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Unicorn Companies: The State of Play in 2019

The landscape of private firms valued at US$1bn or more is evolving quickly. Where do things stand and what is coming next?

The original "unicorn" companies are coming of age. After remaining private for longer than many of their predecessors and amassing multi-billion-dollar valuations, the likes of Uber and Airbnb are considering IPOs in 2019.

The move to go public by a number of these US$1bn+ giants has caused market observers to wonder whether a broader movement toward public exchanges is imminent. The unicorn ranks have expanded rapidly in recent years, with around 150 companies in the US alone now holding the vaunted status, and roughly the same number abroad.

This expansion, together with the wave of potential unicorn IPOs, raises the question: Does unicorn status even matter anymore? The amount of capital prepared to invest in private companies continues to grow, raising the prospect of further proliferation of companies valued at US$1bn or more. In China, a new technology unicorn emerged around every four days last year, according to an analysis by consultancy Hurun.

Other issues are also coming to the fore as some unicorns seek a public exit. For instance, governance experts are discussing the problems that could arise from dual-class ownership policies in place at some of the companies. On the investment front, both institutional and private investors are looking to buy shares of the firms in anticipation of their public debuts, given the potential windfall they could receive after the listings.

As the makeup of the enchanted forest shifts, what does the future hold for its remaining inhabitants? Which sectors are most likely to see new unicorns appear? And will the title retain its sheen for much longer? We spoke with four leading experts to learn about the state of play for unicorns in 2019.

The experts

Sean Ammirati
Professor of Entrepreneurship, Tepper School of Business

Lise Buyer
Founder, Class V Group

Kevin Kennedy
Partner, Simpson Thacher

Eric Sibbitt
Partner, O'Melveny & Myers

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After years of speculation about going public, several of the biggest unicorn companies are planning IPOs for 2019. Do you think this could cause a new wave of large companies going public as opposed to seeking other forms of exit?

Lise Buyer, Class V Group

I don't think any one or two companies going public changes the conversation at others per se. It is the performance and Wall Street's acceptance or dismissal of those new issues that commands the attention of board members of other companies considering the move to public status. If the unicorns are well received, that may provide encouragement to others to follow.

Kevin Kennedy, Simpson Thacher

There's an entire wave of companies right now that have deferred going public beyond what we typically see. These companies are far more mature and successful than companies in other eras would be at the time of their IPO. Some of them are really high-caliber, high-quality companies, and if they do go public this year, it could open up the doors and get people excited about the public markets. The analogy I would make would be to the period of 1997-98, when there was a real downturn in the IPO market. It was the longest quiet period in IPOs for some time, mostly because of what was going on in Asian markets. Then, eBay went out with a pretty highly anticipated IPO – we were fortunate enough to be able to work on that one. That really blasted open the doors, and you saw a torrent of companies going out for the next 18 months, in probably the biggest boom in IPOs in American market history. I think some of these companies considering IPOs now are of the same caliber as eBay was.

Eric Sibbitt, O'Melveny & Myers

I'd say it ultimately depends on the success of these larger IPOs. If one goes out and then it starts trading down, that can have a negative effect on all the others. On the other hand, if the management at companies see that the market is trading up and there's momentum there, then an IPO may be a more attractive vehicle relative to M&A or other types of exits. There's also the bankers' side of the equation, which is investor demand. Obviously, investors always like things that they expect will go up in value.

Another thing to note is that as a result of the changes under the JOBS Act, emerging growth companies are able to submit draft registration statements confidentially, so there are always a lot of potential offerings waiting in the wings. Sometimes they sit there for years, but if the market is good and their own circumstances are good and bankers are ready to take them out, you could see a big wave very suddenly. In the past, you'd have to see new initial public filings, and you'd have a longer lead time to see what's out there.

Sean Ammirati, Tepper School of Business

As Kevin mentioned, this wave coming up now are companies that have been gestating much longer as private companies. But ultimately, if you think about the people who invested in them, the plan was always to go public at some point, right? I think there are a number of reasons why the current wave delayed their IPOs, including the fact that investors who used to invest only in public-market companies are now able to invest in private companies as well. So you have capital sources that have emerged that facilitate staying private longer. There are also some regulatory issues, such as the fact that Sarbanes-Oxley has flatly made it more expensive to go public.

