Hamilton Lane
Research

THE UNICORN PLAYBOOK
2019 EDITION

By Roderick Berry, Managing Director

In the investment world, the term "Unicorn" is widely understood to represent a privately-held company that has reached a billion-dollar valuation. In fact, we debated even defining it here. But, for the uninitiated, let's take a quick trip down memory lane all the way back to…2013.

When the venture capitalist Aileen Lee first coined the term that year, 39 such companies were in existence. Much like the mythical beast itself, a private company with a one-billion-dollar valuation was still a statistical rarity at the time. However, in just the past six years, the unicorn ranks have swelled at an ever-increasing rate.

Today (as of June 30, 2019 to be precise), CBInsights reports that the current herd of unicorns now numbers 366, with a cumulative valuation of $1.1 trillion. And, this number has continued to grow despite the fact that the group has been culled over the past year due to numerous high-profile IPOs and M&A deals.

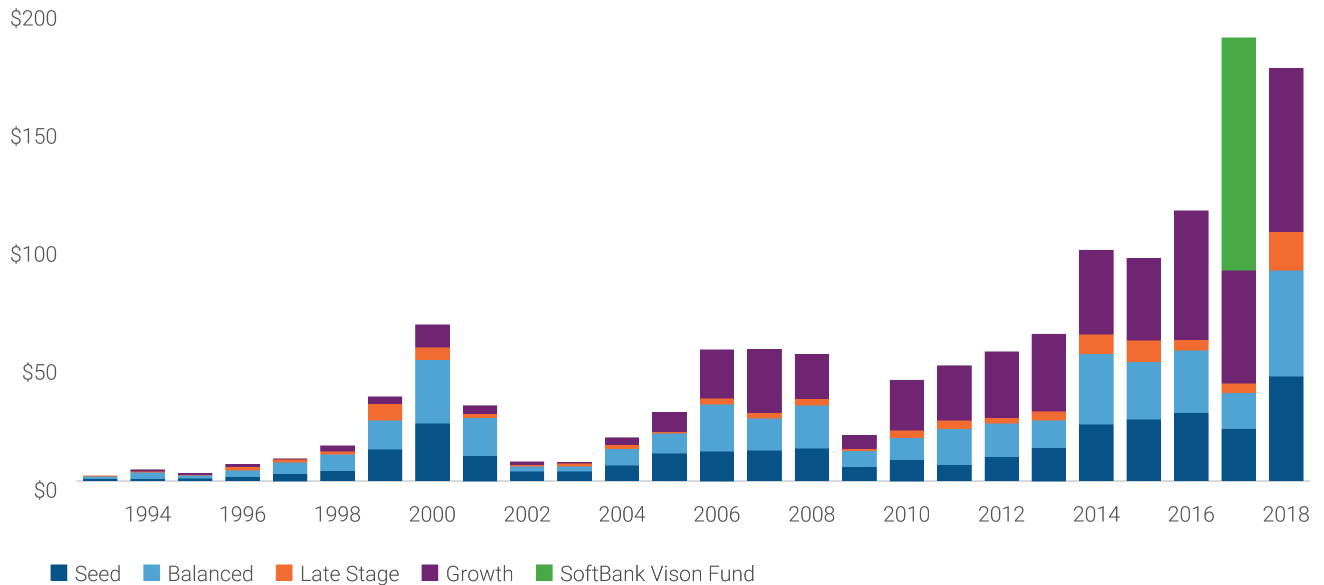
Pressures to Stay Private Longer

The swelling ranks of unicorns have been attributed to a number of factors; but if we had to choose the most impactful, we'd argue it's the significant increase in private capital available to companies.

