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The valuation gap between public and private markets





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In December 2019, the Wall Street Journal called 2019 the Year of IPO disappointment. Uber, Lyft, Slack, WeWork and Peloton were the most prominent examples. Uber, which had a private valuation of about \$76 billion just before its IPO in May, dropped to a market cap below \$50 billion before the end of the year. Lyft's market cap fell to \$11 billion, down from its last private valuation of about \$15 billion. WeWork was valued at \$47 billion in private markets. According to CNBC, public investors wanted to value the company as low as \$10 billion before cancelling their IPO (CNBC, This year's disappointing IPO class is causing a 'reckoning' among private investors, September 30, 2019). The first weeks of Peloton's life as a public company were also harsh, as investors that have seen the market debuts of Uber Technologies and Slack Technologies punished it for privileging growth over profits. It became clear that there is a large gap between private and public market opinion about appropriate business strategies and valuations. What are the reasons for the significant differences between private and public valuations? Can it be explained by inflated private valuations, different valuation methods or simply differences in the availability of information and consequently a mismatch in the expectation of future earnings potential? In the following paragraphs I will provide fundamental insights into the different approaches to valuation in public and private markets, how they compare and where their respective limitations may explain the discrepancies in prices. I will further use Peloton and WeWork to showcase that access to information and a thorough analysis of a company's business model are required to accurately determine a company's value.

It is becoming clear is that markets cannot value loss making technology start-ups for an IPO with the information they are provided. Well-functioning capital markets must have the ability to separate firms that are worthy of raising capital from those that are not. In the future, founders and their investors will have to consider creating an appropriate information base for valuation and evaluate their organizational structure and shareholder rights if they want to enter the IPO market.

STATUS QUO IN VALUATION

Business valuation is not straightforward. For young, fast-growing companies with little or no revenue or profits and less-than-certain futures, assigning a valuation is particularly difficult. As Aswath Damodaran mentioned in his book “The Dark Side of Valuation” published in 2018, the very characteristics of fast growing firms such as dynamic financials, a mix of public and private equity, disconnects between market value and operating data, a dependence on equity funding, and a short and volatile market history, all have consequences for both intrinsic as well as relative valuation approaches. The most common method for intrinsic valuation is the discounted cash flow method, while valuation metrics such as price- to-earnings (P/E) or Enterprise Value/EBITDA (EV/EBITDA) are commonly used in relative valuation.

However, both P/E or EV/EBITDA are not applicable when the operating result is negative or suitable benchmarks are missing. More importantly, these methods cannot account for the unique characteristics of each company in a fast-changing environment, and therefore provide little insights into the driver of valuation. Throughout the period of high growth, negative operating results and venture capital funding, the common metric used is EV/ Sales. But what determines whether a company should have a high or low EV/Sales multiple? What drives value companies? In his publications, Damodaran explains this metric in a more general manner by using the following formula:

$$\frac{\text{Value}}{\text{Sales}_0} = \text{After-tax Operating Margin} \times \left[\frac{(1-\text{RIR}_{\text{growth}}) (1+g) \times \left(1 - \frac{(1+g)^n}{(\text{WACC}-g)} \right)}{(\text{WACC}-g)} + \frac{(1-\text{RIR}_{\text{stable}}) (1+g)^n \times (1+g_n)}{(\text{WACC}-g_n) (\text{WACC}-g)} \right]$$

