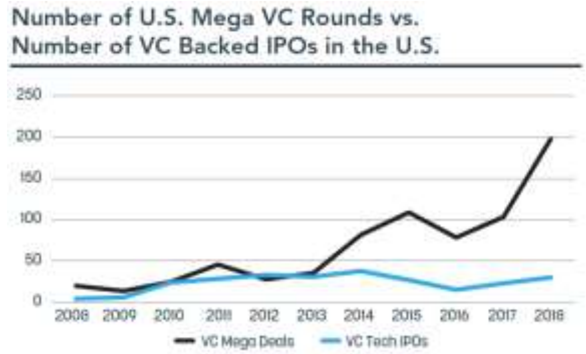
[1] CNN Money. *"10 big dot.com flops"*, https://money.cnn.com/galleries/2010/technology/1003/gallery.dot_com_busts/

[2] IPOUSA represents the top 80% of newly public companies based on full market capitalization. https://www.renaissancecapital.com/IPO-Investing/US-IPO-ETF-Index

[3] Aggregate value of IPOs calculated as the overall offer size of IPOs that reached the trading stage. Wilshire 5000's market cap calculated based on yearly median price

According to the WSJ, the "median age for tech companies going public in 1999 and 2000 was four and five years, respectively, compared with 12 years in 2018."[4]

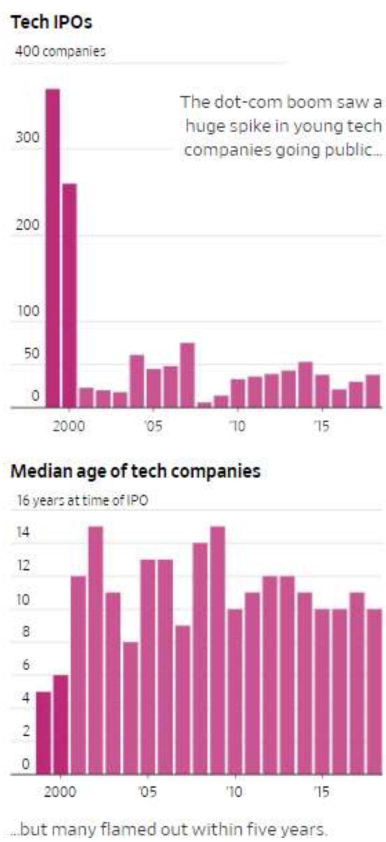


Source: iCapital, Pitchbook and Jay Ritter (University of Florida)

How have companies managed to remain private for so long? The answer to this is mainly the rise of venture capital ("VC") and the pursuit of higher yields during the past ten years of ultra-low interest rates. The graph to the right compares the number of VC mega deals to VC tech IPOs since 2008.

Companies previously had to seek public funding in order finance their operations and growth, whereas today there are hundreds of billions of dollars of uninvested commitments waiting to be deployed into the space, all going after the same subset of opportunities. This has allowed companies to avoid going public, which is a costly process and one that invites scrutiny as to how founders should run their businesses. Another reason companies previously needed to go public sooner was to provide liquidity for founders / employees, but the emergence of the secondaries space in VC has helped alleviate this urgency.

Institutional investors have increasingly been allocating to VC – as recently as Q1 2018, firms saw more money flowing into their asset class than in any quarter over the last 10 years.[5] According to an iCapital report, "venture capital firms and other providers of late stage financing need to return cash to their investors, and many unicorns have become so large they are no longer viable acquisition targets, leaving a public offering as the only logical liquidity path."[6]



Source: Wall Street Journal

Growing in Size & Reach

According to the Wall Street Journal, "median sales were about $12 million then, compared with $173.6 million last year."[5] Remaining in private hands has allowed these companies to mature further before accessing public markets, which overall paints a healthier picture when compared to the dot-com era. This maturity is reflected in many corporate governance structures as well, with companies such as Uber having a clear separation of CEO and Chairman roles, yearly elected Board Directors, and a single share class.