Where is this capital coming from? Glad you asked. In 2012, Congress passed the U.S. Jumpstart our Business Startups (JOBS) Act. The JOBS Act increased the number of shareholders a private company can have before being required to disclose financials by a factor of four. Partially in response to the JOBS Act, there was almost a 300% increase in private capital invested in private software companies from 2013-2015, according to a report by McKinsey & Company.[1]

Another major contributor to the influx of private capital has been the rise of non-traditional venture capital investors. The most prominent example of this phenomenon was the October 2016 launch of the SoftBank Vision Fund, which raised a casual $100 billion to invest in high-growth private companies. To date, the fund's most notable investments have been roughly $10.4 billion in Work, Inc. (formerly WeWork) and roughly $7.4 billion in Uber, according to Reuters.[2]

Global Private Market Fundraising by Strategy
USD in Billions



Source: Bison data via Cobalt, Preqin (March 2019)

So why are companies today on average more valuable than companies in prior periods?

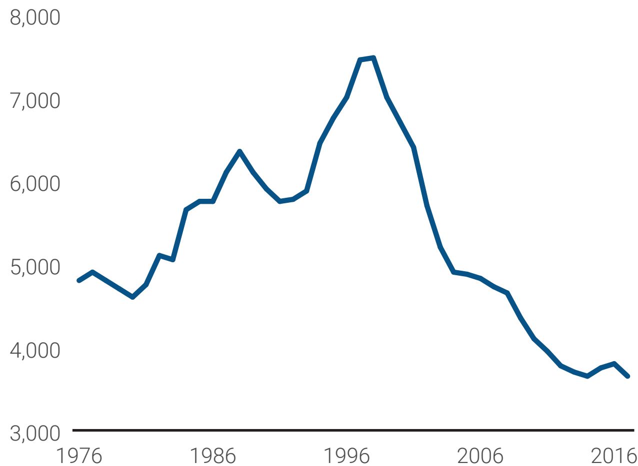
SoftBank also has been a proponent of the relatively recent trend of "blitzscaling." Coined by Grelylock partner and LinkedIn founder Reid Hoffman in his recent book of the same name, blitzscaling involves funding a startup with a transformative, disruptive business strategy with enough capital to enable rapid expansion before any competition can gain scale. Take, for example, the business strategies of companies such as Uber and AirBnB, both of which experienced rapid expansion that notably disrupted the global transportation and lodging industries, in large part before other competitors could gain significant market share.

In addition to the availability and tremendous growth of private capital in recent years, regulations such as the Sarbanes-Oxley (SOX) act of 2002 have made it much more costly to operate as a publicly-traded company. The SOX Act was passed following accounting scandals that occurred at companies such as WorldCom in 2002 and Enron in 2001. In direct response, Section 404 of SOX requires external auditors to evaluate the adequacy of a public company's internal controls. The SEC has estimated that this requirement has disproportionately hurt smaller companies that suffer under accounting fees up to six times higher, in relative terms, than those incurred by larger firms.

Fast forward a few years to the Global Financial Crisis (GFC), and the trend toward even more federal mandates continued, with the post-GFC passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Amongst other requirements, the Dodd-Frank Act created the Investor Advisory Committee at the SEC, which has expanded the regulator's reach into corporate governance. As a result of these new regulations, the SEC has estimated that annual compliance costs for public companies now average more than $1.5 million a year. This is in addition to the average regulatory cost of conducting an IPO, which is estimated to be approximately $2.5 million.[3] Taken together, the combination of easier access to a rapidly-growing pool of private capital and an increasingly onerous regulatory environment makes it easy to see why a smaller company may think twice before choosing the path of listing on a public exchange.

A 2018 study for the National Bureau of Economic Research noted that, at the end of 2016, the U.S. had just 3,627 firms listed on public exchanges—well below the 4,943 that were listed 40-years prior in 1976. When viewed in the context of population growth over the past four decades, the result is even more startling. At the end of 2016, the U.S. had just 11 publicly-traded companies per million inhabitants, compared to 23 in 1976. The number of public companies has dropped every year since 1997 with the exception of 2013. Sobering data, isn't it?