Where

g = Growth rate in after-tax operating income for the first n years

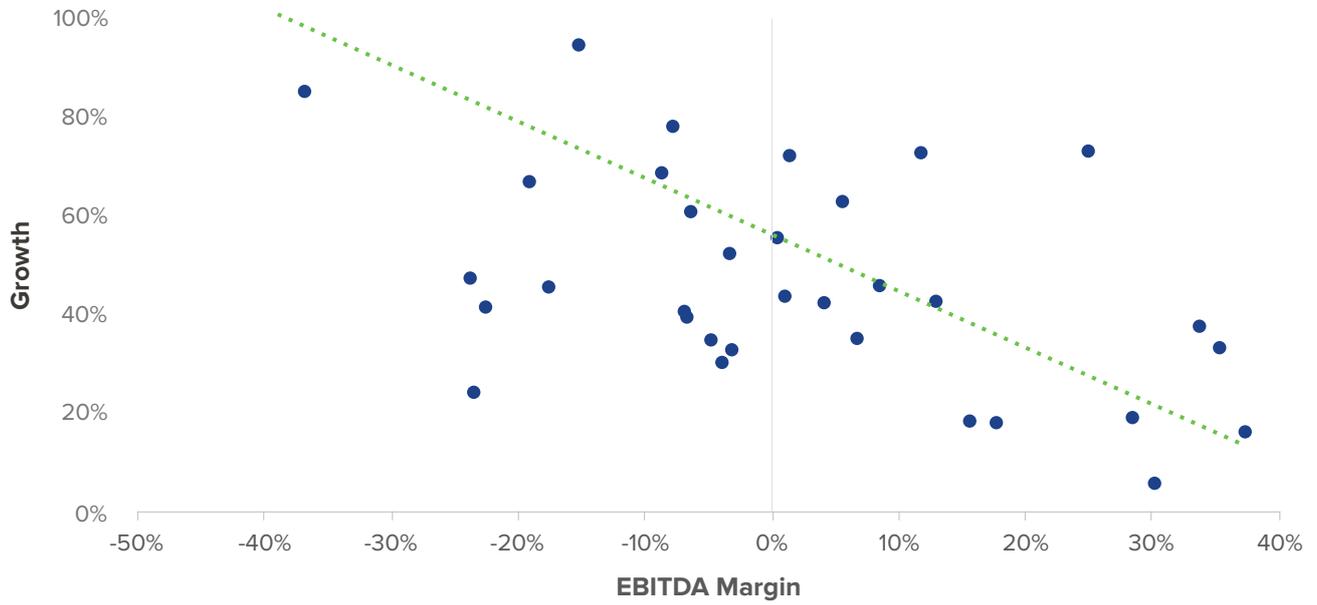
gn = Stable growth rate

RIR = Reinvestment Rate in growth as well as stable periods (Net Capex + Change in Non-Cash Working Capital)

WACC = Weighted average cost of capital

This formula indicates that the value of a company in comparison to its current year sales depends on the operating margin, tax rate, growth rate, cost of capital as well as the required reinvestment rate. While taxes and cost of capital do not differ significantly for two companies in the same industry, geography and stage, the growth rate, required reinvestment rate and operating margin most likely do. In practice all three are related and influence each other. For instance, the growth rate and a company’s operating margin are negatively correlated. As a result, companies that focus mainly on growth will have lower or even negative operating margins. At the end of 2018, Bain & Company analyzed 124 publicly traded software companies to show the relationship between growth and profit margin (Bain & Company, Hacking Software’s Rule of 40, Dec 2018).

The results showed a negative correlation. Our analysis yielded the same result as shown in the illustration below.



Sources: Capital IQ, Oaklins Calculations

Therefore, justifying a high valuation is usually not as easy as looking for above average results in all three metrics.

