Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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2019 Tech IPOs: Where Are the Earnings?

In last week's Mitch on the Markets column, I made the case that market pullbacks could boost the case for technology stocks. I elaborated by pointing specifically to strong price-to-cash flow metrics for some of the best names in the tech sector (relative to the S&P 500), while underscoring robust return on equity (ROE). Though I do not advocate market timing, I made the point that during market pullbacks and corrections, we may be able to take advantage of better entry points for long-term ownership of some of the best earnings generators in the world.

I was referencing, of course, technology companies that actually generate positive earnings.

Year-to-date, we have seen an influx of exciting new technology IPOs. Many of these companies have flashy brand recognition with exceptionally fast growth rates and multi-billion dollar valuations. But many of them have also never turned a profit.

As you know, our earnings-centric focus here at Zacks Investment Management dictates that most – if not all – of these high-flying growth IPOs will not make their way into our strategies upon being listed. We need to see sustained earnings growth and rising earnings projections over time, and we want to own companies that beat earnings expectations consistently – *not companies that have no earnings at all.*

Back in the late 1990's, many investors fell into the trap of buying newly listed technology companies for reasons other than earnings. There was widespread "fear of missing out" as money poured into dot coms with excessive valuations and negative cash flow (bad move then, bad move now).

I'd argue that we're seeing a similar environment today, where many IPOs are listing at valuations that are sometimes double or triple what's justified. Interestingly enough, however, the market's reaction appears to be much different this time around. Many of the most recent high-profile IPOs have fizzled out of the gates, with investors wary of overpriced, overvalued companies with untested leadership and no clear path to profits. I actually see this as a good sign for markets – there seems to be a healthy dose of skepticism versus over-the-top optimism.

I'll give you five examples of what I mean:

• **Uber (UBER):** Shares have fallen nearly -30% since their debut, as the company said it lost over $5 billion in Q2 and reported its slowest revenue growth in the company's short history.[1]

• **Lyft (LYFT):** Uber's main rival is also yet to post a profit, and investors may see Uber as too difficult to surmount in the long term. Shares are off nearly -50% since listing.[1]

• **Peloton (PTON):** The fitness/bike start-up has reported deep losses for its in-house stationary bike technology, shedding -11% on its first day of trading and off about -2% since.[1]

• **Slack (WORK):** The company with a mission of eliminating email from corporations for more streamlined and organized communications is off nearly -40% since its IPO.[1]

• **WeWork (not listed):** The shared office space company experienced somewhat of an epic downfall in its approach to listing. It went from enjoying a private market valuation of $47 billion, to watching its valuation plummet to $15 billion and its CEO get ousted right around the proposed time of listing. Investors got a look at the financials and haphazard management, and punished the company for -$1.37 billion in losses in the first half of 2019. WeWork pulled its planned IPO as a result.[1]

Compare these names to a company like Google, for instance. Google went public in 2004 with a remarkably high $23 billion valuation, but the company had also reported a $400 million profit for the year. Amazon went another way, selling shares only three years after its founding in 1994, but with a paltry valuation of just $400 million. Amazon raised just $62 million in its IPO but is worth almost $1 trillion today.

The point here is not that any or all of these unprofitable IPOs are destined to fail. It may be that they all turn a profit within a year or two and start growing earnings at a nice clip. The point is that as long as they are losing hundreds of millions or even billions of dollars, in my view, the risk, price, and valuation are probably all way too high.

Bottom Line for Investors

When I made the case for technology stocks benefiting from market pullbacks, I was referring to the crop of tech companies with established businesses, positive and increasing earnings, and robust leadership. In the IPO world, you may find companies with some but not all of those qualities, that instead bear the promise of exponentially fast growth rates and high risk/reward profiles. Not my cup of tea.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The New York Times, September 26, 2019. https://www.nytimes.com/2019/09/26/business/tech-ipo-market.html

IN FOCUS THIS WEEK

- Weakness in U.S. Manufacturing Spurs Recession Chatter
- U.S. stocks finish Q3 in positive territory
- America's Shale Boom is Showing Signs of Topping Out

Weakness in U.S. Manufacturing Spurs Recession Chatter

On Tuesday, the Institute for Supply Management (ISM) released U.S. manufacturing numbers that pointed to continued weakness in the sector. The U.S. manufacturing PMI came in at 47.8 in September, marking the second consecutive month of contraction and the weakest reading for the index since 2009 (readings below 50 indicate contraction). The manufacturing recession is a global issue, with many pointing to the trade war as the likely culprit. Global manufacturing activity as measured by IHS Markit contracted in September, which marked the 5th sub-50 reading in 5 months. A trend of slowing global economic growth has arguably contributed to the weakness in manufacturing, but it also underscores how interconnected the manufacturing sector is in terms of value/supply chains and trade. Very few complex products are assembled completely in a single country. Other macroeconomic data pointing to weakness – which contributed to market volatility early in the weak – was U.S. factory activity contracting for the second straight month (and hitting a 10-year low), and new export orders hitting their lowest levels since March 2009.[1]

Yes, But What About Services?

Much of the concern this week centered around manufacturing weakness, but readers should note that manufacturing accounts for approximately 10% of the U.S. economy, whereas services account for approximately 70% of the total economy. So even as manufacturing slows and even contracts, the key data to note is what's happening in the services sector, in our view. Looking to the ISM Non-Manufacturing (Services) survey, which was released on Thursday, we see that the services sector continued its expansion but at a slower pace than expected. The ISM Non-Manufacturing reading came in at 52.6, which signals growth, but was lower than the expected 55.3 reading. Even still, growth is growth.[2]

U.S. Stocks Finish the Quarter (Q3) in Positive Territory

despite all the noise lately, U.S. stocks as measured by the S&P 500 posted modest gains (+1.7%) for the quarter ending September 30. As of the end of Q3, U.S. stocks had posted their biggest year-to-date gains (+19%) in over 20 years. In our view, stocks have spent the better part of the year climbing the proverbial "wall of worry," with fears about the trade war, inverted yield curve, and now manufacturing weakness driving the narrative that the U.S. economy is fast-tracking to recession. Stocks, at least to date, have been telling a somewhat different story. Low interest rates across the world and modest, but still positive, growth have helped keep money flowing into equities.[3]

America's Shale Boom is Showing Signs of Topping Out

in the first half of 2018, U.S. oil production grew at a 7% rate. In the first six months of 2019, that growth number is down to less than 1%, according to the Energy Department. Some of the slowing production is attributed to "core operational issues," such as wells that were drilled too close to each other and producing less than expected. But another reason cited for the slowdown was a plateau in the fracking technology that had in previous years driven sizable year-over-year growth in production. The U.S. production boom has helped alleviate global supply in times of shock (attack on Saudi Arabian facilities) or other supply disruptions, such as sanctions on Iran. If production falls going forward, there could be more vulnerabilities to total global supply, the glut of which has led to stable and relatively low prices.[4]

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[1] The Wall Street Journal, October 3, 2019. https://www.wsj.com/articles/here-is-how-interconnected-manufacturing-is-across-the-globe-11570096801?mod=djem10point

[2] CNBC, October 3, 2019. https://www.cnbc.com/2019/10/03/september-ism-non-manufacturing-index-at-52point6-vs-55point3-est.html

[3] The Wall Street Journal, September 30, 2019. https://www.wsj.com/articles/global-markets-end-tumultuous-quarter-on-quiet-note-11569833596?mod=djem10point\

[4] The Wall Street Journal, September 29, 2019. https://www.wsj.com/articles/shale-boom-is-slowing-just-when-the-world-needs-oil-most-11569795047?mod=djem10point

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