STREETWISE

WeWork Debacle Teaches Investors a Lesson About Value

The shock of WeWork's failed IPO has helped awaken investors from the dream that easy finance will last forever.

By James Mackintosh

Perhaps all you need to do to play the stock market is pay close attention to WeWork.

The debacle at the consciousness-elevating office-rental company appears to mark a turn by investors away from rewarding revenue to a focus on profits.Put another way, the shock of WeWork's failed initial public offering has helped awaken investors from the dream that easy finance will last forever.

The new approach showed up immediately in the market's reaction to third-quarter results.Pre-We, in the days when investors cared only about growth, it was the sales line that mattered, not the bottom line.

But a stream of highly valued growth companies reported better revenue than forecast only to find investors dumped the stocks due to disappointing earnings.Tesla did the opposite, with worse-than-expected revenue but an unexpected profit, and shares soared.

Google-owner Alphabet was the latest to follow the pattern on Monday, reporting earnings below analyst predictions and revenue better than expected, and the immediate response was a fall in its shares in after-hours trading.The fall was only 1.6%, but compare that with the results a year earlier, when investors were still chasing growth: Alphabet beat earnings expectations yet shares dropped because it missed on revenue.

The hard-nosed new approach is part of a broader shift across markets that suggests value is back. Say it again: Cheap stocks that have been struggling for more than a decade are back in vogue.

Before getting too excited, note that this hasn't been going on long and might well not last. There have been plenty of false alarms for value investors who have had a miserable time watching the long bull market in growth stocks.

The current pattern is repeated across many other markets. Since U.S. value stocks began to beat growth in late August, global stocks have beaten U.S. stocks—probably because the U.S. has far more big successful growth companies, and the rest of the world more beaten-up value.

Value has also been doing better as Treasury yields pick up from very low levels. The 10-year yield has jumped from below 1.5% in early September to 1.84% on Tuesday, as hopes of a U.S.-China trade truce rise.

There are several ways to think about the move. Higher bond yields are due to expectations of a better—or at least less-bad—economy, which should help economically sensitive stocks such as manufacturers, oil companies and banks, which had fallen out of favor and so dominate value.

Equally, higher bond yields mean a higher discount rate, making future earnings worth less compared with earnings today. By definition, growth stocks have more of their earnings potential further in the future, so higher yields should make them less appealing than they were when yields were lower (Note the should: It is hard to spot the connection in reality as so many other things are going on).

Finally, investors might reasonably worry about whether and at what price the market will keep supplying cash to subsidize money-losing companies as they chase growth.This year's IPOs were notable for being loss-making, with only 25% expected to have positive net income in their first year, according to David Kostin, chief U.S. equity strategist at Goldman Sachs, the lowest since the dot-com bubble burst in 2000.Only 8% of technology, media and telecom companies coming to market last year were profitable in their first year, the lowest in data back to 1995.

WeWork was an extreme example of a company forced to dump its ambitions and focus on survival because investors would no longer finance a land grab of growth at any cost.But there are plenty of companies whose business models involved a lot more losses still to come as they chased growth.These include this year's three most-valuable IPOs: Uber, Lyft and Pinterest.All forecast to lose money for at least three years as they chase predicted sales growth of around 30% a year.Lyft said last week it expected to make money in the final quarter of 2021 on an underlying basis, prompting a jump in its stock.

The more sensitive investors are to the financing needs of these types of companies, the more they will care about the short term—mainly cash flow, but also quarterly earnings—rather than growing sales in the long run.With bond yields rising a bit and investors showing less desire to back new lossmaking IPOs, it will be harder to finance losses.It becomes self-fulfilling that if other investors are unwilling to make cash easily available, it is right to worry about short-run cash flow, and so also earnings, and to prefer companies that can finance their own growth.

I think all these factors are at work.Billions of dollars of losses on WeWork have pushed Softbank's Vision Fund to tell companies to focus on cash flow.

SoftBank was willing to stake tens of billions on what seemed to be mad bets on growth without any hope of profit, and after WeWork it is hard to believe anyone will soon step up to replace them.

If the economy recovers, there is plenty of scope for value stocks to rebound a lot further, as economically exposed sectors had been all but abandoned by many investors.If the trade war resumes and the economy worsens, value will surely be hit again.But perhaps with WeWork fresh in their minds, investors won't be so willing to pile into growth stocks instead.

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