Private equity tower is flush amid risks galore

ROGER MONTGOMERY

For a long-time now growth has trumped profits.

Since the global financial crisis, the best performing stocks have been those that prioritised revenue growth over profits fuelled by an ideological winner-takes-all pursuit of the network effect. Of course, the race to win requires reinvestment of all and any margin, as well as additional capital.

All busts are preceded by a bubble, and all bubbles are preceded by a boom. Importantly, all booms are founded on a legitimate basis for expecting future growth.

But what the smart money does at the beginning the fool does at the end.

Just days ago Australian web design business Canva received another dose of capital at a valuation of $3.7 billion. Less than 18 months ago, In January 2018, Canva raised $40m in a Series A round at a valuation of $1bn.

The company's revenue for the six months ending December was reported to be $25m, on which it generated profit of just over $1m for the same period.

In January 2018 when Canva's founder Melanie Perkins was interviewed by the ABC and asked how she could objectively confirm Canva's new valuation, she said: "That's exactly how venture capital works — the investors determine the price of the company that they believe it's worth."

At $3.7bn the company is trading on a historic price-to-sales multiple of 74 times.

Over in the US, the VC world is finding piles of cash are easier to come by than ever.

Consequently, valuations are being skewed upwards. Start-up DoorDash offers to get your breakfast, lunch and dinner delivered from your favourite restaurants right to your doorstep with one easy click.

It makes a small profit on the hundreds of millions in revenue it generates but only if you exclude salaries and rent. Just over a year ago the food delivery company was "valued" at $US1.4bn ($20.2). It raised $US250m for a $US4bn valuation in August, $US400m more for a $US7.1bn valuation in February. And last week it raised $US600m in new funding for a $US12.6bn valuation.

In other words, its valuation has soared by $US11.2bn in a mere 14 months. This isn't normal and as the economist Herb Stein once observed, "if something cannot go on forever, it must stop".

In the case of DoorDash it's probably worth noting the Singaporean sovereign wealth fund, Temasek, was one of the February Series F round investors. Why is that relevant? Temasek invested in ABC Learning Centres at $7.40 per share when I valued the company at less than 50c. ABC Learning ultimately collapsed.

I think this bubble will collapse too. But I don't propose to suggest this tech bubble is like the one I experienced first-hand in 1999. That bubble was fuelled by enthusiasm for internet companies that, it was hoped, would eventually work out how to generate revenue.

This bubble is not the same. Growing revenue from zero to billions of dollars is hard work and requires dedication.

Many of the current crop of stockmarket and private equity stars have indeed achieved billions in revenue. This time the hope is that the cost base can eventually be tweaked, or the scale will eventually be so great, that profits will ultimtaley flow.

Where the two bubbles are identical however is that investors

Canva CEO Melanie Perkins has overseen another injection of capital for the Australian web design business

are betting on "potential" rather than "proof"'.

I have never in my career seen so many massive-loss-making, revenue-growth-chasing companies go public and trade at such lofty, nay absurd, valuations. And the pile of red-ink at the profit line has never been higher either.

Younger fund managers, those who were still in school when the last bust occurred, think it's normal to pay almost anything for a company that must scale enormously to eventually (hopefully) generate an economic return.

But excitement hasn't always been the preserve of the young: sadly, they have sucked in a whole bunch of old heads who should know better.

Since 2009, global private equity capital raised annually has risen from $US315bn to more than $US800bn in 2018.

A flawed proposition

Perhaps most tellingly, the number of private equity firms around the world has mushroomed from just over 4000 firms globally in 2008 to nearly 8000 in 2017.

With so much money looking for an alternative to the punitive rates offered by cash since the GFC, it's not surprising so many PE firms have hung the shingle up to "help". It then follows, that with so many PE firms all looking to park record amounts of cash in new opportunities, revenue and EBITDA multiples (where there is EBITDA) have all expanded too.

By way of example US leveraged buy out (LBO) transaction EBITDA multiples have expanded from an average 7.7 times in 2009 to over 11.2 times today.

