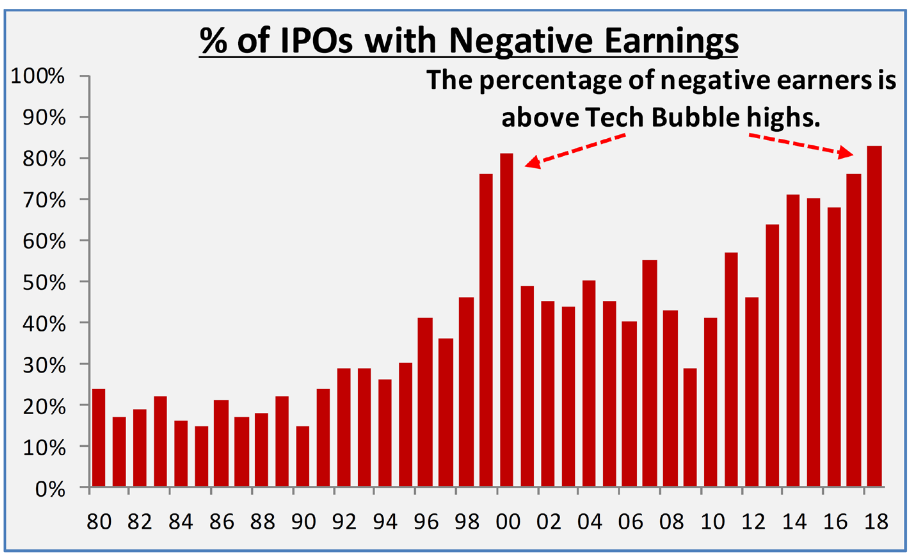
# April 2019 – Uber: The $110 Trillion Unicorn?

Over the last month, we have fielded an increasing number of calls asking about the merits of investing in some of this year's high-profile, technology company initial public offerings (or, IPOs). We think some of these businesses, such as Pinterest – a social network of sorts where users can track their various hobbies and interests – have large addressable market opportunities and can eventually become consistently profitable if management teams execute well. We think other businesses, such as the ride hailing networks (Lyft and Uber), may be structurally challenged due to intense competition, limited pricing power and rising labor and technology costs. But what is common amongst almost all the technology companies going public this year are high valuations and limited to no profitability. This doesn't necessarily mean these are bad investments; it just means the valuations leave little room for operational hiccups, with any slowdown in growth likely to be followed by share price declines.

Going public without any profitability isn't atypical. Most companies IPO at relatively early stages in their life-cycle, prior to their businesses reaching full scale. The capital raised via IPOs is often critical to firms securing the financing necessary to grow their businesses to the point of maturity where they do reach profitability. However, this year's group of IPOs features an unusually high percentage of firms that have yet to turn a profit, despite many of them nearing 10-years old (see below chart and table).[1] Moreover, investors are willing to pay premium prices to own these firms (as reflected in their lofty market cap to sales ratios), with the hope that their high sales growth rates will endure for years.