> "Going forward, I would expect the timeline for going public will continue to be longer for many companies."
> Sean Ammirati, Tepper School of Business

Going forward, I would expect the timeline for going public will continue to be longer for many companies. I think the only way you'll see a massive trend to going public earlier would be if the private capital sources dry up or if something changes in the regulatory environment. If some of these large mutual funds stop making private investments in the US$10bn+ category, the public markets may become the most viable option again. But I also don't see any indication that these companies are going to stay private forever.

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Following Spotify's public debut with a direct listing instead of a traditional IPO, unicorn companies Airbnb and Slack are reportedly

considering the method as well. Why do you think the direct listing appeals to some unicorns? Do you expect it to gain further in popularity?

Lise Buyer, Class V Group

There are a number of appealing factors about a direct listing—and a number of drawbacks. Spotify was not raising any new funds; its direct listing was all about transferring ownership of shares already owned by third parties to other third parties. For pure secondary transactions, a direct listing is a less expensive option—probably. It's worth noting that Spotify still paid out US$35 million in fees. The stock opened at US$149 and is now trading below that, and many of the 2018 IPO shares are currently trading below their respective issue prices, in line with the market for technology shares in general. A direct listing is an alternative worthy of consideration for those not wanting to actually raise any new money, but the key is alternative, not panacea.

Kevin Kennedy, Simpson Thacher

It's going to be somewhat unique companies that take advantage of the direct listing option—as Lise said, it's not for everyone. The first prerequisite is that you're going to have to be widely known. You need to be a company that doesn't really need the benefit of the marketing pop that comes along with an IPO—there's a lot of branding that goes into an IPO. I think a lot of companies view it as much about getting their name out there to consumers as it is about actually going public. The IPO process helps with that tremendously.

The other obvious issue is that a company doesn't need additional funding if they're doing a direct listing, right? That's not most companies either. It narrows it down to a small slice of the world.

Eric Sibbitt, O'Melveny & Myers

Obviously it was a big deal when Spotify decided to take the direct listing approach. Direct listings are exceedingly rare. They are an interesting option for a small subset of companies, and that's often the very large, high-profile tech companies that frankly don't need to raise money through an IPO. They can get funding through the private capital markets, and they often also have a diverse and distributed enough investor base that there is built-in liquidity.

The great risk of a direct listing, of course, is that you don't know how it's going to trade once it goes out. When you look at a traditional IPO, you have a very orderly process, where you decide who's going to be able to sell, and everybody else is locked up for a period of time, and the investment bankers go out and line up orders, in that way trying to create an orderly introduction to the market. When you're doing a direct listing, you don't have those lock-ups, so anybody can sell and anybody can buy.

There's more risk to that, but if you have a large enough company with enough investors and they don't have the need for capital, then it can be an interesting way to see how the market prices things. You may have some pretty big discounts and commissions from a typical IPO as well, since bankers and the company try to price the IPO so that it will go up in the aftermarket. So in some sense, you could argue they're pricing it at a discount. In addition, the bankers get a fee and generally it's going to be higher for an IPO than if someone's just paying a commission on trading in the open market.

Sean Ammirati, Tepper School of Business

I agree with Kevin that a direct listing is an interesting option when a company has a strong consumer brand—when it's already a known business. The model makes sense if retail investors would be interested in the offering. So perhaps a B2C company with a well-known brand, rather than, say, a B2B infrastructure tech company. You can mention Spotify at the holiday table and your family and friends know who you're talking about; Pivotal Software, maybe not so much.

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In which sectors do you expect to see the most new unicorns emerge in the next 12-24 months? And in which sectors do you expect to see more unicorns go public?

Lise Buyer, Class V Group

This will depend on market volatility. Unicorns are so anointed by private market investors who clearly assume public market investors or strategic buyers will see these companies as even more valuable when the time comes. Expectation and reality may align—it certainly will do so in some cases—but maybe not all. The creation of new unicorns depends on how much money private investors choose to invest and what appear to be the most intriguing new companies or industries. I would expect continued software investment

along with a focus on AI, autonomous vehicles and other businesses that catch the fancy of those looking to deploy that private capital.

