Trends & Ideas

PRIVATE CLIENT SOLUTIONS

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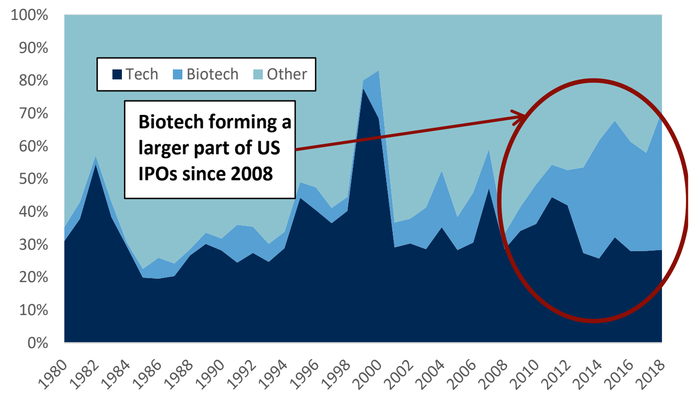
Unprofitable Debuts

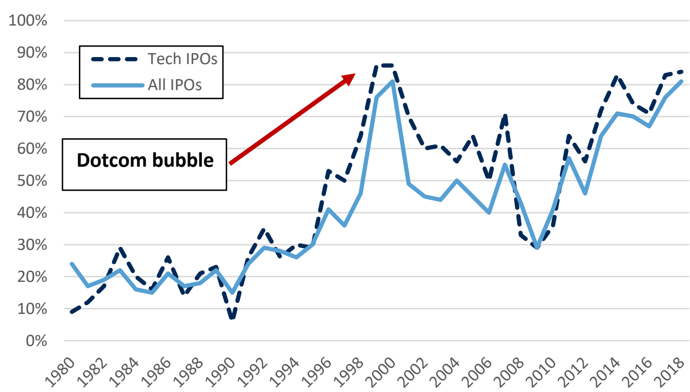
We have seen a string of initial public offerings (IPOs) so far this year including the likes of **Lyft (LYFT-US)**, **Zoom Video Communications (ZM-US)** and **Pinterest (PINS-US),** and expect more to come in 2019. These include the highly anticipated launches of **Uber Technologies** and **Airbnb**. With valuations in excess of a billion dollars, we can't help but notice that these newly-public companies are mostly unprofitable (i.e. have earnings below $0). In fact, data from Jay Ritter, finance professor at the University of Florida who has been compiling data on IPOs since the 80s, shows that 84% of US tech IPOs were not profitable in 2018, 2% shy from the all-time highs experienced during the dotcom bubble. The lack of profitability, however, has not deterred investors from bidding up the most recent IPOs with ZM, PINS and LYFT up 72%, 28% and 6%, respectively, on their first day of trading.

Proportion of US IPOs



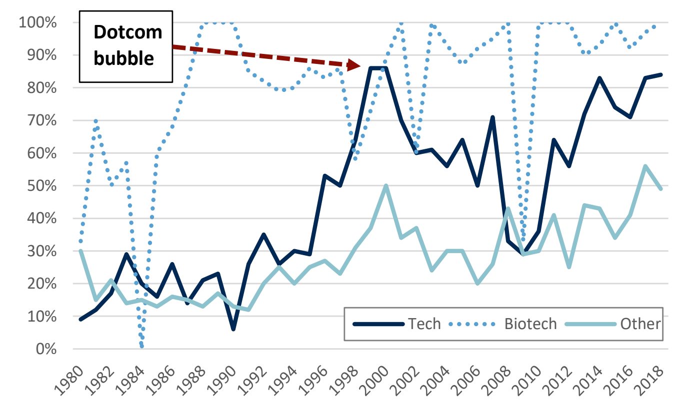
Source: Ritter, J.R. (2018, December). *Initial Public Offerings: Updated Statistics*. https://site.warrington.ufl.edu/ritter/ipo-data/. Raymond James Ltd

Unprofitable IPOs Close to All-Time-Highs



Source: Ritter, J.R. (2018, December). *Initial Public Offerings: Updated Statistics*. https://site.warrington.ufl.edu/ritter/ipo-data/. Raymond James Ltd

