Investment Insights
Buy That Hot IPO Stock? Not Us, Thanks

Morningstar Investment Management LLC
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Introduction

The market for initial public offerings, or IPOs, seems to be heating up. Lyft, Uber, and other tech "unicorns" that have reached billion-dollar valuations[1] before going public are fueling the fire.

If the IPO market is hot, you might expect that we, as contrarian-minded, valuation-driven, and fundamentally-rooted investors are cool to IPOs. That's right, we'll be passing on most, if not all, of this current raft of "unicorn" IPO stocks,[2] especially in our more conservative, value-oriented Select Equity Portfolios. Here's why.

Key Takeaways

- Most IPOs these days are from companies that have never turned a profit.
- We don't know how to confidently value these companies and believe they're too risky.
- As long-term, focused equity investors, we prefer to buy shares of consistently profitable businesses and try to avoid loss-making companies. We consider this an advantage over passive stock funds that must own the market, no matter how risky some stocks are.

1 CBInsights.com noted as of April 26, 2019, there were 343 unicorns in the IPO pipeline with a total valuation of $1.15 trillion. For a complete list, see https://www.cbinsights.com/research-unicorn-companies

2 Note that we are not saying we would never buy tech stocks, nor that we would never buy any firm with an IPO in 2019. We would consider buying most stocks, but only after careful consideration of their fundamentals and valuation. We might consider buying a recent IPO stock if we felt its business model was well established and the stock was trading at a discount to our more confident estimate of intrinsic value.

The Tale of National Student Marketing

National Student Marketing went public on April 24, 1968 and soon became a market darling despite its limited earnings. *The Wall Street Journal* described the initial public offering 51 years later thus:

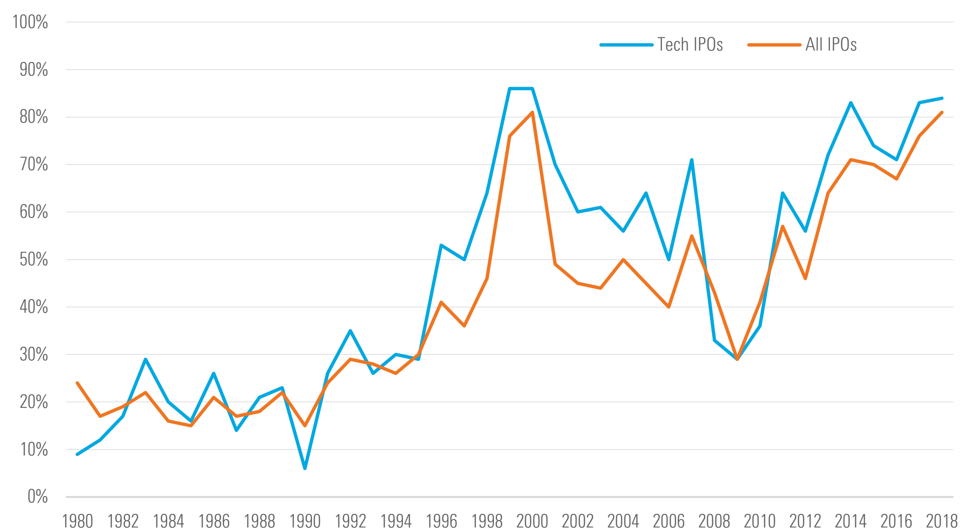
> *The company, which signed up undergrads to flog vinyl LPs, employment guides, posters and other schlock on college campuses nationwide, was a huge hit. … the stock surged 133% to close the first day at $14, or roughly 100 times earnings.*[3]

The company's founder, Cort Randell, got rich quickly. *The New York Times* reported[4] that, "(b)ased on Mr. Randell's projections, the company was touted as the hot stock of the year, and many prominent institutional investors—including Bankers Trust, Morgan Guaranty and the Harvard and Cornell endowment funds—snapped up shares." The stock eventually peaked at $134 before crashing when investors learned that most of the company's earnings were the result of "creative accounting," according to the *Times*. Randell pled guilty to four counts of stock fraud and served eight months in a Federal prison.

Cort Randell Was Born Too Early

Today, ambitious entrepreneurs don't have to cook the books, as plenty of companies are going public, despite bleeding red ink. Of the 134 IPOs in 2018, 81% reported negative per-share earnings for the previous 12 months, according to data from Jay Ritter, a finance professor at the University of Florida.[5] That's up from 24% in 1980 (see Exhibit 1).

Exhibit 1 Percent of IPOs With Negative Earnings



Source: Ritter, J.R. "Initial Public Offerings: Updated Statistics." Data are trailing 12 month earnings at time of IPO, 1980-2018. https://site.warrington.ufl.edu/ritter/files/2019/01/IPOs2018Statistics_Dec.pdf

3 https://markets.createsend1.com/t/ViewEmail/d/4DF2CE819EBB27302540EF23F30FEDED/3B269E72C9DF93C805AF428974F65BCD

4 https://www.nytimes.com/1986/12/07/business/archives-of-business-a-rogues-gallery-cortes-randell-student-market-hoax.html

5 Prof. Ritter is the Joseph B. Cordell Eminent Scholar at the University of Florida's Warrington College of Business. He holds a Ph.D. from the University of Chicago.

