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INDIVIDUAL INVESTOR ACCESS TO THE NEW ECONOMY COMES AT A (HEFTY) PRICE

Public-market investor demand for New Economy tech stocks is increasing the disparity between public and private market valuations.

One of the effects of the pandemic is that it has driven an already wide gap between the value of late-stage, pre-IPO (initial public offering) tech companies and their post-IPO valuations to a level that's becoming hard to fathom. Put another way, the magnitude of the gap over the past six months suggests that either private investors are valuing these pre-IPO unicorn companies far too low, or that public investors, in their exuberance for New Economy stocks, are piling into these newly public tech companies with such abandon that we may be facing another bubble. But one thing is certain: Private market investors are reaping the greatest rewards, while public investors are taking on more risk with less potential upside.

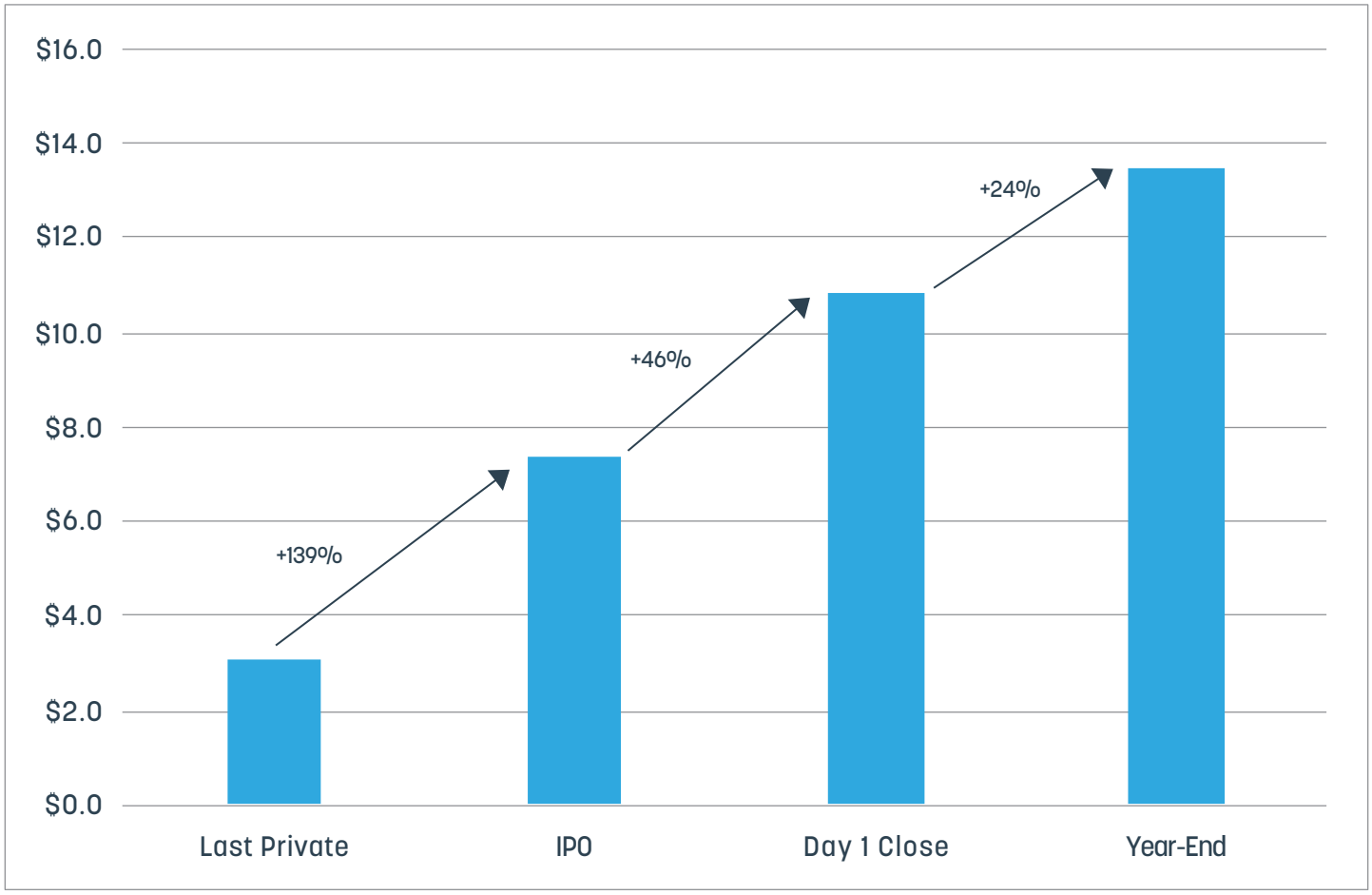
TODAY'S IPOS – MORE MATURE WITH HIGHER VALUATIONS

