‘WeWTF?’ WeWork dream will test bulls

The latest unicorn looking to list provides an example of ‘consensual hallucination’

ROGER MONTGOMERY

A WeWork’s hipster heaven work space in Manhattan

As this bull market is extended I have written about Uber, about Tesla and about Lyft — a plethora of companies that simply wouldn’t exist but for the altruism of a tidal wave of high-net-worth investors running from low interest rates into the arms of private equity funds.

As the old aphorism warns, Wall Street will sell what Wall Street can sell. If frustrated high-net-worth investors want to escape low interest rates by speculating on start-ups with no prospect of making a profit, except from selling that start-up to a bigger fool, then that is the service private equity funds will provide.

A new record number of private equity firms around the world are now holding a record $US1.9 trillion ($2.8 trillion) of uncalled capital to invest in a record number of deals at record high multiples so that they can IPO a record number of unprofitable unicorns. It’s plainly absurd.

Falling, nay plunging, short-term interest rates are stimulating debate about whether assets are universally supported when rates decline.

In theory, lower rates are a little like turning the Earth’s gravity off. But instead of floating humans, financial markets witness floating asset prices. When rates fall, the process of discounting future earnings back to today results in the present value of future earnings going up. And the further out in the distant future those possible earnings are, the more impact declining rates have on valuations.

But how high can asset prices rise when they are divorced from reality?

History shows that investment analysts have a bad habit of being too optimistic about the magnitude of a company’s future earnings, the speed with which those earnings will be delivered and the length of time the growth will last. By looking at an individual company in isolation, analysts are collectively convicted of projecting stronger earnings growth than is possible. All you need to do to prove this is to aggregate all those projections and realise the sum total is not possible. In other words, they cannot all be right, they cannot all be profitable and they cannot all grow for that long.

And sometimes even individual examples appear plainly absurd. You might recall I previously compared the claim in Uber’s prospectus that its TAM (total addressable market) was $US17 trillion. But given global total GDP is $US75 trillion and Uber cannot operate in China, which is 15 per cent of the global economy, Uber’s claimed TAM is equivalent to 27 per cent of global GDP. I can safely say that Uber does not have a total addressable market that is more than a quarter of the global economy. Ridiculous.

WeWork is the latest unicorn looking to list on the stockmarket and offer its loyal founders an opportunity to exit. According to NYU professor Scott Galloway, its claims are even more absurd than we have recently had from Uber.

Galloway summarises the period in financial market history in which we now find ourselves as “consensual hallucination”. It’s apt. When one hallucinates, a very different reality is created and in an article entitled “WeWTF”, Galloway reckons WeWork’s investors, its staff and founder are all on a giant acid trip. He suggests any analyst who believes WeWork is worth more than $US10 billion is “lying, stupid or both” and points out that the bankers who are facilitating the IPO “stand to register $US122 million in fees flinging faeces at retail investors”.

Low rates reality

There’s an important point to make here: if all the world’s high-net-worth and ultra-high-net-worths have piled into these companies through private equity funds, before they IPO, who will be left to buy the companies from them when they do list? It tells me that faeces may indeed hit the fan.

Of course, keep in mind we are distinguishing here those companies that make massive claims but no money from those companies on more reasonable multiples and making billions in revenues and profits. We aren’t talking about Google, Facebook or Apple, or even Amazon.

Galloway talks of a cult at WeWork, a cult that believes its own “bs” and points to the prospectus’s “dedication”: “We dedicate this to the power of We — greater than any one of us, but inside each of us”.

As Galloway observes: “So, We isn’t a real estate firm renting desks, it’s a Space as a Service (SAAS) firm. I know, use the word ‘technology’ over and over, despite having little R&D and computers and stuff, and voila ... we’re Salesforce.”

More concerning is the sort of reinvented accounting I recall in 1999 before the tech bubble burst. At WeWork the prospectus notes the use of “community-based EBITDA” (earnings before interest, tax, depreciation and expenses) that removes other expenses, including real estate, which “comprise the bulk of cost required to deliver the service”.

Galloway suggests a more honest description of WeWork’s invented earnings metric would be “EBEE: earnings before everything else”. But I would be more concerned about the $US700m of stock the founder has sold and the fact WeWork is not a tech company but merely a rent arbitrageur — leasing properties at one price, then fractionalising them to rent out at much higher prices.

If WeWork has hyped the market by simply charging skyhigh rents to start-ups that want a hipster environment, then the gig will be over when the spigot of cheap capital funding start-ups ends.

How long will low rates continue to support prices and behaviour that is tantamount to a misallocation of capital amid a suspension of reality? Only time will tell but I don’t expect we should have to wait too long.

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Keep calm and carry on (with cash on side)

DON STAMMER

Most views on the investment outlook these days are gloomy. As a consequence, interest rates have dropped to exceptionally low levels. Recently, yields on 10-year government bonds were 1.5 per cent in the US, 0.9 per cent here, and a negative 0.7 in Germany. Sharemarkets have been anxious and volatile.

To compensate lenders for having their funds tied up for a longer time, longer-dated interest rates are usually higher than shorter-dated ones; the yield curve is generally “upward sloping”. However, when economic conditions turn tough, shorter-dated rates often exceed longer-dated ones for a time. The yield curve “inverts”.

When the yield curve inverts, it encourages expectations that an economic downturn is imminent. And when the all-important yield curve for US government bonds inverts — as it’s done recently — investors are spooked!

There are several ways to measure the “slope” of the yield curve. In the US, the best measure is the spread between the yields on two-year and 10-year government bonds, which has inverted only fleetingly in the past months. In Australia, it’s the spread in yields on three-year and 10-year bonds.

Will we experience the global recession that’s now widely predicted? Global growth has slowed, especially in manufacturing, and Germany appears on the cusp of recession. The risk of a major economic downturn is higher this time around.

What can investors do when fear of a global recession is widespread, though recession is not, at this stage, a reality? They might like to build up their cash holdings for a time, where that’s possible, from dividends and maturing investments, even though returns on cash now lie somewhere between skinny and negligible.

Investors might improve the returns earned on their interest-bearing assets by: shopping around banks and credit unions for better deals; extending the range of quality bonds they consider; and switching to positive return bond funds from those who use the benchmark of market returns. (And investors holding short-dated bonds will be less likely to suffer capital losses than longer-dated bonds as and when bond yields rebound).

Some investors might consider switching a part of their savings from interest-bearing assets to the hybrid securities issued by the Australian banks, given that the worst fears have abated of the banks suffering big losses on the housing loans they’re made (and the benefits of franking credits have been maintained). Hybrid securities can be complex and become risky in a banking crisis.

Despite predictions of imminent global recession, sharemarkets haven’t crashed. What’s more, the current season of company earnings results offered excellent results from stocks including Australian Securities Exchange, CSL, Resmed, McMillan Shakespeare and Treasury Wines; but disappointing announcements from Adelaide Brighton, AMP, Blackmores, Seven West Media and Telstra.

Even if equity risk premiums widen because of dangers in the global economy, there will probably be opportunities for investors to buy quality shares at bargain prices in market sell-offs.

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