THE CORRELATION OF GROWTH AND PROFITABILITY

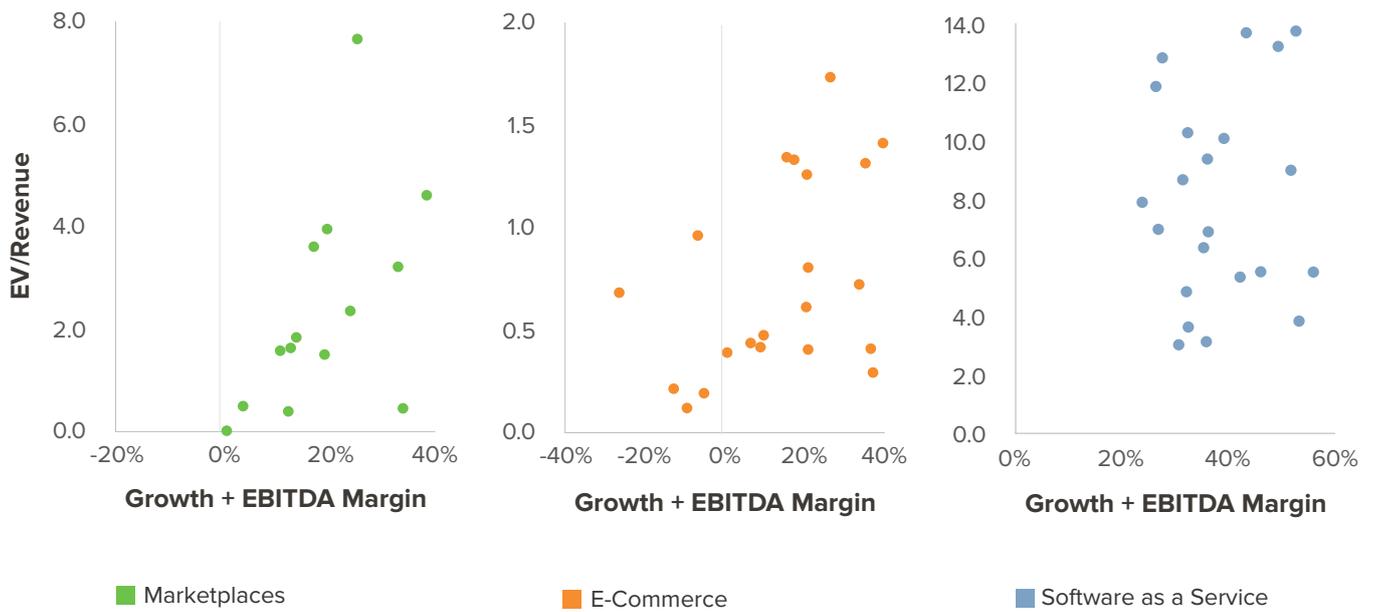
Goldman Sachs analyzed the comparability between the valuation of growth stocks to those in the S&P Global index. Their approach was to compare the Free Cash Flow Yield (FCF Yield), which is the EV/Sales multiple divided by the FCF Margin, of publicly traded Software as a Service companies to that of the average company in the S&P Global. To allow the comparison Goldman Sachs adjusted the marketing and sales spending of fast-growing companies to that of the average company in the S&P Global. They found that at the time, the average public Software as a Service company spent 37.1% of revenue on sales and marketing and had an average growth rate of 35%. They then adjusted the sales and marketing spending to that of a company with a 10% growth rate, which was the average growth rate of companies in the S&P Global index. The results show that, after adjusting for growth, the FCF Yield was comparable to that of the average company in the S&P Global. This indicates that above market average EV/Sales multiples of fast-growing businesses may not be unjustified.

Price/Earnings/Growth (PEG) Ratio

Another attempt to make companies with different growth rates more comparable, is based on the Price/Earnings/Growth (PEG) Ratio. The PEG ratio of 1 is sometimes said to represent a fair trade-off between the values of cost and the values of growth, indicating that a stock is reasonably valued given the expected growth. An analysis suggests that companies with PEG values between 0 and 1 may provide higher returns. However, the simplicity and convenience of calculating PEG leaves out several other important factors. Out of the many times-series and cross-sectional problems, the absolute company growth rate used in the PEG does not account for the overall growth rate of the economy, and thus an investor must compare a stock's PEG to average PEG's across its industry and the entire economy to get an accurate result. Furthermore, a low PEG in times of high growth in the entire economy may not be particularly impressive when compared to other stocks, and vice versa for high PEG's in periods of slow growth or recession.

