

The Cream of the (Cash Burning) Crop

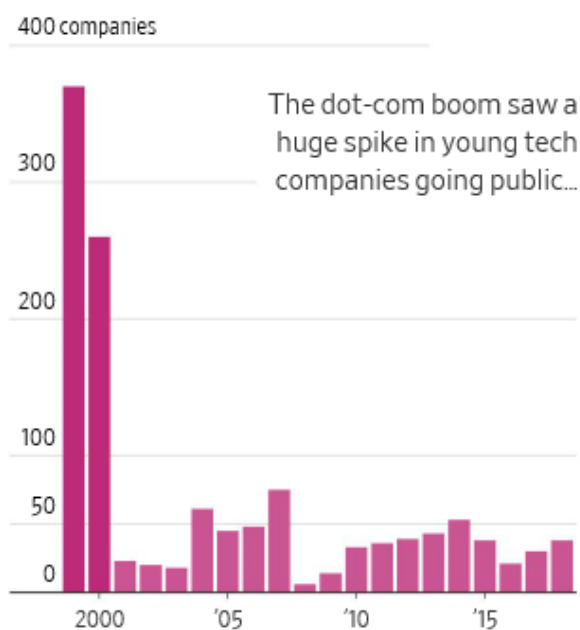
“WeWork’s planned IPO turned into a highly publicized debacle that suggested investors may finally be done overpaying for blazing-fast growth.”

– IPO specialist Renaissance Capital

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In 1999, 547 companies rushed towards public markets looking to capitalize on the zenith of the dotcom era. The vast majority of those companies were comprised of young tech darlings and, all told, companies that went public in 1999 took in a record haul of \$108 billion. Following the turn of the millennium – and following the eruption of the massive dotcom bubble that resulted in the collapse of many of these companies – the number of tech Initial Public Offerings (IPOs) fell sharply from 250 in the year 2000 to just 19 in 2001.

Tech IPOs



Source: Wall Street Journal

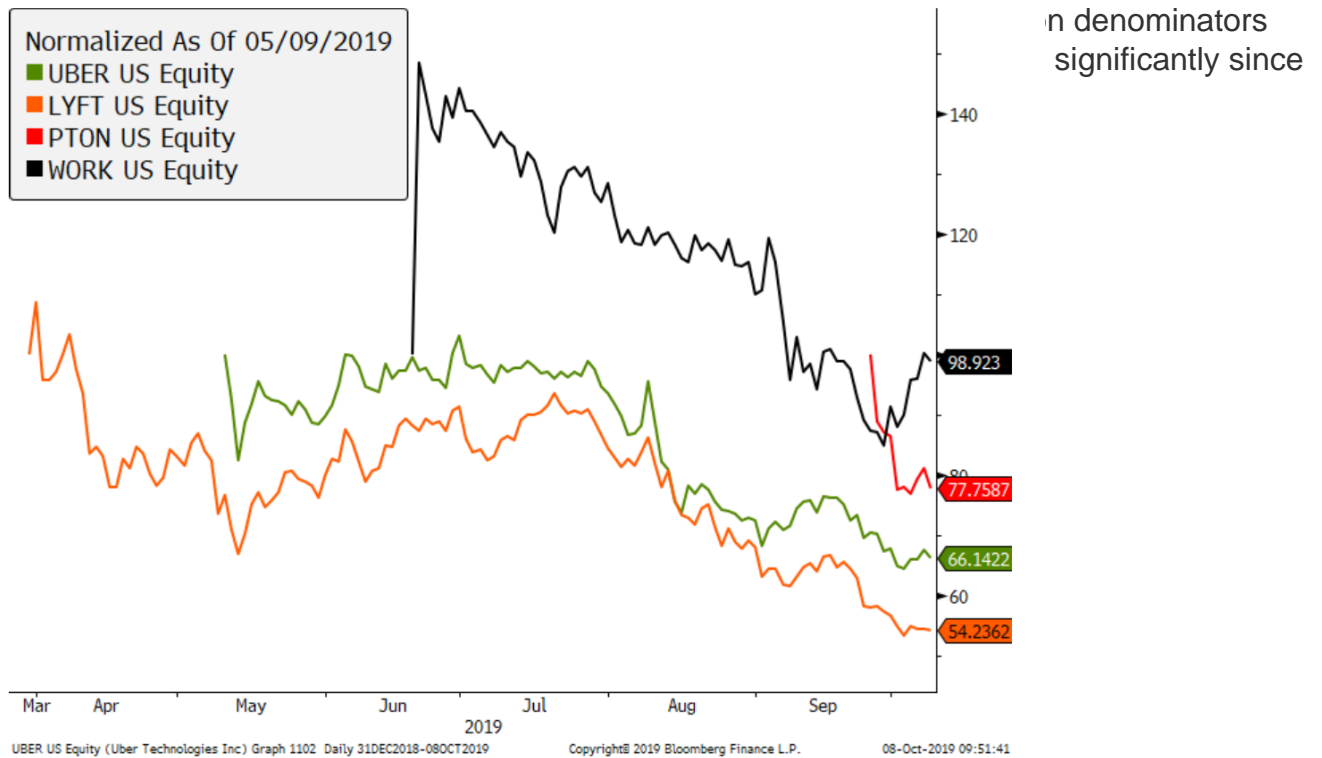
Looking ahead two decades, markets saw a large number of unicorns built from the ashes of the greatest market blow-up since the Great Depression take a similar stride towards public markets in 2019. Many pundits have suggested that the IPO frenzy of 2019 is different from 1999, and in many regards they are correct. The IPO frenzy of two decades ago saw hundreds of internet companies with little more than a business plan and a “dot-com” in their name raise ridiculous sums of capital. The average age of those companies was roughly 4 years at the time of IPO with median annual revenues of \$12 million. In contrast, the crop of companies that have gone public so far in 2019 are much more established with an average age of 10 years at the time of