An article from The Economist highlights that, "unicorns are more substantial than the turkeys of the 2000 tech bubble (…) Ride apps

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[4] The Wall Street Journal. *"Uber Aims for Public Valuation of as Much as $100 Billion, Below Expectations,"* https://www.wsj.com/articles/uber-aims-for-public-valuation-of-as-much-as-100-billion-below-expectations-11554915215?mod=article_inline&mod=article_inline

[5] Pitchbook, *"1Q 2019 Analyst Note."*

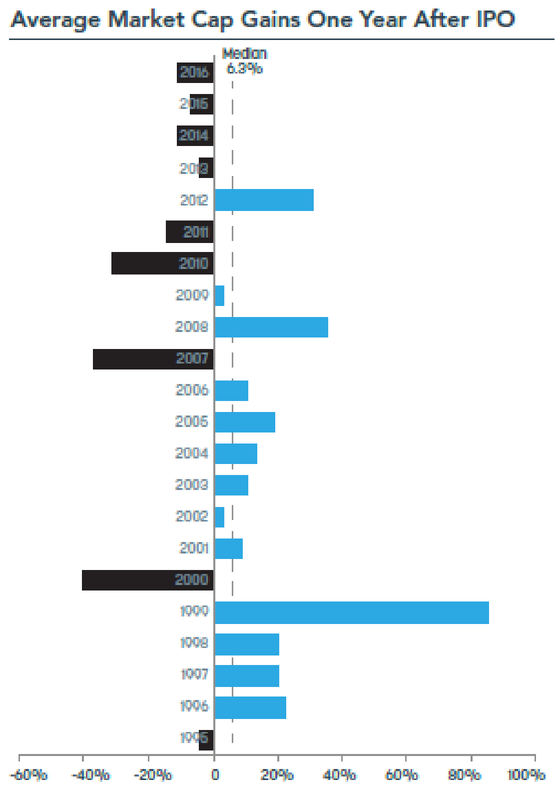
[6] ICapital Private Equity Insights. *"Age Really Does Matter When it Comes to Unicorns."*

are more convenient than taxis, food delivery is lightning quick, and streaming music is better than downloading files. Like Google and Alibaba, the unicorns have large user bases."[7] While increased revenue figures and user-bases sounds positive, it is important to look at both sides of the equation. For example, Uber, which is preparing to go public as soon as May, has accumulated revenues of more than $11 billion and "captured" an estimated 70% of the U.S. ride hailing market.[8]

The question one must ask is at what cost? Many startups do not have loyal customer bases, forcing them to employ "land-grabbing" tactics to secure market share, which has resulted to be a very expensive strategy due to its price-cutting nature. The article continues by stating, "managers are terrified of cutting their vast marketing spending for fear of losing customers. Many firms are scrambling to develop ancillary products to try to make money from their users," preventing them from increasing margins.[9]

IPO Valuations are Rich

The chart on the right shows that since 2011, only one IPO vintage (2013) has generated positive returns for investors 12 months after public offerings. When comparing these figures to previous years, one can better understand how younger companies accessed public markets, allowing for more value creation to take place versus today where a lot of that value has already been created in private markets.



Source: iCapital, FactSet, Goldman Sachs

This past weekend, SoftBank announced the possibility of listing its $100 billion Vision Fund – the largest venture capital fund in the world.[10] The Vision Fund has been deploying capital into late-stage decacorns since 2017, and many of their investments are already in the process of going public. Why would SoftBank list its portfolio of companies instead of just waiting for them to individually IPO? While SoftBank states that it needs more capital to continue investing into new opportunities, we also see this as another potential sign that value creation has reached its peak in private hands, and that SoftBank is taking advantage of this window of opportunity when valuations and sentiment are strong to exit their positions.

While today's IPO companies are more mature in size and age, they continue to be very expensive – Lyft's rocky IPO illustrated this point. Lyft reported a valuation of approximately $24 billion for its IPO, pricing

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[7] The Economist. *"The Trouble With Tech Unicorns."*

[8] The Wall Street Journal. *"Uber Aims for Public Valuation of as Much as $100 Billion, Below Expectations,"* https://www.wsj.com/articles/uber-aims-for-public-valuation-of-as-much-as-100-billion-below-expectations-11554915215?mod=article_inline&mod=article_inline

[9] The Economist. *"The Trouble With Tech Unicorns."*

[10] Bloomberg. "*SoftBank Is Said to Consider IPO for $100 Billion Vision Fund.*" https://www.wsj.com/articles/softbank-considers-ipo-for-100-billion-vision-fund-11556882710

its shares at $72 – a very "hot" IPO.[11] Yet, investors did not buy in because of the intrinsic value, but rather to "flip it" as hype drove up the price. Eventually, Lyft's price dropped, trading at $58 by April 22nd.