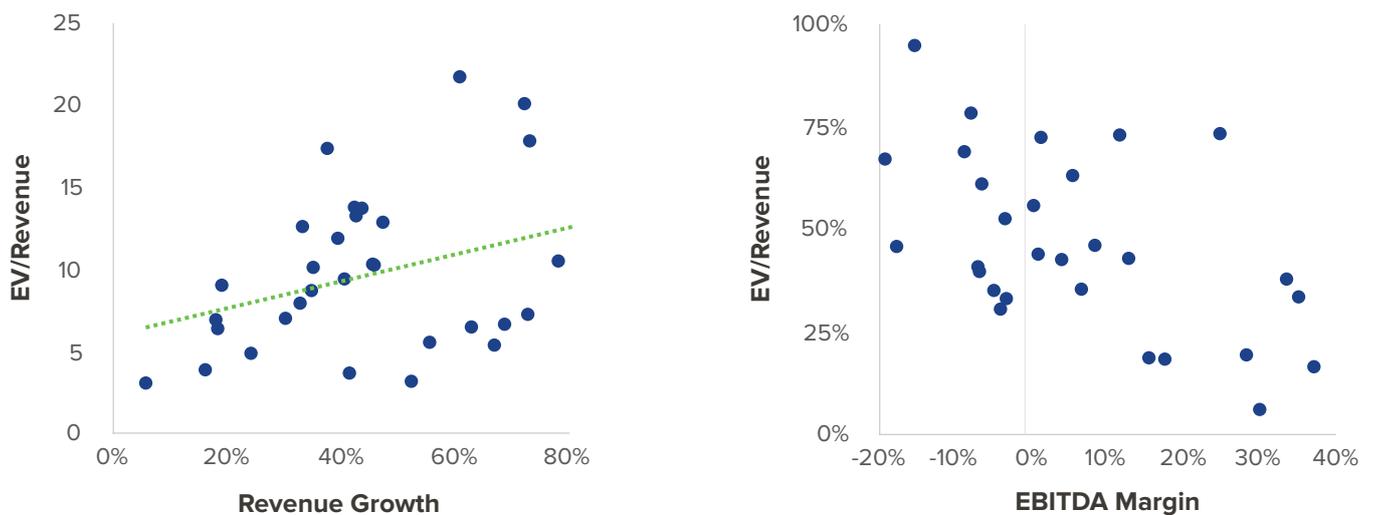
Rule of 40

A similar approach that is more often used in the venture capital world is to consider revenue growth as well as operating margin, by adding up the two and dividing the sum by the EV/Sales ratio. This approach is called the rule of 40, where as a rule of thumb $\% \text{ revenue growth} + \% \text{ operating margin} > 40\%$ is considered better than the norm. Similar to the PEG ratio the rule establishes a relationship between the growth rate and profitability of a business and defines a healthy operating zone for a growth stage business. Consequently, the Rule of 40% metric may be a solid first pass filter for a growth equity investor to determine whether a business might be a good investment candidate. In addition, running a regression analysis of publicly traded companies shows that high multiples are partly correlated with a good performance in this metric. However, running a regression of the sum of growth and operating margin as well as the EV/Sales multiple shows that there is not a correlation for all types of fast-growing businesses.



Sources: Capital IQ, Oaklins Calculations

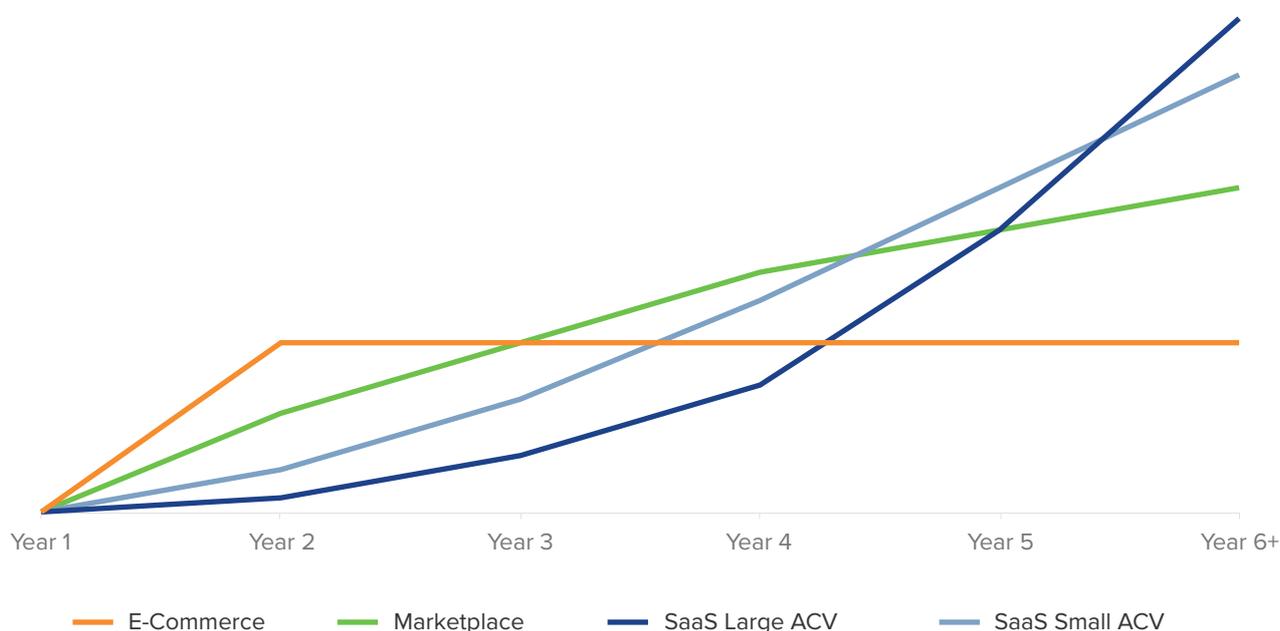
This shows that the rule of 40 has its limits. Running a regression against the two inputs growth and profitability separately shows that marketplaces and Software as a Service are mostly driven by growth, while profitability in e-commerce is of much more importance. The results of the individual regressions for Software as a Service businesses are shown below.