According to University of Florida finance professor Jay Ritter (and despite a handful of winners) 83 per cent of IPOs in the first three quarters of 2018 "lost money in the 12 months leading up to their debut". The previous record for that stat was 81 per cent.

In Australia, Israeli-based Afterpay-wannabe Splitit issued a prospectus for its IPO at 20c per share. By March of this year, and within two months of listing, it was 1000 per cent higher at $2, giving it a market cap of $534m or 1069 times its revenue. Since March however, Splitit shares have fallen 57 per cent.

Over in the US, Uber's shares have fallen such that anyone who invested privately in the company over the past three years has lost money. And according to Bloomberg, investors who bought Uber's stock at the listing price of $US45 lost $US655m in the first day of trading, more than any other IPO in US history (it is trading at about $US39.90 now).

These changes mark the beginning of the end for unbridled enthusiastic sentiment that buying technology IPO's are a free ticket to financial freedom. And the shift in sentiment may be significant.

If retail investors begin to notice the bad taste being left in their mouths from buying recent IPOs after they float, it won't be too long before the exit window for private equity firms looking to foist their loss-making love children, those with no clear path to profitability, on an unsuspecting public begins to close. Moreover, with all the money raised by private equity, the deals they invest in must necessarily be larger, which explains why so many companies have been in private equity hands for so long. By way of an admittedly example, Uber raised

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$US24.7bn over 23 funding rounds spread over a decade (and it still only generated 2 per cent penetration, and arguably the low hanging fruit, which means it only gets harder from here). Larger deals must be followed by larger exits, but with most of the world's institutions, endowments, high net worths and ultra-wealthy investors already backing the IPOs, there are only retail investors left to buy them after listing.

Obviously, there will always be winners. Companies with best-in-class products and services, and those able to leverage large user databases to expand and improve collaboration tools or platforms, will always have a market and/or generate improving margins from the "network" effect.

But the belief that all companies, especially the 83 per cent that lost money, are worth owning because they will all be winners, is a flawed proposition that has defined many past bubbles.

Cheap money has once again precipitated a misallocation of capital and we wonder whether the declining aggregate returns from buying loss making IPOs after listing may shift sentiment in favour of a reversal of multiples for high-risk unicorns

For old fashioned value investors, those who prefer profits over promises, it's better to sit this one out.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

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Love of an MGB a vehicle for a friendship

AJ BAIME

Bruce MacCormack, 81, a retired IBM executive living in Bellingham, Washington, and Chet Kenoyer, 64, a real estate agent in the same town, on their 1971 MG MGB, as told to AJ Baime.

MacCormack: In September of 1998, I bought the 1971 MGB for my wife, Patricia. The MGB was a very successful British-built car in the 1960s and '70s. This particular one was a chrome-bumper car, manufactured before US safety regulations caused MG to change the look with rubber bumpers. Huge numbers of these cars were built, but in 1998, it was rare to find one in such great condition.

We did some things to pretty up the car: chrome wire wheels, a black roll bar. But my wife began to get anxious driving such a small car. I'm a Jaguar collector and was running out of space. So in June 2003, I put the MGB up for sale.

Kenoyer: That summer, I was at a local car show and I saw this red MGB. I have been a British car fan all my life, and I thought, 'Wow! That's cool'. A few days later, I saw an ad for a red MGB for sale in the *Bellingham Herald*. I called the number and this guy, Bruce, answered. I asked if this

Chet Kenoyer and Bruce MacCormack with the 1971 MGB they have both owned

was the car I had recently seen at the Bellingham car show and he said 'yes'. I went to see it and bought it for $US9000.

MacCormack: Chet and I remained friends, and I knew he was not driving the car much. After a while, I thought, 'I really miss that car'. One day in 2012, I called Chet and said, "I have a proposal for you". We met at his office. I said, "I will buy the car back for the same price you paid for it. Then, I will leave it to you in my will".

Kenoyer: I thought: That is novel. I said I would think about it. A few days later, I got a letter I had to sign for, from an attorney. When I opened it, there was a note from Bruce, a cheque for $9000, and a copy of a codicil in his will.

