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IPO: It's Probably Overpriced?

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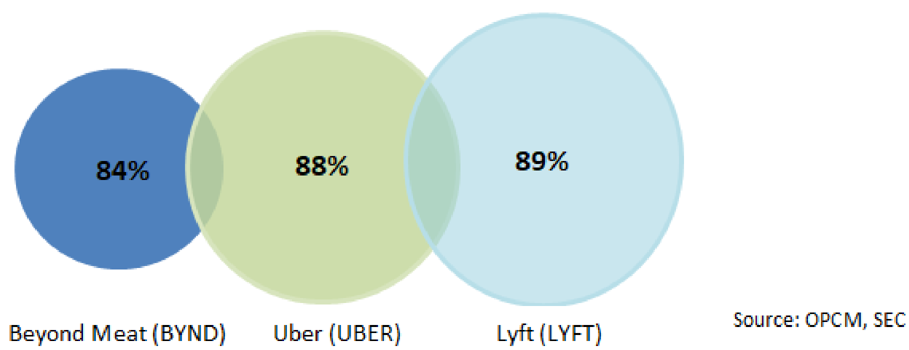
We have long known that 2019 held the potential to be somewhat of an IPO extravaganza – a year in which some of the largest private companies, many located in the Bay Area, were set to go public. Some of the most high profile companies in the world including Lyft, Uber, Beyond Meat, WeWork and Airbnb headline an impressive list of companies that pegged 2019 to make their public debut. In the second quarter alone, 62 separate IPOs raised roughly $25 billion, making it the most active quarter by deal count in four years.[1] At the halfway point of the year, the scorecard for these newly minted public companies is rather mixed, with some offerings surpassing even the most optimistic of expectations and others, including the largest IPO this year, Uber, logging a relatively disappointing debut. The most surprising IPO by a wide margin has been the extraordinary success of Beyond Meat, the maker of plant-based meat alternatives. The stock (Ticker: BYND) was up over 160% on May 2nd, the day of its IPO, and is up over 540% since going public. Seeing the remarkable success of listings like BYND has created somewhat of a frenzy, both from private companies seeking to take advantage of a favorable market environment and from investors afraid of missing out on the next Beyond Meat. Given these dizzying dynamics, we figured it would be a good time to dig a little deeper into IPOs by looking at their purpose, how to assess the risks of investing in IPOs and finally, our take on how to approach investing in the current wave of offerings.

When a company is just getting started and has yet to generate sustainable profits – the funds you need to run the business typically comes from one of two places: internally from founders and employees, or from a third party entity like a venture capital (VC) or private equity (PE) firm. Successful firms with ambitious growth plans often tap VC or PE firms to provide capital to fund their initial growth in exchange for an ownership stake in the firm. As companies continue to grow, management may ultimately decide that an IPO is the best route for the firm. Often, the actual purpose of the public offering gets lost in the media circus that accompanies nearly all large IPOs. By going public via an IPO, companies are able to raise large amounts of capital by selling ownership stakes to public investors. Going public also serves as an exit strategy for earlier investors, including employees and VC/PE firms, allowing them to sell their previously illiquid ownership stakes in public markets.

Part of the intrigue of investing in IPOs comes from the possibility of instant gratification in the form of incredible returns over a very short period of time. Look no further than Beyond Meat, whose first day return was slightly higher than the last *eight year* cumulative return for the S&P 500! This is not possible in most areas of the market which tend to accrue more steady returns over several years. Of course, the opportunity to see outsized gains comes hand in hand with the near-guarantee of stomach-churning volatility. The elevated volatility is driven by several factors. First, when companies go public they typically only sell a fraction of their shares to the public, creating a situation of limited supply of shares coupled with volatile demand, which can magnify moves in the stock. One related topic is the somewhat unusual concept known as share lock-ups. When a company goes public, the vast majority of the company's ownership will typically remain with employees and early investors. However, in an effort to facilitate a smooth IPO, companies typically restrict employees and early investors from selling until a pre-designated lockup period expires – usually between 90 to 180 days after the initial offering. Looking at Lyft, Uber and Beyond Meat, over 80% of company shares will become available to be sold when the lock-up ends later this year. The expiration of lockup periods has historically pressured share prices as investors look to cash in on their new found wealth. Another factor contributing to the outsized volatility of IPOs is the type of investors initially buying and selling new issues. Though it varies company to company, typically only a small fraction of trading in a new IPO is done by long term investors. The majority of trading comes from hedge funds and other firms employing algorithmic trading who often have little desire to hold onto the shares beyond the next 30 days or even 30 seconds. These factors combine to create a very turbulent environment for a new stock.

Percent of Shares to Be Released upon Lock-Up Expiration



Due to the fervor and excitement that come with most IPOs, one of the most important areas to evaluate before making an investment is the level of growth that is being priced into the stock. After all, a company may have a very bright future but if the market is already acknowledging this with sky high valuations, then bright prospects may not translate into superior returns for the stock. While more of an art than an exact science, we can get a general idea of growth expectations by looking at initial valuations of companies and compare them to existing entities, both new and old. Let's stick with Beyond Meat as an example and take a quick glance at what level of growth the market is currently pricing into the stock. Looking at Enterprise Value to Sales (a popular valuation metric for high-growth companies since few have profits), BYND is currently the most expensive non-financial company with a market capitalization over $1 billion in the entire Russell 3000® Index (an index of the largest 3000 U.S. public companies). At 42x EV/Sales, BYND is currently valued at more than twice the level of young, high growth software companies like Twilio (TWLO), Workday (WDAY) and ServiceNow (NOW) despite being a consumer products company which typically carry lower multiples.

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Mature consumer products companies like Tyson Foods (TSN), Kellogg (K), and Conagra Brands (CAG) trade at EV/Sales ratios in the range of 0.8x to 2.2x. Unfortunately for companies like BYND, one market truism that has withstood the test of time is that valuation multiples compress over time as companies mature. Due to lofty starting valuations, Beyond Meat could grow sales at 30% every year for the next decade and still trade at a roughly 50% premium to its' consumer product peers (3.0x)…and this assumes that Beyond Meat's stock price doesn't appreciate *at all* over the next 10 years. This is just one example but it stresses the importance of knowing what the market is expecting from a company and can serve as a warning sign should the company disappoint.

Looking at implied growth rates or valuations for companies is only a small part of the legwork necessary when analyzing an IPO, or any company for that matter. Assessing the competitive advantages, looking into quality of the management team, monitoring how the company allocates capital and coming up with a total addressable market for the company's products are other pieces of the puzzle that need to be put together before any investment should be made. If you read financial publications or watch CNBC, you've likely seen headlines along the lines of, "Caution: 2019 Is Quickly Reaching 2000 Bubble Levels for IPO's" or, alternatively, "Don't Miss Out on The 2019 IPO Goldrush!" Headlines like these are sensational and are only written to attract eyeballs. Each company that goes public has its own unique characteristics that will drive its fundamentals and stock price over time. And, despite the comparisons to 2000, the reality is that today's IPO market is nothing like 2000. The majority of companies going public today are more mature, have better funding and are supported by more attractive business models relative to what we saw in 2000. But this also doesn't mean that every "unicorn" that goes public this year will become the next Google. A few words of advice from our investment team when debating whether to invest in the next "hot" IPO: be skeptical about a company's prospects when the market is not, recognize superior business models but validate their staying power and most importantly, give yourself a margin of safety by not overpaying for the next "sure thing."

[1] Source: Dealogic