Sources: Capital IQ, Oaklins Calculations

This difference can be explained by two very important aspects: Firstly, e-commerce businesses have repeatedly failed to become profitable in the past. Consequently, the ones that do see a significant increase in price once proving that their business could reach profitability. Secondly, this can be explained by the type of revenues that are generated when acquiring a customer. While e-commerce businesses usually generate most of their revenue with a customer on the first purchase, there can be a significant delay in value creation with subscription-based businesses as well as marketplaces that have repetitive sales with one customer, such as AirBnB or Uber.

This is especially true for Software as a Service businesses that have very large average annual contract values (ACV), where most of the revenue that is generated comes from add-ons and upsells. However, their customers tend to stick around for longer, which gives them the upside over the long run. The exemplary value creation is shown in the illustration below.



Source: Oaklins Analysis

Consequently, most Software as a Service business models and marketplaces with repetitive sales are prone to be misinterpreted when using the commonly used metrics.

CONSIDERING OTHER OPTIONS

In the search for precise valuations, some well-established principles work fine, even for high-growth companies such as technology start-ups. Discounted-cash-flow valuation, although it is more commonly used for mature companies, works where other methods fail, since the core principles of economics and finance apply even with start-ups. However, the key challenge is to estimate future growth and margin development accurately.

In general, growth depends on how much is invested and how well it is invested. Therefore, commonly growth is estimated by looking at the reinvestment rate and return on capital (ROIC) of past periods. While this is true for profitable businesses, this approach is not applicable for companies that have negative operating results as it would lead to a negative growth and value.

To solve this problem, McKinsey as well as Damodaran suggest that the order and emphasis of the different components should differ from the traditional process for established companies: rather than starting with an analysis of the company's past performance, one should begin instead by examining the expected long-term development of the company's markets—and then work backwards. In particular, they suggest focussing on the potential size of the market and the company's market share as well as the level of return on capital the company might be able to earn. In addition, since long-term projections are highly uncertain, McKinsey adds that the value should include results for different probability-weighted scenarios of how the market might develop under different conditions (McKinsey, Valuing high-tech companies, February 22, 2016). Such techniques can help bound and quantify uncertainty, however, estimating the future market share of the company, which serves as a basis for the terminal value, can be very difficult to do. In fact, such an approach is very likely to fall apart in a due diligence process of a venture capital fund. A founder and CEO of a start-up is expected to be able to provide a solid foundation for any assumption regarding growth and profitability in the company's business plan. Analyzing customer data can help significantly in planning revenue and expenses more accurately but also to evaluate the performance and investment efficiency of business.

CUSTOMER CENTRIC VALUATION

Customer centric valuation involves analyzing the acquisition costs of a group of customers that was acquired in a certain timeframe, usually either a month or a year, as well as its returns over their lifetime. This customer cohort analysis is in fact at its core very similar to analyzing the return on capital and reinvestment rate, however, it is much more suitable for businesses that grow through investing a majority of their earnings in sales and marketing. In this case, the cost to acquire a customer can be regarded as the investment in a new asset and the returns over the customer's lifetime (minus the variable costs for each product and the costs of customer retention) are the returns of such asset.



Source: Oaklins Analysis

The illustrations show how comparable the approach is to an investment analysis of a new production line. Once the product or technology is developed and ready to be sold, this approach measures the true investment efficiency of a fast-growing company. Especially since most of the revenue of fast-growing companies is used to attract new customers.

The importance of customer retention

In addition, analyzing the customer retention shows how well the product is accepted by the end customer and how well the customer service operates, while above industry customer acquisition cost either show an inefficient sales or marketing strategy or that it requires above average effort to sell the product or service. In summary, this metrics provides an indication for future growth potential, customer adaption, investment efficiency as well as the quality of important management decisions when it comes to marketing, sales and customer support. Unsurprisingly, when performing regression analysis on a large dataset of transaction pricing of the fast-growing businesses, the relationship between this metric and the price of a business becomes obvious.

