NASHVILLE NOTES

Circular logic abounds in the tech ecosystem

Tuesday, September 24, 2019 8:59 AM CT

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence or Mercer Capital, where he is the managing director of the financial institutions group.

Maybe the market is not completely insane.

Underwriters were forced to pull the plug on The We Co. IPO a couple of weeks ago. In the pre-unicorn era that I date to 2014, I doubt We Co. would be allowed near the public markets unless underwritten by a lowly bucket shop. We Co.'s lead underwriters were set to be JPMorgan Chase & Co. and Goldman Sachs Group Inc. It says a lot about Wall Street today that these two would be on the jacket of a massive-money loser unless the company might be expected to develop a cure for cancer or some other noble endeavor.

We Co. is a real estate company that signs long-term leases for pricey real estate that it polishes to the nines, and then re-leases the space short term. The company describes itself somewhat differently as a "community company committed to maximum global impact."

A Sept. 13 amended Form S-1 disclosed not only massive losses, but also significant corporate governance issues. Not surprisingly investors challenged the valuation, and they may begin to question the professional ecosystem around the tech sector that seems to be oblivious to business models and valuations that make little sense but produce big fees for Wall Street.

I am not a real estate investor, but my take on We Co. is that the equity appears to be worthless. Year-to-date revenues through June 30 doubled to $1.54 billion from the comparable period in 2018, but the operating loss also doubled to $1.37 billion. Adjusted EBITDA for the six months was negative $510.7 million, while capex (i.e., expenditures for property and equipment) was $1.3 billion.

That is a big hole to fill every six months before factoring in rapid growth to be financed. Cash as of June 30 totaled $2.47 billion, while the capital structure entails a lot of debt and negative equity. The IPO raise also was to be accompanied by a $6 billion senior credit facility that presumably is on hold too for the time being. We Co. may be a big money loser, but it was going to be a money maker for Wall Street this year.

From a valuation perspective, We Co. is problematic because operating cash flows are deep in the red with apparently little prospects of turning positive anytime soon. Therefore, a positive equity valuation is predicated upon some point in the future when cash flows (presumably) turn positive; or as most of you reading this will understand — an utterly fantastic terminal value in a discounted cash flow model.

I have no idea how private investors came up with the value they were willing to place on the company when participating in various funding rounds, but the increase was astounding. Presumably they were relying upon discounted cash flows and transaction comps in which there are plenty of money-losing ventures to compare multiples of revenues and heavily adjusted EBITDA. Anything but current and near-term projected cash flows.

The company pierced the unicorn threshold in early 2014 when affiliates of JPMorgan invested $150 million in the fourth funding round at a post-raise $1.5 billion valuation. T. Rowe Price Group Inc. and Goldman Sachs invested $434 million in late 2014, which resulted in a post-raise valuation of $10 billion.

The seventh and eighth funding rounds are where I think the valuation really gets interesting. In August 2017, SoftBank Vision Fund invested $3.1 billion, which implied a valuation of $21 billion. SoftBank Group Corp., which sponsors the Vision Fund, invested $4.0 billion in January 2019 at an implied valuation of $47 billion.

When the underwriters were forced to pull the plug on the IPO, the targeted valuation reportedly was $10 billion to $15 billion. I do not believe a formal price target was ever set but initial price talk for the IPO was well above $10 billion to $15 billion, although I do not think anyone ever seriously believed $47 billion would be achievable.

The valuation history raises an important point. A transaction in a privately held company infers a meaningful data point about value to investors, but there are a couple of caveats. One is an assumption that both parties are fully informed and neither is forced to act. Great values were realized by those willing to buy during the 2008 meltdown because there were so many forced sellers that ran the gamut from levered credit investors forced to dump bonds to the likes of Wachovia Corp. and National City Corp. The price data was legitimate, but many sellers faced margin calls and had to dump assets into an illiquid market.

I may be on thin ice, but I wonder if SoftBank's markup of its initial $3.1 billion investment in We Co. with a second investment 18 months later at more than twice the initial valuation was the opposite of a forced seller. Did SoftBank need a higher valuation to support its ability to raise more capital? SoftBank founder Masayoshi Son has an incredible track record spanning decades, but the markup was so big for a company that incinerates cash that the validity of the investment as a valuation data point is suspect in my view.

The second issue relates to private equity valuation generally, but especially those in the tech sector, where startup losses and ongoing capital requirements can be huge. The valuation issue relates to using transaction data from investments in other money-losing enterprises. Is it always valid to apply multiples paid by investors in a funding round of a money-losing business to value another money-losing business? It seems like circular logic to me that ignores basic economics such as cash flow. The valuation data may be factual, but it may be nonsense.

Of course, it may be that I just do not get it. Given that I have spent decades working with banks and other businesses that are expected to produce real rather than pro forma earnings, like many value investors I have a hard time with growth companies, especially ones like We Co. that can tout fantastic revenue growth but that are not remotely close to making money.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

Published with permission.
Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.