The Number of Publicly Listed U.S. Firms



Source: C. Doidge, K. M. Kahle, G. A. Karolyi, and R. M. Shulz, NBER Working Paper No. 24265. Includes U.S. firms in CRSP that are listed on the NYSE, AMEX and NASDAQ. Investment companies, mutual funds, REITs, and other collective investment vehicles are excluded.

If that weren't enough, a 2018 study by S&P Global Market Intelligence found that the average age of a company at the time of its IPO in the U.S. was 13.3 years in 2018. Compare that to the time in 2002 just prior to the SOX Act when the average age of a company at the time of its IPO was 3.1 years.

Finally, growing cash balances of large public companies, particularly in the technology and health science sectors, have contributed to soaring M&A activity over the past two decades. As a result, many of the emerging private companies that had yet to reach the new level of critical mass required to go public chose instead to exit through a sale of the company. In fact, 2018 marked the third biggest year of global M&A activity of all time, with announced transaction volume of $4.1 trillion, according to JPMorgan.[4]

Emergence of Unicorn IPOs

With all of the pressures and incentives to stay private longer, it is no wonder that the list of unicorns has grown from 39 in 2013 to today's count of 366. In 2018, we saw a decade-high total of 21 unicorns list on U.S. public exchanges at a total value of $49 billion, according to PitchBook[5], and Renaissance Capital believes that we may see 119 unicorns complete their IPO this year.[6] Further, the total deal size of 2019 IPOs is expected to reach $100 billion, breaking the record set in 2000 during the peak of the dot.com explosion. Even within the context of a $33 trillion public equity market in the U.S., this is an enormous number.

Of course, much of this newly-created wealth will find its way back into the process of funding newly emerging companies through angel investors, as well as venture capital and private equity funds. This recycling of capital back into startups is not an unfamiliar phenomenon in Silicon Valley, but the scale of this cycle is unprecedented.

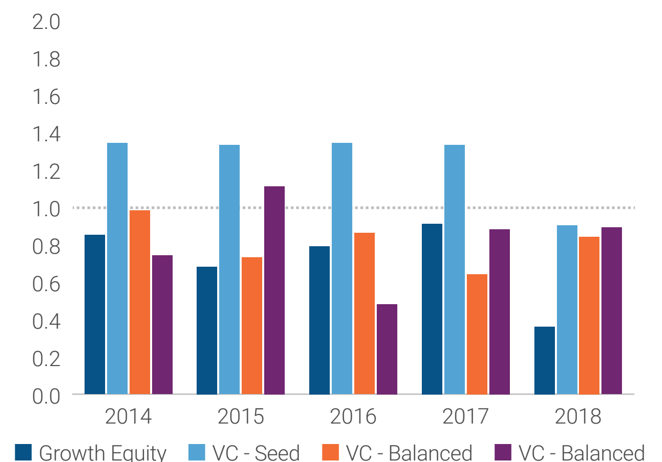
And now to the obvious next question: With all of the forces behind the long-running trend to stay private, what is motivating these unicorns to exit through an IPO now?

One obvious influence is that investors and employees have grown impatient and are demanding liquidity; let us recall that last year, the average age of a company going public in the U.S. was 13.3 years!

In addition, the cycle of venture capital fundraising has continued, with growing fund sizes to boot. But, as shown in the chart below, the increased time until exit has essentially resulted in fund liquidity ratios (for all but VC seed funds) falling below 1.0x over the past five years.

