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Premium

Behind the popularity of new economy stocks

A WeWork location near New York City's Times Square. WeWork was recently reported to be considering a rescue valuation of US$8 billion (S$10.9 billion) following a failed initial public offering, a whopping US$39 billion discount to its last valuation in a round invested into by SoftBank in January. PHOTO: NYTIMES

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The rise of the new economy will continue to have a profound impact on the lives of investors, but putting money in such stocks may not yield the returns many hope for.

Loke Wen Wei

WeWork, Snap, Airbnb, Grab. Most of these names are familiar to us because of the impact they have had on our lives - from renting a swanky co-working space to taking fancy selfies, letting our apartments to holiday-goers and booking a ride-sharing car.

They have also been a major focus for investors around the world because of eye-popping valuations achieved in private markets, some in public markets, while many others are expected to come into the market soon.

Several famous investors, most notably SoftBank via its Vision Fund, have invested in some of these companies, while some have had successful exits. Given such strong popularity and patronage, is there room for these firms in value-oriented investment portfolios?

SO WHY ARE NEW ECONOMY STOCKS SO POPULAR?

There are generally three assumptions underlying most new economy investments:

•The market opportunity is large and under-served, or inefficiently served. Airbnb created a large new market connecting private residential landlords with short-term renters from around the world. With such a large and untapped market, surely Airbnb must be worth a huge amount of money?

• The industry scales - meaning only a handful of dominating players will survive. Snap was touted as the key to millennial communications due to its ability to take fancy selfies with private instant messaging. And, once users were on Snap, it would draw other millennials into its ecosystem, creating a "locked in" network effect, and become the dominant channel for advertising to millennials. With such dominance of millennial communications, surely there must be huge value to extract?

Valuations and net losses

SELECT NEW ECONOMY COMPANY VALUATIONS

Company	Estimated valuation (US$ billion)*
WeWork	47
Snap	25
Airbnb	31
Grab	14

SELECT NEW ECONOMY COMPANY NET LOSSES

Company	2018 net loss (US$ billion)
WeWork	1.6
Snap	1.3
Airbnb	Unknown**
Grab	Small

*Last reported significant funding round, which may not reflect indicative or secondary transactions.

**Airbnb claims to be mildly Ebitda positive, which suggests that it is still running material net losses.

Sources: BLOOMBERG, CNBC, CNN, REUTERS
SUNDAY TIMES GRAPHICS

• They are displacing, or are expected to displace, existing operators at a rapid rate. Grab has created waves in the region as an alternative transport provider, connecting private car drivers with passengers. Grab's global competitor Uber has already greatly displaced taxi fleets around the world with better service and better cars (plus they don't even need to own them). Surely ride-sharing companies will come to be the main mode of automotive transport, generating value for shareholders?

ARE THEY SENSIBLE INVESTMENTS?

To quote Mr Warren Buffett, "to value something, you simply have to take its free cash flows from now until kingdom come and then discount them back to the present".

The stark reality is, while most of these new economy companies have delivered substantial revenues, none of them has found a way to translate that into profits, much less any meaningful free cash flow.

It is unknown exactly when they will break even and we cannot reasonably estimate their long-term earnings potential. How can we expect to see enough free cash flow to justify their valuations?

The difficulty is most of these companies rely on "subsidies" of some sort. This means they cannot price their products to produce a near-term economic return, and instead must rely on a possibly inflated estimate of customer lifetime value - to be mined once they achieve dominance and reprice their offerings upwards. But, in the meantime, they will spend, spend and spend to acquire customers.

Many investors seem to have bought into this concept and believe the narrative - supported by evidence of sequential rounds of capital being injected by like-minded investors at ever increasing valuations, while cash continues to be drained by these companies at unprecedented rates.

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Tellingly, there are signs that optimism in this market is abating. WeWork was recently reported to be considering a rescue valuation of US$8 billion (S$10.9 billion) following a failed initial public offering, a whopping US$39 billion discount to its last valuation in a round invested into by SoftBank in January.

I have chosen to sit on the sidelines while this movie plays out, but I suspect there will be a surprise twist at the end.

Have people made money historically from owning new economy investments? Yes. Are they sensible investments today? Probably not.

• The writer is a fund manager at Phillip Capital.

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