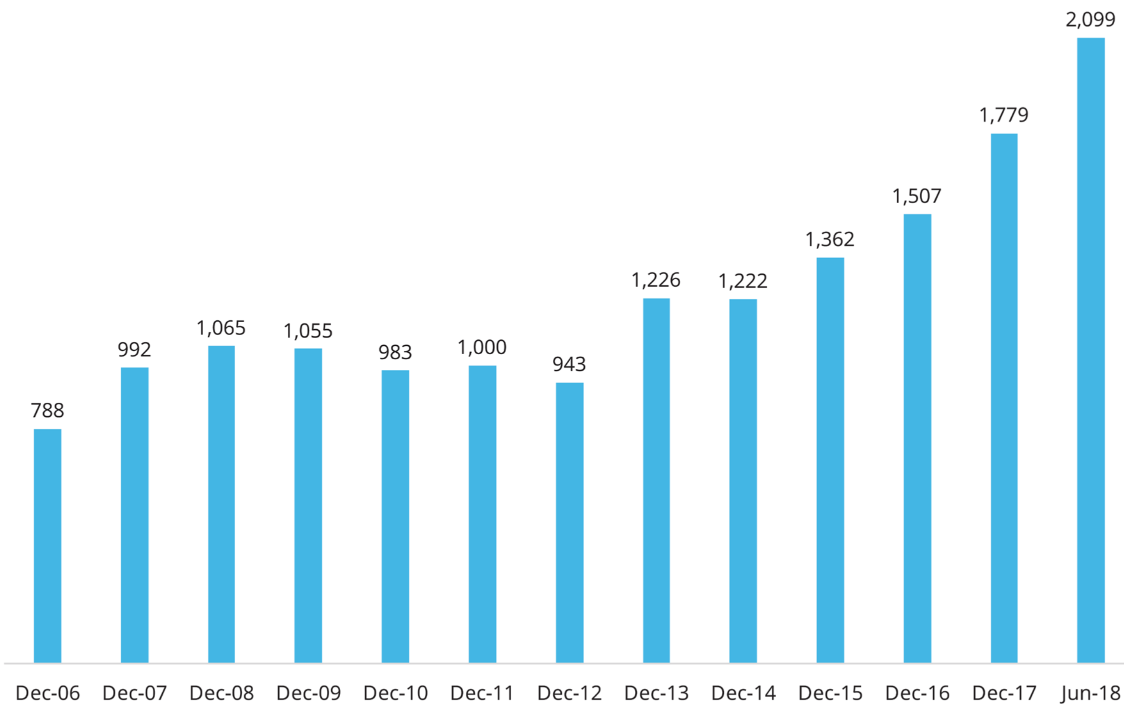



| Company | Founded | Market Cap (Millions) | FY 2018 Sales (Millions) | FY 2018 Op. Income (Millions) | Market Cap/Sales Ratio |
|---|---|---|---|---|---|
| Jumia | 2013 | $ 3,152.80 | $ 130.57 | $ (169.74) | 24.15 |
| Pinterest | 2010 | $ 16,137.59 | $ 755.93 | $ (74.72) | 21.35 |
| Lyft | 2012 | $ 16,363.62 | $ 2,156.62 | $ (977.71) | 7.59 |
| Zoom | 2011 | $ 17,197.80 | $ 330.52 | $ 6.17 | 52.03 |
| Uber | 2009 | N/A | $ 11,270.00 | $ (3,033.00) | N/A |

In an excellent paper on sources of competitive advantages for investors, renowned investment strategist Michael Mauboussin writes: "Every time that you buy or sell a security and anticipate excess returns you should ask, 'Who is on the other side?' Ideally, you should understand your counterparty's motivation and ask why you have an edge."[2] In other words, when you decide to buy a stock, you should think about why someone else has decided to sell it. Do you know something they don't know? Or vice versa? Thinking about the other side of the trade is especially relevant for this year's class of IPOs.

Prominent technology companies going public today are not doing so because they need access to new sources of financing. Private markets are flooded with capital and many of these firms could easily raise additional funding on generous terms in large private offerings. Per the chart below, global "dry powder" capital – uncommitted funds available for asset managers to deploy – surpassed $2 trillion in 2018.[3] In the U.S. alone last year, venture capital investments exceeded $100 billion for the first time since the "dot-com" era with $130.9 billion invested across 8,948 deals, including 198 transactions surpassing $100 million each.[4]

**Global Private Capital Dry Powder ($billions), 2006 – 2018**




Prospective investors should question why prominent technology companies are going public if large pools of capital are willing and able to finance additional funding rounds, allowing the firms to remain private and thus avoid tedious SEC filing requirements, quarterly shareholder updates and the daily volatility of public markets. To some degree, the answer is that private investors and long-time employees need liquidity (although that can be facilitated in private market transactions). But to a larger degree, we think the answer is that growth-starved investors looking to own "the next Amazon" are on the other side of the trade. In the current low-growth, low interest rate environment, public investors are temporarily receptive to paying premium valuations to own these high-growth firms. For the companies and their insiders, selling into a seller's market is a much better deal than selling into a buyer's market.

While some of these new firms could grow into formidable and profitable businesses over time, we think it's a safe bet that none will be the next Amazon, Microsoft, Google, Facebook, etc. for a variety of reasons. For one, the companies going public today face fierce competition. In contrast, today's large cap technology firms essentially have become natural monopolies in their market segments. Perhaps more importantly for potential investors, the valuations at which these firms are going public means that future returns are unlikely (and arguably impossible) to match those of Amazon or Microsoft. Prior to the development of such robust private investment markets, prominent technology firms went public at much earlier stages in their development and at much lower valuations. When Amazon went public in 1997 it raised $54 million at a $414 million valuation.[5] When Microsoft went public in 1986 it raised $58.7 million at about a $600 million valuation.[6] Since going public Amazon has returned 129,942%, and Microsoft has returned 204,952% (including dividends).[7] When Uber goes public next month and raises approximately $9 billion at an estimated $85 billion valuation, the only people who will get rich from the offering anytime soon are current investors and insiders who already own the stock. If Uber has the same return over the next few decades as Amazon, it will be worth just under $110 trillion. Short of hyperinflation, we're going to go out on a limb and guess that won't happen.