Venture & Growth Strategies: Annual Liquidity Ratio

(Distributions/Contributions) By Calendar Year



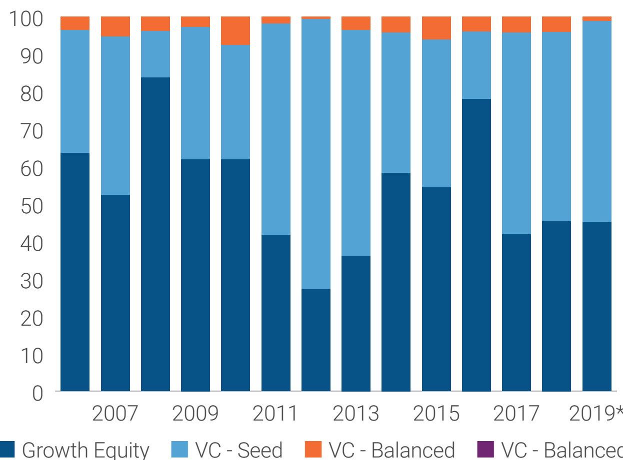
Source: Hamilton Lane Data via Cobalt (March 2019). Cash flows through 9/30/18.

According to the NVCA, 2018 marked the fifth consecutive year that VC fundraising exceeded $30 billion. But, in what may be another signal of an inflection point for the market, during the first quarter of 2019, fundraising slowed as the aging of venture portfolio companies has left many LPs over-allocated to the investment class.

The combination of over-allocated LPs and the increasing number of mega-funds over $1 billion planned in upcoming quarters has finally ratcheted up pressure on funds to return capital through exits.

Further, the growing size of the unicorn companies has reduced the pool of potential acquirers, which has slowed M&A activity as a percentage of total exits in recent years, according to PitchBook and the NVCA.

Exit Value ($B) by Type



Source: PitchBook: The 1Q 2019 PitchBook-NVCA Venture Monitor; all datasets are current through 03/31/2019.

*As of 03/31/2019

Make it an IPO...but not

So you're a 13-year-old unicorn and you think you might want to IPO, but for one or a combination of the reasons detailed above, you are hesitating. What's a teenage unicorn to do? Here's a look at some alternative options:

Secondary Market

Traditionally, companies used the IPO process as a fundraising round, as the public markets provided a ready source of capital to continue the expansion of business strategies. However, as we've outlined here, with the tremendous amount of private capital available today, the motivation to go public has trailed off.

Another factor here has been the emergence of exchanges that provide secondary markets for shares of private companies, which have become more liquid in recent years. These new exchanges allow private companies to sell shares to accredited investors before they have gone public. While this has further removed some of the need to go public simply to create liquidity for insiders and early investors, these exchanges are still thinly traded.

DPO

For a mature, well-known unicorn that has plenty of capital, but seeks broad liquidity that is not available on secondary exchanges, the direct listing or direct public offering (DPO) has become an increasingly attractive alternative. The DPO process allows companies to list on a public exchange at a fraction of the cost of an IPO, where per-share underwriter fees can reach 8%. For instance, the $8 billion Uber IPO generated fees totaling $106 million for the bankers.[7]

A direct listing also alleviates the risk of leaving money on the table with a mispriced IPO. For instance, the recent Crowdstrike Holdings (CRWD) IPO finished the first day of trading 70.6% above the offer price of $34. In essence, the company diluted its existing shareholders with the new offering that was priced at a significant discount to the value the public markets ultimately attributed to the stock.

Further, insiders and early investors in companies that have undertaken a DPO are not subject to a six-month lockup period as is the norm for companies that exit through an IPO.

In April of 2018, Spotify Technology (SPOT) was the first meaningful unicorn to test the direct listing waters. They used a reference price of $132 for the DPO, which was near the prices observed through secondary market exchange transactions. As we exit the second quarter of 2019, FactSet reports that SPOT was trading at $146.22 per share.

Perhaps foreshadowing further direct listing activity during the balance of 2019, Slack Technologies (WORK) completed its DPO on June 20. The market's appetite for high-growth technology unicorns was soon revealed, as WORK's stock rose 48.5% in the first day of trading from the $26 reference price used for the listing.

Positive investor reaction to the Slack Technologies' direct listing was by no means an outlier. In the second quarter, many high-profile unicorn IPOs were met with similar investor enthusiasm.