Biotech IPOs – Almost Always Unprofitable

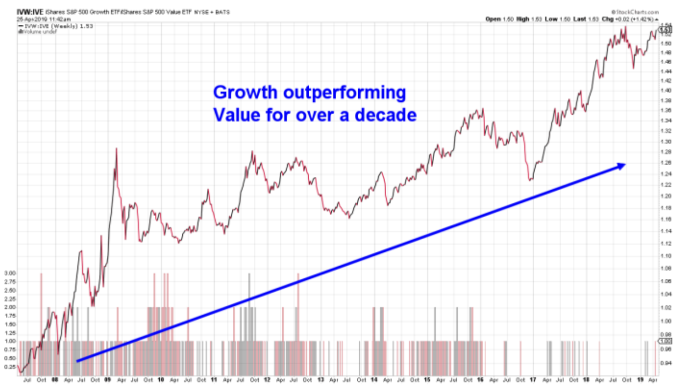


Source: Ritter, J.R. (2018, December). *Initial Public Offerings: Updated Statistics*. https://site.warrington.ufl.edu/ritter/ipo-data/. Raymond James Ltd

Growth Wins

When categorizing the IPOs into tech, biotech and other we find that a larger portion of companies making their debut are biotech, going from comprising 5% of the total in 2008 to 43% as at 2018. Over the past 10 years, an average of 90% of biotech companies were unprofitable at the time of their IPO. Reason could be that these companies are pursuing later-phase trials for their products and may need to raise capital through IPO in order to spend on research and development (R&D). In this case, investors are risking their capital for the hopes that these trials have a positive result despite the company's unprofitable nature. Almost a third of IPOs over the past decade have been tech companies, which have also been seeing an increasing trend in unprofitability going from 33% of tech IPOs not being profitable in 2008 to 84% in 2018. Investors are still piling into IPOs, paying a premium multiple for the hopes that one day those companies could become profitable. Investors in this case are more interested in the revenue growth potential, forgoing short-term profits for long-term gains, along with the possibility that this company could become an industry disruptor similar to an **Amazon.com (AMZN-US)**, **Alphabet (GOOG-US)** or **Facebook (FB-US)**. This phenomenon is not only present in the IPO market as we've seen this trend of investor preference for growthier companies since the financial crisis. The iShares S&P 500 Growth ETF (IVW-US) has outperformed value for over a decade, its longest winning streak on record as shown in the chart below. Clearly, in a world where growth is increasingly scarce, investors are willing to pay a heavy premium for growth companies.

Growth Outperforming Value since 2007



Source: StockCharts.com

Is This Time Different?

However, even though the level of unprofitable tech IPOs are reaching dotcom levels, we note that there is a significant difference between today's IPOs and those seen almost 20 years ago. Many of those dotcom IPOs were not proven business models and were still in the early stages of development. Today, even though tech companies are unprofitable, they actually have revenues and have been operating for years in most cases.. LYFT, which was founded in 2012 and reported US$2.1bln in revenues last year (up over 100% from 2017), showed a net income loss of $911 mln in 2018. As significant as that may seem, the company could have been profitable had it not allocated almost US$1.1 bln in capital to growth initiatives (e.g. expanding its customer base) by spending on sales/marketing and R&D. Airbnb, the much sought after IPO, has actually been profitable for the past two years. So if the most recent companies wanted to be profitable they just might, but then they may have to give up, or at least moderate, their growth ambitions.

Conclusion

Investors may continue to pile into unprofitable IPOs and forego current profits in hopes for growth so long as the macro environment remains supportive. However, if we begin to see economic indicators deteriorate, then that may cause a rotation out of growth towards safer/more defensive areas of the market.

We have been cognizant of indicators sending warning signals from yield curves inverting, concerns surrounding US earnings growth and the reasons behind the central banks reversal in their policy. When thinking about IPOs, we urge investors to be aware of the increased risk and volatility associated with such investments at this point in the cycle and recommend investors carefully weigh the risk/rewards in participating in the secondary market of newly IPOed firms.

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