INVESTMENT BRIEF

Q2 2019

Strategic Investment Group®

Land of the Unicorns

In 2004, Google went public valued at what was then an astonishing $23 billion on the back of revenues of $2.7 billion and net earnings of $286 million. Large IPOs are now commonplace. Many, however, are unprofitable. Unicorns – private start-ups priced over $1 billion – are proliferating. Uber, to take one example, went public this year valued at $82 billion despite losses of $3 billion in 2018. This quarter's special topic considers the current dynamics of late-stage venture capital.

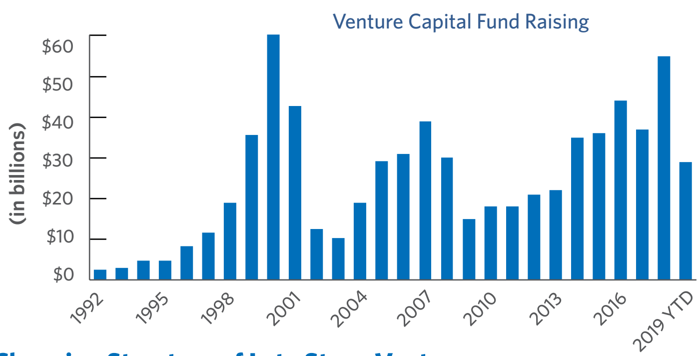
Fundraising Froth

Private equity funds, including venture capital, have been attracting heavy inflows in recent years. Last year saw near record inflows into U.S. venture capital funds – $55 billion – and this year is on track to match that pace (Exhibit 1). Outside of the U.S., SoftBank's $100 billion Vision Fund, the world's largest investor in tech firms, is transforming the venture landscape and an equally large Vision Fund II is on the horizon.

EXHIBIT 1:

U.S. Venture Capital Fund Flows at Near-Term Peak

Source: Strategic. Data through May 15, 2019.



Changing Structure of Late Stage Venture

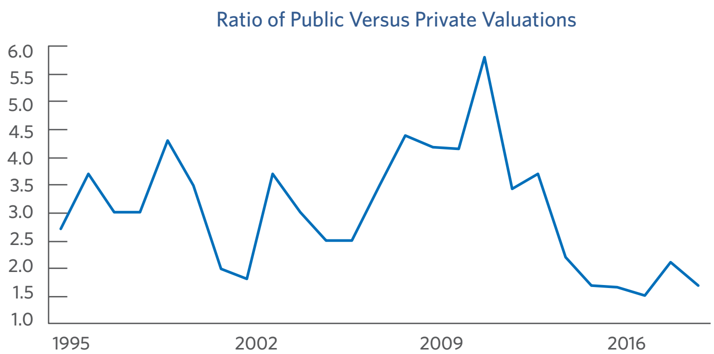
These flows are changing the structure of venture capital in several important ways. First, venture capital funds have been getting much larger. This is significant because venture funds have traditionally been small given the limited opportunity set and the need for a highly selective process to increase the odds of identifying promising start-ups. Second, venture-backed companies are going public later as they can easily benefit from multiple rounds of pre-IPO financing. This dynamic has inflated valuations and increased the share of assets in late-stage venture start-ups. Third, firms at IPO are older and larger. The number of U.S. venture backed private companies with valuations of $1 billion or more (147) has never been higher. Globally, such firms have a record valuation of $582 billion. With investors prioritizing revenue growth over profitability, the losses of these firms are commensurately large. The proportion of money-losing firms going public (81%) is at the same level as during the tech bubble of 1999-2000.

The dynamic of venture capital funding has an inexorable logic. Flows into venture capital funds must be monetized. However, pre-IPO valuations have been so bid up by multiple rounds of financing, that the gain from going public has been eroded (Exhibit 2). The need to monetize investments in late-stage venture capital, rather than private-to-public arbitrage gains, appears to be the motivation for going public.

EXHIBIT 2:

Realized Gain from Going Public Falls

Source: Sand Hill Econometrics. Data through April 2019.



Potential Spillovers – the Case of WeWork

While venture capital remains a small market segment, there are cases with potentially systemic implications. WeWork, for example, is soon to go public with a $47 billion valuation despite losses of $1.9 billion in 2018. It is the largest tenant of offices in New York and other major cities. Considered by some to be a tech company and thus meriting the inflated valuations common to the sector, WeWork's business model resembles a traditional leasing company. Its highly leveraged financial structure depends on short-term tenant leases to fund long-term leases for office space. While its financing structure is akin to a bank, WeWork has no capital buffer, no stable source of financing, no profits, and no lender of last resort. In a downturn, WeWork would face losing short-term funding as occupancy and rents decline rendering it unable to meet its liabilities.

Sign of the Times

Venture capital is inherently a high-risk undertaking that requires a highly selective approach and merits a portfolio allocation that appropriately calibrates the risk. The dynamics unleashed by record flows into the sector are yet another manifestation of the need for caution in a liquidity-fueled, late-stage business cycle.

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