IPO and \$173.4 million in annual revenue.

While the differences are evident, what is strikingly similar about the companies across these two eras is that the vast majority of them burn (or burned) money at a dizzying rate. Take two dominant ride-hailing companies that went public this year as an example: Uber and Lyft. The former lost \$3.3 billion last year, while the latter lost more than \$900 million. And while investors have shrugged off this reality for the better part of 2019, it seems that the winds have started to shift and markets are beginning to take issue with the long-term viability of cash burning companies.

Perhaps most notably of late is the very publicized story of WeWork, whose CEO Adam Neumann was relieved of his post amid heightened scrutiny as the company stumbled towards its planned IPO. Demand for its stock was so weak that after slashing its target price several times, the Board of Directors changed course entirely and decided to go into cash-preservation mode, firing top executives, cutting its workforce substantially, and even looking to sell the \$60 million Gulfstream jet that the company bought Neumann last year. But WeWork is far from the only company that has, until late, successfully ridden on the story of growth over profits. It's simply the most deserving poster child.

Some other notable growth stocks that went public in 2019 include: Peloton (PTON), Lyft

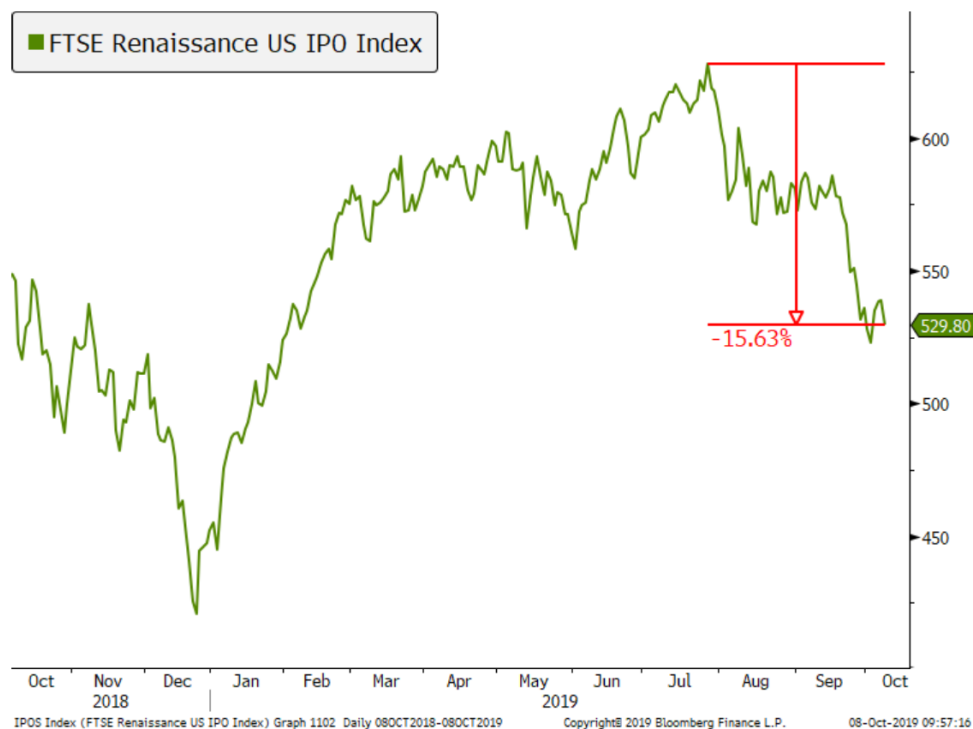




Source: Bloomberg, Evergreen Gavekal

*Beyond Meat is the only exception which has risen 465% above its IPO price. However, the stock has fallen -39.8% since July 26, 2019.