Eric Sibbitt, O'Melveny & Myers

IIt's still a little early but I think in the coming years you'll see a lot of fintech, particularly blockchain-based company, IPOs. For example, there are large trading platforms emerging, and just like other companies that become successful and achieve large valuations, at some point most of them look for a public exit. For some of those companies, an M&A exit may look more attractive—but one thing that's often looked at is whether there are natural buyers in the market for your company. For certain types of firms, if you're unique and kind of pathbreaking, sometimes there's not going to be a natural strategic buyer for you, because you're just a new thing. It's not necessarily something you could bolt on or use to augment an existing strategic company. If you take a large bank, for instance, they're built differently than a lot of fintech companies in terms of their approach to the world. In those cases, putting valuations aside, an IPO is often the most attractive vehicle, and I think that will probably be true for some of the blockchain companies.

"It's still a little early but I think in the coming years you'll see a lot of fintech ... IPOs."

Eric Sibbitt, O'Melveny & Myers

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In August 2018, Apple's market capitalization passed US$1 trillion (before falling below that mark in recent months), and both Microsoft and Amazon are currently around US$800bn in value. With the largest tech companies now boasting valuations hundreds of times higher than US$1bn, do you think the number still carries symbolic value?

Lise Buyer, Class V Group

At the proverbial end of the day, valuations are always meant to reflect the discounted stream of projected future earnings for companies. Admittedly, sometimes one has to look very far into the future to make the math actually work, but any round number valuation really reflects the theoretical economic prospects for the business. Numbers like a trillion garner headlines, but aren't meaningful—or generally sustainable—other than as correlated to the underlying fundamentals of any one business.

Kevin Kennedy, Simpson Thacher

Clearly the US$1bn valuation mark needs to be inflation adjusted at some point. Inflation can be cost of living, but it can also be just the number of companies out there. The name is about rarity, right? A unicorn is something so scarce that it is actually mythical. If every other company has a US$1bn+ valuation, then it's more like a mule and less like a unicorn.

All the same, I think people will still talk about it. I don't know if the US$1bn nomenclature was so much about the valuation as it was about the phenomenon of a lot of really robust private companies that hadn't yet gone public. In my mind, it was always less about how much they were worth and more about the fact that there is a group of companies that would've gone public much sooner in their trajectories in other eras than these folks have chosen to.

Eric Sibbitt, O'Melveny & Myers

I think the US$1bn valuation still carries weight as a significant mark, but it doesn't generate as much of a wow factor as it did at one point in time. Valuations have increased overall. There used to be a lot of attention in the media tracking the increasing number of unicorns, but I'd say it doesn't create as much buzz as it did a few years ago.

Sean Ammirati, Tepper School of Business

I think it's important to go back and remember where the term unicorn was originally coined. I'm pretty confident that the first time that handle was added to startups was in 2013 when Aileen Lee, who is the founder of Cowboy Ventures and was at Kleiner Perkins before that, wrote an article for TechCrunch called "Welcome to the Unicorn Club: Learning from Billion Dollar Startups." The point she was trying to make was that for a Series A, US$400m venture fund, which is a very standard type of VC fund, they needed companies to reach an exit at over a US$1bn valuation for them to hit their return targets for investors. She walks through the math on why this is the case, and for what it's worth, I believe that math still holds to this day

So in that sense, the US$1bn valuation is still very relevant for that style of venture firm. I believe it's still the goal for Series A investors managing multi-hundred-million-dollar funds. If someone is going to invest in a US$400m dollar fund, they need to return multiples of US$400m, and remember that the return curve of a venture fund follows a power law curve. That means that in most of the best-performing funds, the best investment in the fund drives as much of a return as

the rest of the deals combined. So if that is the profile these investors should be expecting and you've got US$400m to invest, you need companies to exit well north of US$1bn.

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When a company becomes a unicorn, it often gains more media attention and public scrutiny. In your view, are there potential downsides to the new scrutiny these companies gain? Do you think it is always good for a company to become a unicorn?

Eric Sibbitt, O'Melveny & Myers

Obviously, to be valued highly and be called a unicorn is what a lot of companies, especially tech companies, strive for. There are a lot of benefits in terms of media attention and general market awareness. After all, many

"...it's true that the more successful you become, the more critics and other people can scrutinize you."

Eric Sibbitt, O'Melveny & Myers

companies are trying to become known names not only to be able to sell stock but in order to meet their actual business objectives. So it can be really valuable in that sense.

But it’s true that the more successful you become, the more critics and other people can scrutinize you. It's just like in a traditional IPO—often, as soon as a company files for an IPO, you see media editors or, say, people with intellectual property claims come out of the woodwork. Once you're seen as successful, you're also seen as an attractive target, and having the unicorn moniker helps to signal that you’re an attractive target.