As a result, we are seeing how companies going public are revising their valuations lower. Pinterest and Zoom brought down their IPO share prices to reflect more conservative valuations, which seemed to work in their favor. Uber has also lowered its valuation to an $80-$90 billion range, down from an initial valuation of $120 billion.[12] These revisions show that the prices at which companies were expecting to go public may be artificially inflated, as their valuations do not seem to be in line with fundamentals.[13] Uber "may not achieve profitability," according to its CFO.[14] This is not a positive indicator in our view, yet it doesn't seem to faze people publicizing the IPO as the "biggest of all times."

BSP View

Many companies are rushing to IPO as public markets have been quite strong. Companies want to go public when conditions are looking rosy, as a strong broader equity market can increase the likelihood of a successful listing. This is one reason companies are racing to go public, before market dynamics shift.

While many "unicorns" and "decacorns" are overvalued in our view, we do not foresee them triggering a recession in the short-term (1 to 2 years). Our belief is rooted in the fact that the current IPO market is still at an early stage, with public listings just beginning to pick up after years of sluggish activity. Valuation multiples for equity markets are lower today than they were during the dot-com era, when Fed Chairman Alan Greenspan famously referred to the then-bubbling market conditions as "irrational exuberance." In addition, the share of IPOs relative to the total equity market capitalization is also materially lower, indicating the market has capacity for new participants.

In 2019, we do not expect IPOs to enter bubble territory, but we cannot assume the same going too far into the future. We will continue to closely monitor how markets react to the next wave of IPOs, always maintaining a critical view of our investment thesis for equity markets. Although the companies currently listing in the public markets are more mature in terms of age and size than listings of the dot-com era, the probability of another bubble forming is not out of the question. Bubble risks will likely be created by companies that do not have a clear path to profitability or lack the platform effects needed to maintain dominance in their respective fields.

In summary, we recommend our clients to use all of the products and services created by these unicorns, as we find them to be fascinating – yet, we recommend to avoid investing in IPOs, or at least to do so with a great degree of caution. We expect to see a highly volatile IPO environment and a scattered distribution of outcomes for these newly listed equities.

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[11] Reuters. https://www.reuters.com/article/us-lyft-ipo/lyft-valued-at-24-3-billion-in-first-ride-hailing-ipo-idUSKCN1R92P4

[12] The Wall Street Journal. https://www.wsj.com/articles/uber-lowers-its-valuation-target-again-11556238053?mod=searchresults&page=1&pos=3

[13] Aswath Damodaran, *"Uber's Coming out Party: Personal Mobility Pioneer or Car Service on Steroids,"* http://aswathdamodaran.blogspot.com/

[14] Reuters. *"Uber unveils IPO with warning it may never make a profit,"* https://www.reuters.com/article/us-uber-ipo/uber-unveils-ipo-with-warning-it-may-never-make-a-profit-idUSKCN1RN2SK

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The material seeks to compare historical IPO activity with current market conditions via comparison to various indices, including the S&P 500 Index, Renaissance IPO Index and Wilshire 5000 Index which are provided for information purposes. The Renaissance IPO Index is a rolling two-year population of newly public companies whose unseasoned equities are delayed in their inclusion in core U.S. equity indices and portfolios. IPOs that meet liquidity and operational screens, are included in the Index at the end of the fifth day of trading, or upon quarterly reviews, weighted by float capitalization, capped at 10% and removed after two years. The Index is designed by Renaissance Capital and calculated by FTSE Group. The Wilshire 5000 Total Market Index is a market capitalization-weighted index composed of more than 6,700 publicly traded companies that meet the following criteria: (i) companies headquartered in the United States; (ii) stocks actively traded on an American stock exchange; (iii) stocks have pricing information that is widely available to the public. The S&P 500 Index, Renaissance IPO Index, and Wishire Index were selected to allow for comparison of the historical IPO activity/performance to well-known and globally recognized indices. Comparisons to indices in this material have limitations because indexes have volatility and other material characteristics that may differ from the referenced strategy or security. In addition, the volatility and securities of the indices may be materially different from that of an investor. Therefore, actual performance may differ substantially from the performance of any referenced index). Investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Due to these differences, indexes should not be relied upon as an accurate measure of comparison and are for informational purposes only. Unless noted otherwise, all index returns are denominated in U.S. dollars.

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