Again, that is not to say these firms can't be solid investments if they continue to grow and eventually produce significant profits. We are just cautious for now given their valuations – with market cap to sales multiples as high as 50! Paying 50 times a company's sales to own the stock could eventually pan out if sales continue doubling for several years and profitability substantially increases. But such multiples embed exceedingly lofty and aggressive assumptions. After the late 1990s tech bubble deflated (note: we don't think we are in a market bubble today), Scott McNealy, the CEO of Sun Microsystems – a once high-flying tech stock – gave a memorable interview with Businessweek magazine where he touched on his stock's incredible rise and subsequent fall:

> "Two years ago we were selling at 10 times revenues when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero [research and development costs] for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"[8]

While fundamental business operations and cash flow generation drive a company's performance over the long-term, the initial valuation one invests at does matter when it comes to future return prospects. As exciting as some of the new IPOs coming to market are, we would caution potential buyers to consider the assumptions embedded in their valuations and think hard about who is on the other side of the trade. Is the company selling shares because it needs the capital to fund future operations and growth initiatives, or is it selling because investors are receptive to paying a high valuation to buy its stock?

On an unrelated note, we wanted to briefly mention the selloff in health care stocks this month, which has been driven by increasing political discussions on national health insurance and drug pricing. In short, we think the selloff across health insurer, pharmacy benefits manager and biopharmaceutical stocks has been overdone. While many of these stocks have rallied sharply from recent lows, the S&P 500 Health Care Index is still down 3% for the month, which compares poorly to the nearly 3.8% rise in the broader S&P 500 Index.[9] As we get closer to the Democratic primaries, we think it is likely that debates about "Medicare for All", other insurance market reforms and prescription drug pricing will remain in the headlines. For the most part, we encourage long-term investors to ignore the noise and volatility. Many portfolios have owned firms such as Johnson & Johnson, Pfizer and Merck for years, if not decades, and are sitting on large capital gains that would be subject to taxation if sold. If bouts of volatility persist, health care may become a compelling area to add exposure as valuations are compelling compared to the broader market (with the S&P 500 Health Care Index trading at 15.5x expected earnings vs. the S&P 500 trading at 17.7x expected earnings).[10] Without making any political judgment, amongst the current Democratic frontrunners only a Bernie Sanders candidacy poses a serious longer-term threat to these businesses. And for Mr. Sanders' proposed reforms to be implemented, the Democrats would also need to re-take the Senate. Currently, we view each of these as relatively low-probability events. However, we will stay watchful of these developments and alert you if we think the fundamentals for any of these companies have changed for the worse. For now, we remain (and expect to remain) comfortable holding health care stocks in our portfolios.

As always, thank you for your continued support and please let us know if you would like to discuss your portfolio, new investment opportunities or any of the subjects covered in this month's letter.

Sincerely,

| | |
|---|---|
| Peter Karmin | Stuart Loren |
| Managing Member | Director |

**Citations and Disclosures**

[1] Wolfe Research (April 26, 2019); Bloomberg.
[2] Michael Mauboussin, *Who is on the Other Side* (Fed. 12, 2019). Available at: https://www.bluemountaincapital.com/wp-content/uploads/2019/02/Who-Is-On-the-Other-Side.pdf.
[3] Preqin Insights, *Alternatives in 2019: Private Capital Dry Powder Reaches $2tn* (Jan. 28, 2019).
[4] PitchBook, *PitchBook-NVCA Venture Monitor Q4 2018* (Jan 9, 2019).
[5] Bloomberg.
[6] Bloomberg.
[7] Bloomberg (as of April 28, 2019).
[8] Businessweek, *A Talk with Scott McNealy* (March 31, 2002).
[9] Bloomberg (as of April 28, 2019).

[10] Bloomberg (as of April 28, 2019).

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