Using this information, it is possible to perform relative valuation with much more accuracy. In addition, it makes intrinsic valuation through a discounted cash-flow valuation much more reliable. The data on how much is spent to acquire each customer and how much each customer contributes before he stops buying my product or service, can be used to fairly accurately estimate the growth by simply taking the investment in sales and marketing in each month in the future and dividing it by the cost per customer acquisition, which have to be adjusted for international expansion and the future availability of good leads. Using the sum of revenues of the customer cohorts of each month then results in a projected income stream. Data from comparable publicly traded companies can help to estimate how costs will evolve in relation to revenue growth.

There are different approaches to calculate the cost of capital. In any case, the beta should be adjusted over time as the company matures. If possible, the development should be linked to certain milestones in the company's future development such as successfully introducing a second level management, which is proven to be the step that makes many technology companies fail. There is only one downside to this approach: It requires data that is often not available to public markets.

DILUTION PROTECTION CLAUSES AND EXTRAORDINARY CIRCUMSTANCES

Dilution protection clauses and voting rights in venture capital investment contracts can add to an inflated valuation. Dilution protection is the broad term for any contractual obligation that aims to preserve a shareholder's existing ownership percentage stake in a company. Particularly in early rounds dilution protection clauses are very common. Outlined in a company's funding and investment agreements, anti-dilution provisions protect venture capital investors by automatically issuing more shares to them if a company sells more shares at a lower price than the previous round, thereby letting them maintain their original ownership stake percentage. Therefore, dilution protection provisions will make a downward adjustment in the price per share very unattractive to all shareholders that not are protected by the provisions, as it would significantly dilute their ownership. As a result, once a high price per share is set in one round, it is usually not adjusted in future rounds, even if the price turns out to be unjustified. This can lead to an inflated valuation in later rounds and can explain some of the differences between private and public market valuations. It is oftentimes the lead venture investors' responsibility to benchmark the valuation while generating enough return for their own funds. This leading role sometimes forces investors to apply changes in voting rights and leadership during an investment round. Both can lead to a premium in valuation as the management team usually demands to be compensated to give up control. It is therefore crucial to consider how company's past development aligned with major changes in market and overall investor sentiment. In addition, each individual existing investors' assumed intention and investment strategy at the time of their investment have to be considered, as both could have influenced contract terms and valuations.

EVALUATING PROMINENT EXAMPLES

While the success of Software as a Service business models was proven multiple times, newer business models still have to gain investors trust. It is not only the market size and growth rate that led venture capital investors to invest large amounts in business models such as Uber and WeWork, it was also the performance in metrics that most public investors disregard. But even if public market investors attempted to evaluate the true potential of such businesses, they would have a hard time finding the information that could be used as a basis for an accurate intrinsic valuation or pricing.

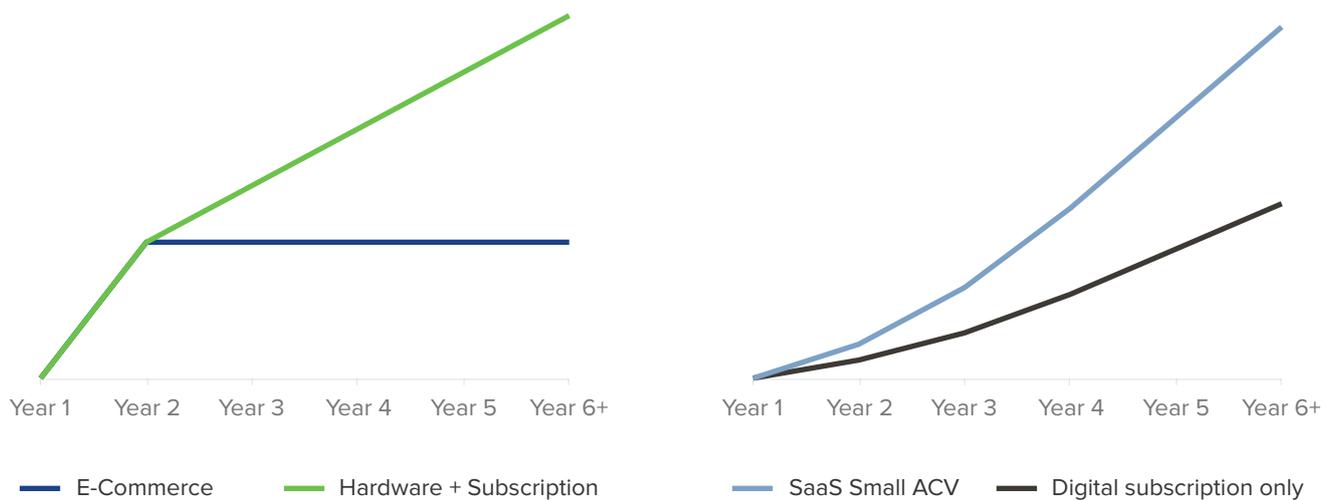
Peloton: E-commerce or subscription business?