Despite having never turned a profit but rather incurring heavy losses, some of these firms have been richly valued. Take the example of ride-sharing firm Uber Technologies, whose pending IPO will reportedly value the firm at between $80 billion and $90 billion.[6] That valuation was dented by the declining post-IPO share price of competitor Lyft. Neither of these companies has reported a profit.

IPOs Present 2 Dangers to Investors

We see at least two dangers here. The first is finding the right price for a stock. It's hard enough to estimate a stock's fair value—that is, to estimate the net present value of its discounted future cash flows. But when the company's cash flows are negative, this becomes akin to reading tea leaves. Returning to Lyft, whose shares debuted in late March at $72, the *Journal* writes:[7]

> *That price was well above Lyft's last private funding round and higher than the initial range targeted by the company and its underwriters. But after spiking on its first day of trading, the stock has been buffeted by waves of selling. On [April 10], Lyft shares fell 11% to $60.12, hurt in part by news of Uber's valuation expectations.*

Surely Lyft's business prospects haven't bounced around as much as its expected and then actual share price has. We suggest that the market can't settle on a share price because any price is speculation, not the result of fundamental investment research.

To illustrate this, we turn—as we often do—to Warren Buffett, who, at the 1998 Berkshire Hathaway annual shareholder meeting was asked about teaching a course on investing. Part of his reply was that his final exam would ask students to value an Internet company—notorious for being unprofitable at the time of IPO. And then he memorably added, "And anybody that gave me an answer I would flunk."[8]

Our second concern is that companies that aren't profitable at the time of their IPO might never make a profit. Like, ever. Some companies even warn about this in their filings. Taking on faith the future growth and profitability of a company looks extremely risky to us as intrinsic value-oriented investors. And this is borne out by Prof. Ritter's data, which shows that even companies that are profitable at the time of the IPO go on to underperform the market by 12 percentage points on average in the next three years. Unprofitable companies lag by nearly 27 percentage points on average![9]

So, yes, even companies that are profitable when going public can be risky. A separate study of IPOs confirms it. Jeremy Siegel, the Russell E. Palmer professor of finance at the Wharton School at the University of Pennsylvania, studied about 9,000 IPOs starting in 1968. He assumed the stocks were bought at either the offer price or on the first day of trading or at the end of its first month of trading,

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6 https://www.marketwatch.com/story/ubers-ipo-is-even-more-dangerous-for-investors-than-lyfts-has-been-2019-04-29

7 https://www.wsj.com/articles/uber-aims-for-public-valuation-of-as-much-as-100-billion-below-expectations-11554915215?mod=article_inline

8 https://buffett.cnbc.com/video/1998/05/04/morning-session---1998-berkshire-hathaway-annual-meeting.html

9 This is yet-to-be-published data provided by Prof. Ritter. Market returns are represented by the Value-Weighted CRSP Market Index; for more information see http://www.crsp.com/products/documentation/stock-file-indexes. Interestingly, Ritter finds that total trailing 12-month sales at time of IPO are an even better predictor of future returns than profitability. Unprofitable companies with low sales deliver negative returns—an annual loss of 5.2%—over the three years following an IPO.

then held through 2003. An article on the Financial Planning Association's website describes the study's results:

> *The findings may shock you, as IPOs were found to underperform the market by an average of 2 to 3 [percentage points] per year, with four out of five IPOs underperforming a small-cap stock index. Of the four out of five that underperformed, half of them underperformed by more than 10 [percentage points] per year, more than a third underperformed by more than 20 [percentage points] per year, and approximately one in six underperformed by more than 30 [percentage points] per year! While those odds may not be as bad as playing the lottery, they are certainly much worse than most other investments.*

We Try to Avoid IPOs

Of course, we find it comforting that Warren Buffett takes a similar stance as us. On the eve of Lyft's IPO, he told CNBC: "I think buying new offerings during hot periods in the market ... I don't think it's anything the average person should think about at all. … You can go around making dumb bets and win. ... It's not something you want to take as a lifetime policy, though."

We certainly don't have that policy. As an active investor, we are not obliged to invest in all firms. We generally prefer to try to avoid lossmaking businesses, in favor of undervalued, fundamentally strong firms that have been consistently profitable. By hopefully side-stepping mines and focusing on our highest conviction ideas, we aim to deliver better risk-adjusted returns over the long term. We contrast our approach with that of an index fund that is obliged to invest in all comers of a certain size. We think our prudent approach to avoiding money-losing "unicorns" should pay off once the market sobers up and focuses more on the fundamentals and less on the hype.

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