The average unicorn that went public last year – excluding the outliers in the top and bottom deciles – was valued at just over $3.1 billion in its last round of private financing.[1] This average unicorn came to the public markets in 2020 with an IPO market capitalization of approximately $7.5 billion (about 10 times Microsoft and 20 times Amazon's market caps at their IPOs). Moreover, public market investors quickly drove these stocks up another 50% in their first day of trading, which predominantly benefits existing private market shareholders and those participating in the IPO, while obliterating the more disciplined metrics and thought processes that determined the last private round value.

The CEO of Airbnb, Brian Chesky, was left momentarily speechless on live television after he was told his company's shares were set to begin trading at $139, up from the IPO price of $68. Airbnb finished its first day of trading with a valuation of $100 billion, roughly 3.5x its valuation just eight months earlier as a private company, generating a major windfall for its private investors and those fortunate enough to get in at the IPO. No wonder Chesky was speechless.

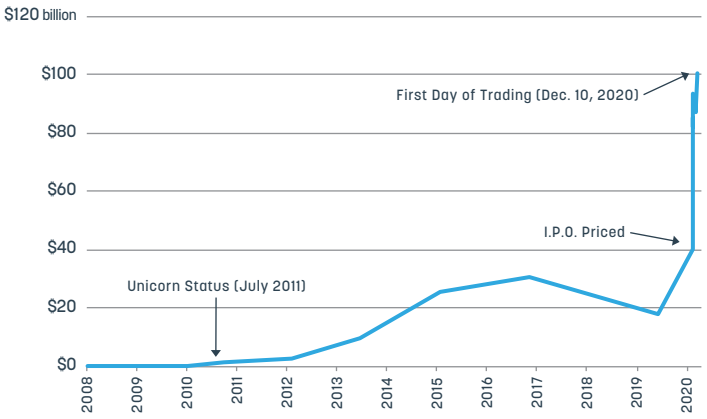
> "...in their exuberance for New Economy stocks, [public-market investors] are piling into these newly public tech companies with such abandon that we may be facing another bubble."

Public Markets Bid Up Tech IPOs



For illustrative purposes only. Source: iCapital calculations, based on underlying data gathered from Crunchbase, CNBC, Pitchbook and Yahoo Finance.[2]

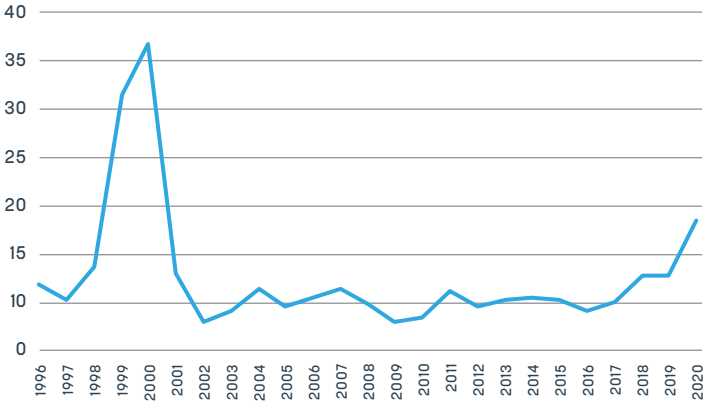
Airbnb's Valuation in Private and Public Funding Rounds



Source: PitchBook • By The New York Times

A look at the historical price-to-sales ratio of new IPOs also shows the spike in valuation that has occurred amid the pandemic. The median technology 2020 IPO came public with a price-to-sales ratio of 13.4x, a level not seen in two decades.[3]