Peloton is a good example of a company that is difficult to evaluate with the standard valuation approaches. To better understand Peloton, one has to first understand its business model. Its current product portfolio is made up of its bikes, treadmill as well as fitness and wellness subscription services. In its S-1 filing before its initial public offering (IPO), the company revealed impressive revenue figures. For FY2019, Peloton reported revenues of \$915 million, up 110 percent from \$435 million in FY2018. That is over 400 percent growth from the \$218.6 million in revenue it reported FY2017. The company reported over 1.4 million members. According to the filing, the company noted that it grew its Connected Fitness subscribers from 35,135 as of June 30, 2016, to 511,202 as of June 30, 2019, representing annualized growth of approximately 144.1 percent.

However, Peloton's growth has not come cheaply and therefore its net losses also increased over the same timeframe. Peloton posted a net loss of \$195.6 million in FY2019, which is a significant increase from a net loss of \$47.9 million in FY2018 and of \$71.1 million in FY2017. The company has gone from generating cash from its operations to sharply negative operating cash flow. In FY2018, the company's operating activities generated \$49.7 million in cash. In FY2019, that number changed to a negative \$108.6 million. While it is common for fast-growing companies to run deficits, such a significant increase in net losses is not attractive to any investor. The company's sales and marketing costs appear to be the cause, growing from \$151.4 million in FY2018 to \$324.0 million in its FY2019. The firm did report \$162.1 million in cash and equivalents along with \$216.0 million in marketable securities before its IPO. While that protects the company from bankruptcy for a while, at the current pace of cash consumption it will not last forever. This creates a risk of failure that has to be reflected in the price.

The first step in analyzing the performance and prospects of the company is to understand how valuable and sustainable its revenue stream really is. To do so, it is crucial to know how much of the revenue comes from selling bikes and treadmills and how much is recurring revenue from fitness and wellness subscription services, which cost the customer around \$39 a month. Digital subscribers pay \$19.49 a month just to access Peloton content on their smartphones. In other words, Peloton derives its revenue from one-time Hardware sales as well as subscription-based, recurring sales. That being said, the company is neither a pure e-commerce company, nor can it be compared to a software as a service business. It all depends on the company's revenue mix and gross margins. Looking at FY2019, Peloton's blended gross margin was about 42 percent. That is quite impressive, given the company's quick revenue growth. Hardware ("Connected Fitness Products") had gross margins of 43 percent, which is better than most investors expected. However, the company's recurring digital classes revenue ("Subscription") had margins of roughly 43 percent as well. That in turn is very low for a subscription business model. The filing therefore shows that Peloton is reliant on his hardware sales.

Going back to value creation, at first glance there are two types of customer groups: Hardware + Subscription and Digital Subscription only. For Hardware + Subscription customers one can assume that the initial sale of the exercise bike most likely results in break-even on a per customer level on day 1, with long-term potential due to the recurring revenue and the customer stickiness due to the large upfront investment. For the Digital Subscription customers one can assume a revenue generation comparable to a small ACV software as a service business, with the important downside of far below-average gross margins. The customer value curve of both customer groups are illustrated below.



Source: Oaklins Analysis

According to the filing the first group makes up for most of the revenue. If investors saw Peloton as a pure e-commerce business, the company would have been punished much harder for the expensive growth and therefore the steep decline in operating margin. If sales are presumed to be mostly recurring however, the revenue growth is much more sustainable and would lead to increasingly positive operating results in the coming years. And that is what happened in the months after its IPO. Since its IPO, the market priced Peloton between four and ten times revenue, which is more in the range of a Software as a Service business rather than a pure e-commerce business. In regard to the return on capital invested in customer growth, the market seems to believe that Peloton's investment decisions will yield a healthy return. In addition to investing in marketing and sales, the company has invested in improving its offering, which seems to have paid off as well. Metrics disclosed in the company's filing also indicate that Peloton users are becoming more engaged with the connected subscription service. In FY 2019, Peloton subscribers logged an average of 11.5 workouts per month, compared to an average of 7.5 workouts per month in FY2017. This could indicate that both Peloton's investments in cultivating a network of fitness instructors as well as their investment in new content have created value.

