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EXECUTIVE BRIEFINGS
BUSINESS AND MANAGEMENT: VALUATIONS

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Valuations: optimistic or desperate?

In a blog post on the 2nd November, 2013, Aileen Lee, the founder of private equity firm Cowboy Ventures, coined the term 'unicorn' to denote a tech start-up that had achieved a valuation of USD 1 billion. Ms Lee counted 39 such companies in America alone. Less than two years later, on January 22, 2015, *Fortune* magazine in the article *The Age of Unicorns* computed 80 such firms across the world. A year later, in January 2016, Venture Beat documented a staggering 229 unicorns in existence globally. Collectively, these companies were valued at USD 1.3 trillion and had obtained private funding to the tune of USD 175 billion. The analysis went on to explain that most of these companies hit the billion-dollar mark within 5-6 years of inception. In many ways these numbers defy logic – not least because the terms of reference have mysteriously changed from revenues and profits, the very basis for the existence of a business – to stock valuations.

Who makes the most money?

The following statistics may provide an explanation. When Microsoft went public in 1986, its market capitalisation was approximately USD 500 million. Today it stands at almost USD 300 billion, having delivered an astounding 59,900% return to its investors over 28 years (25% annually compounded). Google offered its growth story to the general public in 2004. Its market cap at the time was USD 23 billion, which now stands at USD 504 billion, a respectable 2,091% return over 12 years. Facebook listed at USD 100 billion in 2012 and stands at USD 318 billion today, delivering a relatively modest 218% return over 4 years. Finally, Alibaba listed in 2014 at a market cap of USD 225 billion and this remains almost unchanged today. This is not a commentary on the performance of these companies nor the fact that older businesses have done better than newer ones, it is more a reflection of how wealth creation in the so called 'E-economy' has shifted from public markets to private ones.

In Microsoft's case, the average public investor made money as the firm grew. By contrast, in Alibaba's case most of the money had already been made before a public stock offering by private investors. On the basis of ever increasing valuations during initial funding rounds, the stock price at the time of listing had previously incorporated the assumption of high future growth, implying that unless the company does *even* better from here on, there is not much upside left for public markets. Therefore, if an investor did not enter the business while it was private then one had simply missed the bus. This premise holds true for the other 'unicorns' and internet start-ups and is what explains the desperation of private money to enter 'before it is too late'. The unbridled escalation in company valuations over the last few years, sometimes even in the absence of corroborating cash flows, starts to become a little more understandable.

The way the process works is actually quite simple. From the conception of an e-business idea to its implementation and eventual stabilisation, an organisation could go through over a dozen rounds of funding. The very first round of venture or angel investing typically involves amounts in the range of USD 1-10 million as one is essentially betting on nothing more than an idea and a motivated entrepreneur. Angel funding, in India for instance, has risen by 30% over the past year and is expected to double in 2016. Thereafter, valuations increase by orders of magnitude and by the time the promoters catch the eye of larger institutional funds, they command figures that run into hundreds of millions of dollars. Ostensibly, this is justified on the grounds that by this stage, the business has acquired real assets, employees, customers and some sort of revenue stream. However, in the absence of adequate benchmarks and with constant buffeting from new business models and regulations, the basis for arriving at such numbers remains nebulous.

In the private market, no one is watching

In theory, an unlisted company's stock should be valued on the basis of discounted cash flows (DCF). The other option – using a profit multiple – is less feasible as start ups are unlikely to be profitable in the initial years. However, even the DCF model can be arduous to apply, for two reasons. Firstly, current cash flows are usually nowhere close to being indicative of future ones (which in fact, is what draws investors to these businesses in the first place). As a result, standard models of extrapolation are ineffective. Secondly, technological disruptions are a given in today's environment; hence, the assumption that any business' revenues or customer streams will continue to grow at an exponential rate, no matter how appealing the business model, is surely flawed.

Yet, so long as a company is private, there is neither a stringent accounting standard to be adhered to nor the obligation to disclose financial information to the public, nor consequently the need to justify a valuation methodology. This suits both promoters and private equity investors. Promoters want to raise money while diluting as little of their stake as possible while private investors just want to hop on to the bandwagon.