Median Price/Sales of New IPO's

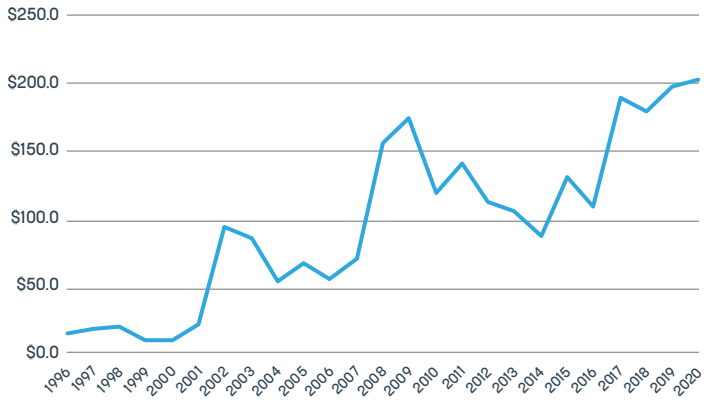


For illustrative purposes only. Source: Jay Ritter, Cordell Professor of Finance, University of Florida

> "In some cases, public investors are paying higher multiples for 12-year-old tech enterprises than what venture and growth equity firms are paying to access companies half that age – that are growing exponentially faster."

Most of these companies are well past their hyper-growth phase. In fact, the average age of a tech company at the time of IPO in 2020 reached a record high of 13 years (Airbnb was 12 years old). These unicorns have used their dozen or so years marinating in the private markets to build their businesses, with the median tech company generating revenue of over $200 million over the 12 months prior to its IPO. This maturity profile is the starkest contrast to the dot-com bubble when companies came public with annual revenues of just $12 million[4] and were much younger. Future tech giants like Amazon, eBay, Salesforce, and Google went public when they were between three- and six-years-old with enormous growth left ahead for public shareholders.

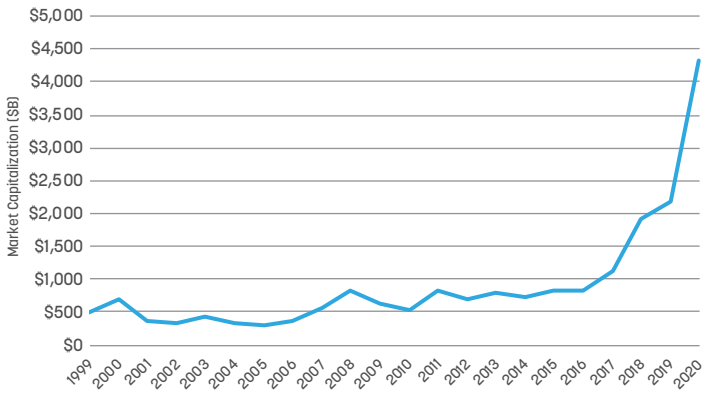
Technology IPOs: Median Sales



For illustrative purposes only. Source: Jay Ritter, Cordell Professor of Finance, University of Florida

The median initial market value[5] of 2020's technology IPOs reached $4.3 billion, continuing a trajectory that saw it reach $1 billion for the first time four years ago. By comparison, it took Microsoft and Amazon multiple years as public companies to reach a similar size.

Technology IPOs: Median Market Cap



For illustrative purposes only. Source: Jay Ritter, Cordell Professor of Finance, University of Florida

The new entrants to the public market in 2020 included three companies with an initial market valuation of more than $30 billion: Airbnb, Snowflake, and DoorDash. The scale of these companies further highlights how different the technology world is today, compared with the days of the dot-com bubble. Questions no longer center on whether there is a business opportunity or if these companies should exist. Instead, today's debate is on the appropriate valuation for such large businesses, some of which have not attained profitability.

In short, even though the tech IPO class of 2020, on average, comprises more mature and larger companies than in prior years, the public markets are rewarding them with valuation multiples that were once reserved for much younger businesses in their hyper-growth phase. A fascinating dynamic for sure, which has – as previously stated – created a massive gap between private and public valuations that is hard to reconcile. Think about it: In some cases, public investors are paying higher multiples for 12-year-old tech enterprises than what venture and growth equity firms are paying to access companies half that age – that are growing exponentially faster.