More broadly, the FTSE Renaissance US IPO Index, which tracks companies that have gone public over the last two years, has also hit a rough patch of late. While the index started off 2019 with a bang, over the last three months the index has delivered far less impressive results, falling -15.63% since its mid-summer high.



Source: Bloomberg, Evergreen Gavekal

You may be asking yourself, why has sentiment seemingly changed among investors? Below we outline three potential reasons why several high-flying growth companies have run into trouble and why they may be running out of time to correct course.

Geo-Political and Macro-Economic Risks

There are several geo-political and macro-economic factors broadly weighing on markets. Namely, the ongoing trade war with China (and others), a looming impeachment inquiry, the inverted yield-curve, heightened tension in the Middle East, and sluggish global manufacturing data. These factors have investors considering the possibility of a global recession and have created a prevailing nervousness around risky assets – particularly companies burning cash at a high clip. In the third quarter of 2019, the best-performing sectors of the S&P were utilities, real estate, and consumer staples – all of which are known for delivering high yields to investors. Assuming geo-political and macro-economic factors continue to weigh on investor confidence, markets should continue to see a rotation out of risky assets and into safe-haven assets and high-yielding value stocks.

Difference Between Silicon Valley and Wall Street

Silicon Valley largely operates within the private market and, therefore, determines the valuation of its investments in a vacuum. Wall Street, on the other hand, operates in the public sphere where the scrutiny of a business is much more robust and open to many market participants. The recent blow-off (and blow-up!) of many cash-devouring stocks that have gone public in 2019 show that there is a real disconnect between private and public markets. Over the past decade, private companies have had significantly more access to private capital than companies in previous eras. This has, as we contended in our July newsletter titled "[The Mysterious Case of the Elongated IPO](#)," given mutual funds, hedge funds, private equity buyout firms, family offices, traditional endowments, and sovereign wealth funds the ability to invest in the later innings of a company's development. In turn, this has propped up valuations at a point where public markets

used to supply the main source of fresh – and we’d argue more reasonably priced – capital.

Recent Changes to Index Rules

Another factor weighing on companies that have recently gone public is changes to the membership requirements in benchmark stock indexes. Updated rules state that companies with multiple share classes can’t be added to indexes maintained by the S&P Dow Jones Indices LLC. Companies with multiple share classes also face restrictions at the FTSE Russell. The trickle-down of this is that many of the largest companies to IPO in 2019 (including Chewy, Lyft and Pinterest) are being ignored by US mutual funds and ETFs. Goldman Sachs wrote: “Multi-class voting to insulate management from its own shareholders comes at a significant long-term cost.” Companies with multiple share classes are facing this fact, as their share prices are not being levitated through the inclusion in many popular and widely owned benchmark indexes.

The IPO market, which started off the beginning of 2019 on fire, looks to have cooled off substantially over the past few months. Following WeWork’s implosion and Peloton’s poor opening day debut, entertainment company Endeavor pulled out of its planned IPO. In what was supposed to be a banner year for the IPO market, investor appetite seems to be diminishing for companies that are growing the top-line (i.e. revenue) fast but mounting bottom-line (i.e. profitability) losses even faster. Taken in combination with increased geo-political and macro-economic risks, sky-high valuations in private markets, and changes to index rules, the road could get even bumpier ahead for unprofitable companies. The question becomes, is there enough time to shift course and prove that high growth will ultimately lead to profits? Amazon is one company that navigated this path successfully, but the jury is still out on whether today’s cream of the cash burning crop will be as fortunate or fall victim to the same fate as many of their dotcom era predecessors.

Along with plunging high-end home prices in Vancouver, BC, luxury condo prices that are down 40% or more in Miami, a deep correction in Manhattan luxury properties, another crash in the cryptocurrency market, and an utter disaster in cannabis stocks this year, the IPO market’s breakdown is mounting evidence that Bubble 3.0 is running out of helium.



Michael Johnston

Tech Contributor

To contact Michael, email:

mjohnston@evergreengavekal.com

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