Notable Q2:19 Unicorn IPOs

	Ticker	June 20, 2019 Mkt Cap ($B)	Post IPO (First Day Stock Price Appreciation)
Beyond Meat	BYND	9.8	163.0%
Jumia Technologies	JMIA	2.0	75.6%
Zoom Video Communications	ZM	24.6	72.2%
Crowdstrike Holdings	CRWD	12.6	70.6%
PagerDuty	PD	3.6	59.4%
Chewy	CHWY	13.7	59.0%
Fastly	FSLY	1.7	49.9%
Slack Technologies	WORK	22.2	48.5%
TradeWeb Markets	TW	9.4	32.6%
Pinterest	PINS	14.8	28.4%
Parsons	PSN	3.7	11.4%
SciPlay	SCPL	1.7	-4.7%
Uber Technologies	UBER	76.5	-7.6%

Source: FactSet

Summary

Over the past six years, the combination of growing regulatory burdens for public companies, expanding sources of private capital through both traditional and non-traditional sources, and years of robust M&A activity has contributed to the growing list of unicorns. At the mid-point of 2019, upwards of $1.1 trillion of aggregate value has been attained by the current list of unicorns, according to CBInsights.

At the same time, mounting pressures from insiders and early investors seeking liquidity from investments pushing past 10-year time horizons have contributed to a growing pipeline of companies seeking an exit through an IPO.

For the first half of 2019, Renaissance Capital recorded a total of 80 IPOs, raising almost $30 billion (excluding Slack Technologies). In the second quarter alone, 62 IPOs raised $25 billion and a pipeline full of large private companies targeting a 2H 2019 IPO could push this year to record levels.

Based on the favorable reception to large IPOs so far in 2019, investor demand appears ready to absorb the growing supply of new publicly-traded growth equities through the balance of the year.

But, the cycle doesn't stop there. The growing number of IPO and direct listing exits will result in cash and in-kind stock being returned to LP investors at record levels over the next year, and much of this capital will find its way back into the private investment cycle to help fund the next round of innovative companies.

In the intermediate term, LPs in the funds that are experiencing an accelerated pace of portfolio exits may find themselves transitioning from an overweight position in the alternative investment asset class to an underweight position.

Near term, LPs could see a meaningful increase in both cash and in-kind stock distributions from their private portfolio investments. In the case of in-kind stock distributions, without a managed process in place, investors may find themselves exposed to public market risk. While a GP completes its investment cycle and calculates final fees at the time of an in-kind stock distribution, an LP's private investment process is not complete until it manages out of the distributed newly-public equity positions, i.e. the "last mile."

A Final Word from HL

In the 28 years we have managed in-kind stock distributions for our clients, we have seen the average distribution event negatively impact investment performance. By employing the services of a dedicated distribution manager, this negative investment impact, during the last mile of the private investment process, can be managed in a way that seeks to minimize potential losses and may even further enhance the returns. No institutional investor would contemplate navigating the private investment world without a solid investment process in place, and the investor certainly should not expose its hard-fought private investment returns to the "last mile" risks associated with unmanaged in-kind stock distribution events.

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Endnotes

[1] McKinsey & Company: "Grow fast or die slow: Why unicorns are stying private" – May 2016.

[2] Reuters: https://www.reuters.com/article/us-wework-m-a-softbank/wework-gets-2-billion-after-softbank-cuts-planned-investment-idUSKCN1P21OH

[3] SEC: https://www.sec.gov/rules/proposed/2013/33-9470.pdf

[4] J.P.Morgan 2019 Global M&A Outlook Report – January 2019

[5] Pitchbook/NVCA Venture Monitor 4Q 2018 Report

[6] CNBC: https://www.cnbc.com/2019/02/04/a-giant-ipo-wave-is-coming-as-unicorns-whet-investor-appetite.html

[7] Fortune: https://fortune.com/2019/05/14/morgan-stanley-underwriter-ipo-date/

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