MacCormack: I was touched that Chet agreed. When I got the car back, I saw a cassette in the tape deck. It was the same Bob Marley cassette I had left there, nine years earlier.

Kenoyer: Bruce told me, "Whenever you want to drive the car, call me and it's yours". We are having some engine work done, and we are sharing the cost. I am excited to get the MGB back, but not for many decades from now.

THE WALL STREET JOURNAL.

Election result sparks revival in SMSF sector

JAMES GERRARD

Good news has been thin on the ground for self-managed super funds. In fact, the latest industry figures released earlier this week show asset growth in the DIY sector growing at only 4 per cent a year compared to 10 per cent-plus for most of the last decade.

Meanwhile, industry funds have had everything going their way. With the re-election of the Coalition, all that has changed. Because, to put it bluntly, the ALP tax agenda could have been devastating for the sector.

At an April election rally in the Sydney suburb of Burwood, Labor leader Bill Shorten said: "If you are getting a tax credit when you haven't paid any income tax, this is a gift. It is a gift. It is not immoral, nor is it illegal, but it is a gift ... It is a gift that is eating our budget."

Labor's proposal to take away franking credit refunds clearly cost them at the polling booths.

Why did the issue become so heated? As the election campaign progressed many investors realised the plan was not only inequitable for retirees, it was not going to be applied across the board and SMSFs were squarely in the firing line.

I'm certain the result would have been thousands of people shutting down their SMSFs and transferring to retail and industry super funds.

Labor had also planned to ban limited recourse borrowing arrangements for SMSFs, which in essence would have stopped them from being able to borrow money to buy property. This would have particularly put paid to plans from people under 50 who aimed to buy property for their funds.

Tony Sloan, a tax partner at BDO Sydney, says: "It is now business as usual for SMSFs with the election over. The Coalition's tax proposals are largely status quo. There are no radical changes ... no major reformative initiatives.

"Apart from some moderate personal tax cuts, most taxpayers are concluding that it's back to business and that tax will take a back seat, where it belongs."

So what does the future look like for SMSFs? Although the Coalition was forced to remove the measure to increase the number of SMSF members from four to six in an attempt to push a broader legislative package through parliament, we may see that proposal come back in the next three years.

Moreover, as investors relax with the rules as they are now, we may also see a trend back towards more SMSFs being established, which would be positive for companies which derive their income from the sector such as ASX-listed SMSF administration service provider Class Limited (CL1) and SMSF-focused accounting firms.

We may also see new products and innovation emerge in the market as the SMSF sector stabilises, which will drive lower costs, more investment options and greater ease of management.

Although borrowing in SMSFs may not be banned, the credit industry has imposed a partial ban with all major banks pulling out of the SMSF lending market. The remaining lenders such as La Trobe and Liberty Financial have been cautious and apply lower lending limits with higher assessment criteria to SMSF trustees looking to borrow. In the lead-up to the election, some investors had gone so far as to restructure in anticipation of ALP changes which will not occur and may never occur.

Sloan says: "Labor was proposing to prevent most types of taxpayers from receiving refunds for excess franking credits. The problem with this announcement was that many taxpayers simply did not understand what this measure actually meant.

"Many incorrectly thought that they would not get the benefit of any franking offsets at all, whereas the measures were simply designed to stop refunds of franking credits. This misunderstanding led some taxpayers to sell shares and hold cash until the situation became clearer."

Other SMSF trustees sold fully franked investments such as bank stocks and moved into real estate investment trusts (REITs) which were seen to be the closest comparable alternative that paid unfranked income.

As such, REITs have experienced a stellar six months but the tide may change again — the lift in bank stocks earlier this week points to such a trend.

Although SMSF operators may need to do some backflips and restructuring where they acted in advance of Labor policy, comfort should be taken that the outlook for the sector remains very much alive and well.

James Gerrard is the principal and director of Sydney financial planning firm FinancialAdvisor.com.au