When the fear of losing *out* is greater than the fear of losing

That is not to say they walk in with their eyes closed. Clearly, extensive due diligence is performed before any funding is given. Analysts look at gross revenues or number of customers, but equally at hard profitability, operating and sustainability metrics. They perform 'what-if' simulations; subject the business model to a variety of 'stress tests'; use a multitude of benchmarks and comparators to verify growth claims; and so on. After all, the fear of losing money is a powerful motivator and fund managers are ultimately answerable to their investors. But the truth, as the previous statistics demonstrate, is that the fear of losing *out* is an even stronger motivator.

The willingness of private equity investors to walk away from an unjustifiable demand, once hailed as their strongest bargaining chip, has weakened to a point where sometimes the question they ask is not 'is such a valuation justified?' but rather, 'will we be able to convince some other investor of an even higher figure?' As long as the second answer is yes, the cart continues to roll. Much like the American housing boom of the mid 2000s, the process is based on an implicit assumption of ever-increasing valuations. As long as the cycle continues *everyone* makes some money and some people make a *lot* of money. When the cycle stops, the consequences are usually a lot worse than even the cynics imagined. What is worse is that the trigger that stops the cycle is both unpredictable and sudden.

Still, its not so bad

The similarity with asset bubbles notwithstanding, there are reasons to believe that things are not quite so bad, yet. For one, unlike the dotcom bubble or the housing market phenomenon, these businesses are 'real', not on paper. They have tangible assets (even software is a tangible asset from a business point of view), employees and customers and in most cases, a business model. Their assumptions may be over optimistic but the worst that might happen is that less money will be made, and by fewer people, than originally believed. Some success stories will still come about.

Second, the involvement of intermediaries, usually the main culprits in the proliferation of asset bubbles, is low. Most negotiations are directly between promoters and investors and the phenomenon is essentially in the private domain. If even downside risks were to play out, the losers would really be the fund managers and their investors – high net worth individuals and hedge funds – who have deep pockets and the ability to absorb losses. The involvement of the common man's money is limited to the small proportion of funds that are indirectly invested through pension funds.

Thirdly, despite the hype, the numbers involved are modest. Even if the USD 175 billion figure cited earlier is considered an under-estimate, the total funding involved is unlikely to exceed a few hundred billion dollars – large enough to cause discomfort but not a calamity. However, the figure is growing and to that extent is a risk to watch for.

Finally, there are some signs of greater scrutiny being brought to bear on the process of valuations. This is happening through the entry of mutual funds and a few other investor groups that are susceptible to regulatory scrutiny. When a mutual fund invests in an unlisted company, it is required to follow mark-to-market norms that are dictated by regulation and accounting standards. Whilst not perfect, such rules bring in a degree of transparency in how it values its investment in an unlisted security. In the very least, they curb increases in valuations in subsequent rounds of funding. Recent data would suggest that these may have begun to take effect.

Mutual funds are the new 'barbarians'

According to the Wall Street Journal (WSJ), as of Q1 2016, mutual funds had invested in at least 49 unicorn companies. Two or three years ago, that figure stood at 15. Further, between Q4, 2015 and Q1, 2016, 29 of these 49 companies were down-valued by their MF investors, in most cases by fairly significant amounts of 10-40%. For unicorn businesses, a down valuation *before* going public was unheard of until now, so this is an important counter trend. Amongst the more prominent demotions were Palantir (32% write down by Morgan Stanley), Flipkart (15% devaluation by T Rowe Price and Principal), Dropbox (29% by Fidelity and Hartford), Airbnb (6-10% by Morgan Stanley and T Rowe Price) and Stemcentrx (38% reduction by Fidelity). Another 11 companies in WSJ's list saw their valuations remaining unchanged while 9 companies saw an increase in their valuation, but only by a few percentage points. Since the most recent valuation figure serves as the benchmark for subsequent rounds of funding, the immediate impact of these write-downs will be to reduce the next valuation. Next quarter, unless the company is able to justify its last valuation, it will get written down again. Dropbox, for instance, has suffered write-downs for four quarters running since Q1, 2015.

Crucially, this phenomenon is injecting some realism into what was previously a unidirectional trend. One cannot be certain that a mutual fund's valuation methodology is more accurate or robust than anyone else's, but it is surely more mechanical and hence less susceptible to emotion and greed. Going forward, there may be heightened inspections of Unicorns. The United States Securities and Exchange Commission recently indicated that it would monitor start-ups that pose a risk to investors, specifically Unicorns that have claimed lofty valuations without the demanding scrutiny of public markets. Anything that brings realism into the valuation game is probably a good thing for everyone concerned but most of all for promoters. They would much rather a slightly slower ride than one that goes too fast and then trips over the smallest of bumps.