GRANT'S
INTEREST RATE OBSERVER®
Vol. 37, No.05d 233 Broadway, New York, New York 10279 • www.grantspub.com MARCH 8, 2019

Eyes unblinkered

In 2018, Lyft, Inc. boosted its revenue by 103% while showing a net loss of $911.3 million. These are impeccable bull-market credentials, and the Lyft IPO is expected shortly.

Now in progress is a speculation on a turn in the Wall Street zeitgeist. Credulity is a short sale, we say, skepticism the coming thing. If the pulse on which *Grant's* has its finger is indeed the pulse of investor sentiment, Lyft will get a flat tire, Uber Technologies, Inc. will run out of gas, WeWork Companies, Inc. will take some unscheduled time away from the office—and Facebook, Inc. will feel the unicorns' pain.

Our thesis will develop in zig-zag fashion, starting with the fact that 157 CEOs of American companies resigned in January, the highest monthly tally of departures since Challenger, Gray & Christmas, Inc. began tracking such exits in 2002.

Another sighting: 25 private-equity general partnerships sold stakes to outside investors last year, according to PitchBook Data, Inc., almost twice as many as the previous record-high sale of 14 in 2016.

You wonder if the CEOs are discouraged, or if private equity isn't all it's cracked up to be. The author of these words is a kind of CEO, and he's not discouraged—far from it. He could tell you stories about his zest for the job but will instead pivot to the not-so-wondrous private-equity business. It will lead to Facebook by way of the temporarily booming venture-capital business.

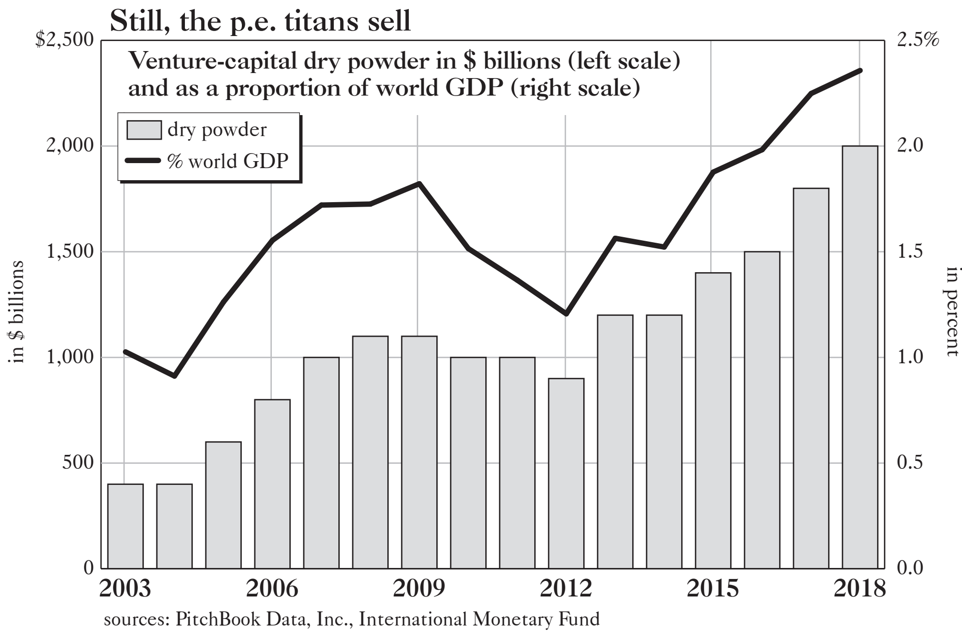
Something must be wrong when the p.e. titans want to lay off risk rather than cash the checks that the $2 trillion of so-called dry powder at their disposal may finally avail them. Perhaps they see no clear path to monetizing the investments they've made. The time-tested way to sell a company was to take it public, but the venture capitalists have been taking a rising share of today's not-especially-vibrant IPO market.

"PE-backed IPOs have accounted for a waning portion of overall U.S. IPOs in recent years, declining in seven out of the past 10 years," PitchBook notes in its 2018 annual U.S. PE Breakdown report. "This trend is likely to continue through 2019 as a herd of VC-backed unicorns . . . gets ready to go public throughout the year."

Crowded out of public markets, private-equity promoters have resorted to taking in each other's laundry. Last year, the source of 52% of 1,049 p.e. sales was a reciprocal p.e. purchase. It was the first time in the history of the industry that so-called secondary buyouts accounted for a majority of p.e. exits.

"The promise of private equity is that rational managers outside of the public limelight can make the tough changes needed to optimize operations," observes colleague Evan Lorenz. "It's less clear how much more a second p.e. manager can improve a previously optimized investment."

Or maybe the true source of the p.e. malaise is the bad habit of overpaying. The descendants of the LBO innovators Ray Chambers and Bill Si-



mon last year paid an average multiple of earnings before interest, taxes, debt and amortization of 10.9 times, according to Bain & Co., only a hair less than the all-time high of 11 times recorded in 2017; 10 years earlier, at the end of the cycle that culminated in you-know-what, buyout multiples peaked at 9.9 times. Based on Bain's analysis, the 10-year pooled returns of all p.e. operators only just topped the returns on the S&P 500 through 2018; and those trailing results are flattered by the cheap buyouts that followed the recession.

To compound the error of overpaying, the p.e. promoters also overborrow. But it's hard to know by how much because the ratio of debt to EBITDA depends on one's definition of EBITDA, and that unholy metric is further corrupted by expected synergies, projected earnings and anticipated cost reductions that may never materialize. Few object when faith is blind.