Sean Ammirati, Tepper School of Business

I think this question comes back to the phenomenon of companies going public later than they did previously. Becoming a unicorn can certainly be a trigger for people to become more aware of these companies that stay private for a long time but have massive valuations. But I think relative to being a publicly traded company, it's a lot less scrutiny. So that's the scrutiny part of your question.

On the media attention point, I think it really depends on how much media attention they try to generate around gaining that valuation. Writing an article that company X is a unicorn is certainly one story that gets written, and every company has its own PR and media strategy. There are certain situations in which an entrepreneur uses that media attention to their advantage for recruiting, publicity, that kind of thing.

But I don't think that's universal either. Take a company like Palantir, which is certainly a unicorn—you don't see them using that for PR in the way some other unicorns do. When your business is selling to three-letter agencies, you probably don't want a lot of media attention. You still raise money at as high a valuation as you can, but you don't necessarily seek out media attention.

Finally, I would say that there should be public scrutiny on companies that are valued that high. You could argue that it’s one of the lost benefits of these companies going public earlier.

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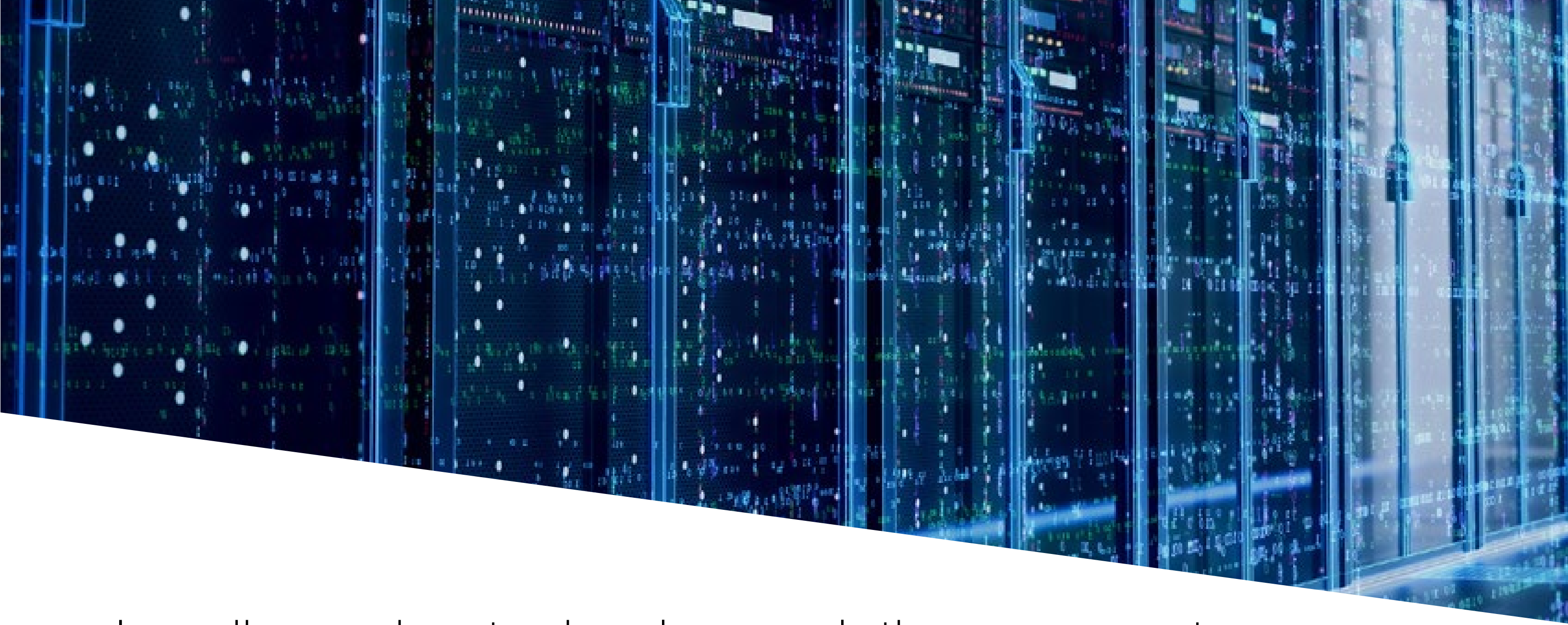

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