Weekly Market Flash

The Unicorns Are Not Alright

October 4, 2019

You can't fool all of the people all of the time, so the saying goes. But the other side of that old chestnut – that you can fool some of the people all of the time – certainly rings equally true. These would be the people who time and time again line up to pay through the nose for the latest magical investment offering promising free lunches forever, always seeming to forget how it ended the last time. The same mindset that had folks going gaga over Pets.com twenty years ago was back in full force these past several months in the form of WeWork and its mystical guru of a CEO Adam Neumann.

This overhyped real estate company with an elusive effervescence of kombucha-scented technology floating through its ubiquitous short-term office leases was slated for an initial public offering this month. Target valuations ranged from the initial $47 billion set in a round of private financing from lead investor Softbank back in January, to as high as $90 billion according to Goldman Sachs, one of the investment banking underwriters. Fortunately for public market investors everywhere, this lemon of a deal never made it to market. That $90 billion valuation had cratered to $15 billion by the time the company started its IPO premarketing last month. Not being able to find demand even at that level, the IPO was pulled and the future of WeWork as any kind of a viable enterprise at all is up in the air.

Livin' On a Prayer, With Negative Cash Flow

WeWork was one of the more prominent names of the so-called unicorns – private companies able to command a valuation of $1 billion or more through successive rounds of venture capital deals. The granddaddy of the unicorn breed was Uber, followed by Lyft and then a Cambrian explosion of names offering up anything from cloud-based service-as-software to a broad spectrum of consumer services ("we are the Uber of dry cleaning/door delivery/airport check-in" as the now-ironic joke goes). It was assumed that many of these unicorns would follow Uber's migration path from venture financing into the publicly traded securities markets through an IPO. It was 1999, all over again.

But there is one big difference between that first round of late-1990s Internet darlings and today's unicorns. All the hype, the froth, the giddy and unrealistic valuations – these all took place in the private (pre-IPO) markets. For a number of the companies which successfully made it through the IPO gates, the experience on the stock exchange has been something of a bracing cold bath. Uber and Lyft are now trading around a third below their original IPO valuation levels. Peloton, a more recent unicorn in WeWork's graduating class, did successfully complete an IPO but is also trading now at a steep discount. The ones with egg on their faces this time around are not credulous mutual fund managers, pension funds and retail investors, but the likes of Masayoshi Son, the Softbank founder/visionary whose $100 billion Vision Fund has at least $20 billion tied up in Uber and WeWork.

Spillover Threats

The relative absence of a unicorn bubble in the public equity markets is very much a good thing. But there are two factors at play which make the situation worth keeping a close eye on. First of all, the technology and communications services sectors in total comprise over a quarter of the total market valuation of the S&P 500. As we often say – when the tech sector sneezes, the market catches cold. If even the relatively small number of public market unicorn alums continue to trade down – on average shares for the cohort overall have fallen by double digits this year – the effect could spill over into more established segments of the tech sector. Back in 2000 it was the flakiest companies that fell first, but by the end of that year investors were indiscriminately throwing all manner of tech names (including blue chips like Microsoft and Oracle) out of their portfolios. Eventually the troubles in tech proceeded to a full-blown market meltdown, with the S&P 500 falling more than 47 percent from peak to trough. That's not to say that conditions are ripe for a replay of 2000-02: as we noted above, there has been much less froth in the post-IPO trajectories of the current crop of unicorns, and the overall market has not been dragged up into the nosebleed valuation levels of that previous era. But weakness in tech can be one of the meaningful headwinds the market faces heading into 2020.

Unfortunate Timing

The other variable that is somewhat reminiscent of the turn-of-the-century market is that we are in a late stage of the economic growth cycle, and likely closer to the end of the cycle than the midpoint. Part of what made the tech bubble fallout spill over into the broader market was that it coincided with the waning months of the growth cycle that began with the end of the 1990 recession. What you saw in the stock market this past week was a meaningfully negative reaction to two data releases suggesting declining fortunes in both the manufacturing and services sectors. The damage was relatively brief and prices have since recovered much of what it lost in the first two trading days of the quarter (and the jobs numbers today suggest that the labor market is still reasonably perky).

But when prevailing market sentiment is negative it often takes just a confluence of a few factors at play to spark a significant pullback. We have had two pullback events of more than 5 percent so far this year and were on the verge of a third one before the market recovered on Thursday. While short-term volatility could still work in either direction, the structural environment over the medium term into next year makes a case for increasing the safety areas of the portfolio allocation pie.

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