Additionally, it would be remiss to talk about 2020's new offerings without discussing SPACs. These "blank check companies" are designed to take companies public without going through the traditional IPO process. The SPAC raises capital through an IPO with the intent of buying or merging with another company within two years, or face liquidation (IPO proceeds are held in a trust account). SPACs can often look at companies earlier in their lifecycle that are approaching the beginning of their IPO window.

"...there is tremendous pent-up demand by individual investors to own well-known unicorns that many of them have had personal experiences with, but that have been elusive for so many years because they stayed private...As a result, many public investors seem willing to pay almost any price to include these New Economy companies in their portfolios, once they become available."

SPACs broke through in 2020 with almost 250 public markets listings, which exceeded the total throughout the 2010s.[6] With approximately 75 SPACs[7] successfully merging with target companies, the majority are still searching for acquisitions. A number of these SPACs are focused on technology-enabled businesses – as well as those in other innovative sectors, including electric vehicles and space exploration – and this secular trend is likely to further drive up multiples for newly public tech companies.

THE PANDEMIC FUELS A TECH BOOM… AND PERHAPS A BUBBLE

The rationale behind this resurgence of tech IPOs, at least in large part, is that the pandemic has pulled the use of technology forward by years and thus the shift from the Old to the New Economy is dramatically accelerating. And, of course, there is tremendous pent-up demand by individual investors to own well-known unicorns with whom many have had personal experiences, but that have been elusive for so many years because they stayed private longer and fueled their growth with private capital. As a result, many public investors seem willing to pay almost any price to include these New Economy companies in their portfolios once they become available.

However, even with a great jolt forward into the Digital Age, many of these newly public tech companies would have to demonstrate a rate of growth over the coming years that would be extraordinary for companies at their level of maturity to justify their current valuations.

Not surprisingly, some are saying that we're entering a golden age of venture-backed exits through IPOs, while others are expressing concern that we may be heading toward a dangerous bubble. Either way, with over 500 unicorns today, private fund managers will continue to take advantage of the valuation disparity and feed the IPO market as long as the demand remains strong. After all, these private investors stand to reap huge profits. Excluding special purpose acquisition companies, January's 11 IPOs are up 68.6% on a weighted average basis, with only one trading below its offer price, according to data compiled by Bloomberg.

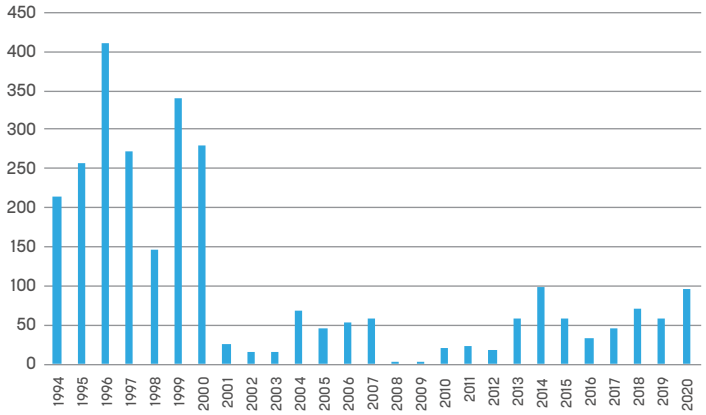
Unfortunately, what public investors are less likely to see during this IPO boom is a return to the period when they could capture an amazing tech company at its hyper-growth phase at a reasonable multiple. Over the past 20 years, private equity and venture capital firms have created a virtuous circle that

has made them the preferred choice of capital for the talented entrepreneurs behind these innovative companies. And, ironically, it was the dot-com crash in 2000 that set into motion a perfect storm that allowed the private markets to supplant the public markets as the primary source of capital for the most promising, young tech companies. Understanding this series of events is important to understanding the valuation gap today and why it's likely to continue.