. . .

Blind faith (the ultra-low cost of capital did the blinkering) likewise sustains the venture-capital promoters. VC-funded startups, under no pressure to show earnings, concentrate on growth instead. And to grow, they advertise.

"Startups spend almost 40 cents of every VC dollar on Google, Facebook, and Amazon," Chamath Palihapitiya, the CEO and founder of VC fund Social Capital, L.P. and a former Facebook, Inc. vice president, writes in his 2018 annual letter. "We don't necessarily know which channels they will choose or the particularities of how they will spend money on user acquisition, but we do know more or less what's going to happen. Advertising spend in tech has become an arms race: Fresh tactics go stale in months, and customer-acquisition costs keep rising."

Other venture capitalists echo this sentiment. "We have tended to shy away from consumer startups because we think the cost of customer acquisition is significant," Simon Yoo, founder and managing general partner of Green Visor Capital Management Company, LLC, one Silicon Valley's top early-stage investors focused on FinTech. "Our experience has shown that founders are often wildly optimistic as to what their customer-acquisition costs will be when they launch their startups. For example, whenever we hear someone say that they intend to use digital advertising to acquire consumers, we instead hear: 'Our go-to-market strategy is to transfer wealth from your L.P.s to Facebook and Google.' Even when you look at some of the iconic consumer-facing startups today, the underlying unit economics (i.e., customer acquisition costs vs. lifetime value of customers) simply don't stack up and at some point the bill will come due."

Public markets eventually discipline loss-making enterprises. Thus, losing money was a viable strategy for Blue Apron Holdings, Inc. before it came public at $10 a share in June 2017—the meal-kit vendor showed a $31.6 million quarterly loss in the very quarter it debuted on the Big Board (the ticker is APRN). Management had succeeded in reducing the net loss to $23.7 million by the end of 2018, largely through cutting quarterly advertising expense to $20.3 million from $34.5 million. But lower advertising outlays translated into fewer customers—a decline, in fact, to 557,000 from 943,000 in only 18 months. Blue Apron today is a one-dollar stock.

. . .

Grant's laid out the bear case on Facebook a year-and-a-half ago (see the issue dated Aug. 11, 2017). Advertising is a cyclical industry and it tracks growth in GDP, is one of the pillars of the argument. The International Monetary Fund estimates that nominal GDP worldwide grew by 6% in 2018 in U.S. dollar terms. Yet last year Facebook expanded its top line by 37%, to $55.8 billion. Of the company's total sales, advertising accounted for 98.5%.

At a certain size, Facebook's growth will begin to match that of the advertising industry as a whole, we reasoned. At which point, Facebook, which nowadays changes hands at 22.6 times trailing earnings, will probably trade closer to the average multiple of the ad agencies that Mark Zuckerberg doesn't own a large (though fast-diminishing) piece of, including Publicis Groupe S.A., Omnicom Group, Inc. and The Interpublic Group of Companies, Inc. We hypothesized that crossover might occur in 2020. Assigning a 13.6 multiple to the $10.29 a share in forecast 2020 Facebook earnings implies a share price of $139.45 vs. the currently quoted $171.26.

Facebook itself acknowledges that that 37% spurt in the 2018 top line is not soon to be repeated. "In Q1, we expect our total revenue growth rate to decelerate by a mid-single-digit percentage on a constant currency basis compared to the Q4 rate," CFO David Wehner said on the Jan. 30 earnings call. "We also expect that our revenue growth rates will continue to decelerate sequentially throughout 2019 on a constant currency basis."

Maybe, too, the prices that Facebook charges have also hit a ceiling—in the fourth quarter, the average price per ad fell by 2%. "The year-over-year decline in the average price per ad reflects an ongoing mix shift towards product services and geographies that monetize at lower rates," Wehner said, not very clearly. And there's less clarity to come, as he alerted listeners on the call that Facebook will soon stop disclosing separately the number of users on its individual platforms, a useful piece of information for valuing the stock. It's rarely bullish when a company wants to tell you less.

Of the 52 analysts who cover Facebook, 40 say buy and only two say sell. It's all the more notable, then, that earnings estimates have been coming down, not going up. Thus, in August 2017, the Street forecast $11.68 per share in 2020 earnings; the consensus today is $10.29 per share. The rapid growth in anti-trolling costs explains part of it. On the January earnings call, Zuckerberg noted that Facebook ended the year with more than 30,000 people on the payroll in safety and security, up from 10,000 a couple of years ago. This and other platform-enhancing investments are largely chargeable for the reduction in Facebook's free cash flow, to $15.4 billion in 2018 from $17.5 billion in 2017.

Venture-capital-funded startups, determined to grow to reach the next valuation range, do not scruple to pay top dollar for digital advertising. American businesses, they naturally seek to conquer the home market before trying their luck abroad.

"It's this preoccupation," Lorenz proposes, "that may help explain one Facebook anomaly. In the United States and Canada, the company generated $34.86 in revenue per user in the fourth quarter vs. $7.37 worldwide. In Europe, which has a similar GDP per capita to the United States, Facebook earned only $10.98 per user in the December quarter. If the VC-led bubble pops or if former VC darlings shift their focus on profits rather than revenue growth at any cost, the average revenue per user in North America may begin to converge with its global average."

Facebook insiders, persistent, heavy and informed sellers of their own stock, may have some sympathy with the analysis.

•

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.