GOVERNMENT REGULATION RAISED PRIVATE EQUITY'S PROFILE

After the dot-com crash, the number of small company IPOs plummeted from 270 in 2000 to just 20 in 2001. Then in 2002, passage of the Sarbanes Oxley Act made it even more difficult for smaller companies to access the public markets. Alongside this, small-cap research coverage began to fade following the Global Analyst Research Settlements in 2003, which created "orphan stocks" that, without analyst coverage, struggled to attract interest from investors. This happened just as the New Economy was beginning to take off and the adoption of the Internet by consumers started to accelerate around the world; the number of people accessing the Internet grew from around 900 million in 2004[8] to 4.6 billion in 2020.[9]

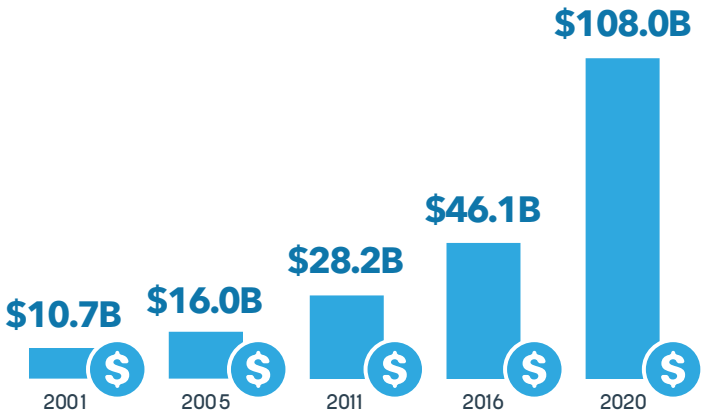
Number of small IPOs (less than $50MM in LTM sales, 2005 $)



Source: Jay Ritter, Cordell Professor of Finance, University of Florida

As a result, private capital stepped in to fill the financing void and assumed a dominant role in fueling the growth of the New Economy. Private capital managers had historically grasped the intrinsic value of digital assets, which was essential because tech businesses often have few hard assets to pledge as collateral, and seek valuations far in excess of their book value. Hence, the amount of private equity raised for late-stage startups increased from $11 billion in 2001 to $28 billion in 2011 to $108 billion in 2020, according to Pitchbook, a research and technology firm covering the private capital markets.

Later-Stage Venture Capital Fundraising has Risen Steadily



Source: Pitchbook

Private markets also started winning the battle for operating talent, which became increasingly critical as capital became a commodity and the competition between private and public financing for high-quality companies shifted to being mostly about strategic vision and human capital. Venture and growth equity firms have been able to leverage their networks of operating professionals and their own expertise in helping tech entrepreneurs navigate their markets and scale their businesses. And private fund managers pursue long-term value creation strategies, avoiding the short-termism that afflicts so many public companies. In addition, staying private also allows tech companies to keep sensitive strategic information out of the hands of potential competitors, whereas going public, particularly in their hyper-growth phase, would bring the unnecessary risk of publicly disclosing key information.

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So, this perfect storm forever changed the relationship between public and private markets and, in a sense, created a world of investor haves and have-nots as it relates to accessing the tech giants of tomorrow early in their development. Most individual investors must wait for these

companies to come public at often breathtaking valuations and thus take on greater risk with less upside, compared with institutional investors and the very wealthy, who can access these companies at more favorable entry points.

However, this is slowly changing as feeder funds and certain '40 Act funds are providing qualified purchasers and accredited investors, respectively, with access to private growth investments. In addition, the Department of Labor issued an information letter in 2020 giving the green light to defined contribution plans to use private equity within asset allocation funds, such as a target date funds. This leveling of the playing field will provide a long overdue opportunity for many individual investors to participate on a limited basis in the growth of tomorrow's market leaders, and perhaps help limit some of the excess exuberance when these companies come to the public markets.

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END NOTES

1. Source: Crunchbase, CNBC, and Pitchbook.
2. Source: iCapital calculations to identify the trimmed means, based on underlying data gathered from sources listing private market valuations, as well as Yahoo Finance for market prices.
3. Source: "Initial Public Offerings: Sales Statistics Through 2020," Jay R. Ritter, Cordell Professor of Finance, University of Florida; January 11, 2021.
4. Source: The median technology IPO in 1999 and 2000 had revenues of $12.1m and $12m, respectively. The median technology IPO was four-years-old in 1999 and five-years-old in 2000. Source: Jay Ritter, Cordell Professor of Finance, University of Florida
5. Defined as the market value at first price after an IPO begins trading.
6. Source: Jay Ritter, Cordell Professor of Finance, University of Florida
7. Source: SPAC Track
8. Source: ITU estimates. ITU is the United Nations specialized agency for information and communication technologies.
9. Source: "Worldwide digital population as of October 2020," Published by J. Clement; Nov 24, 2020; www.Statita.com.

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