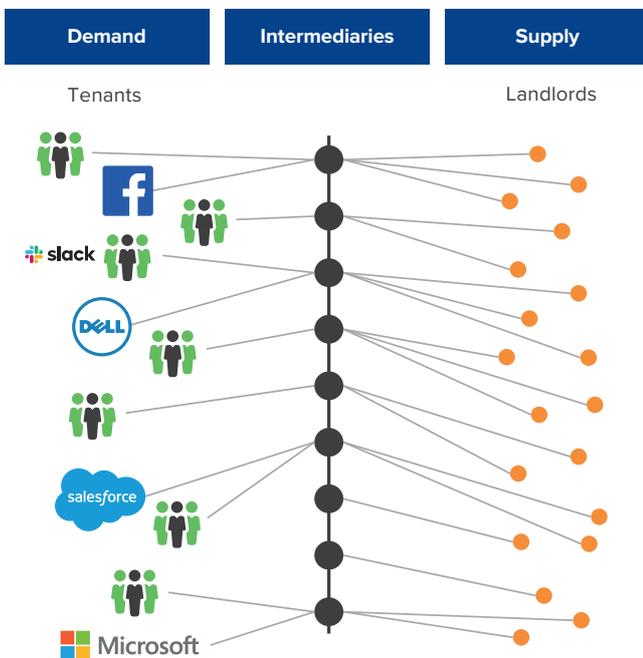
Both areas of investment will lead to revenue growth as well as a better performance in customer metrics in the short term, but also lead to a decline in profitability. In other words, for investors that look at earnings per share, dividend growth, EV/EBITDA or other regularly used metrics, Peloton might have created no measurable added value. However, for investors that focus on customer metrics and revenue growth, significant value has been created by Peloton's recent investments. Such confidence in their past investment decisions can explain the stocks recovery since its IPO. It is also clear, however, that the majority of investors have mixed opinions, resulting in significant volatility in the share prices.

Examining WeWork's business model and valuation

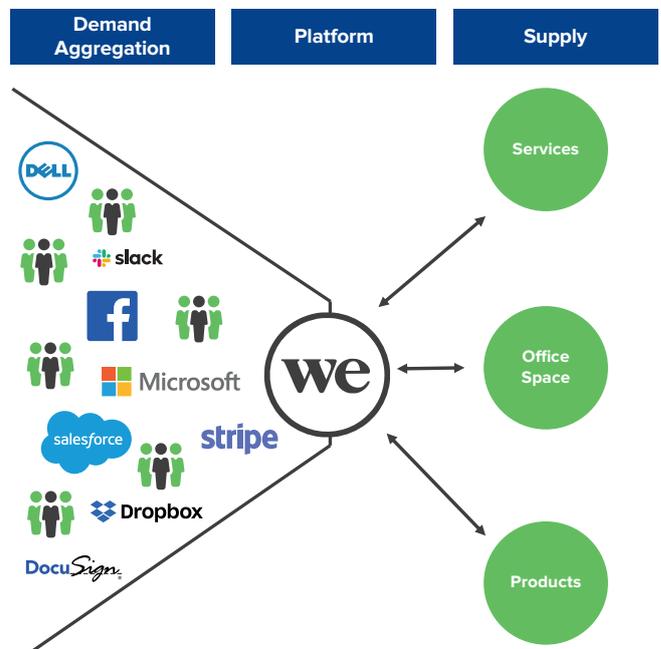
The most controversial and volatile of companies that planned to go public is WeWork. To even begin to understand WeWork's inflated valuation, one has to go back to 2015. Data from a report by CB Insights published in 2019 helps to understand the reasoning behind it. In 2015, WeWork showed a revenue growth of over 100 percent with a mix of small business and enterprise clients. According to the company's filings, WeWork opens two new locations on average on each day. Adding to the growth, the co-working market had grown significantly as well.

The illustration below shows how WeWork positioned itself as a demand aggregator, matching customers with goods and services that meet their needs. In other words, WeWork stated to be a company that solves problems of tenants as well as landlords. Driving the momentum are three key elements: space optimization, value-added services, and data.

Today's Fragmented Real Estate Industry



WeWork Aggregates Demand

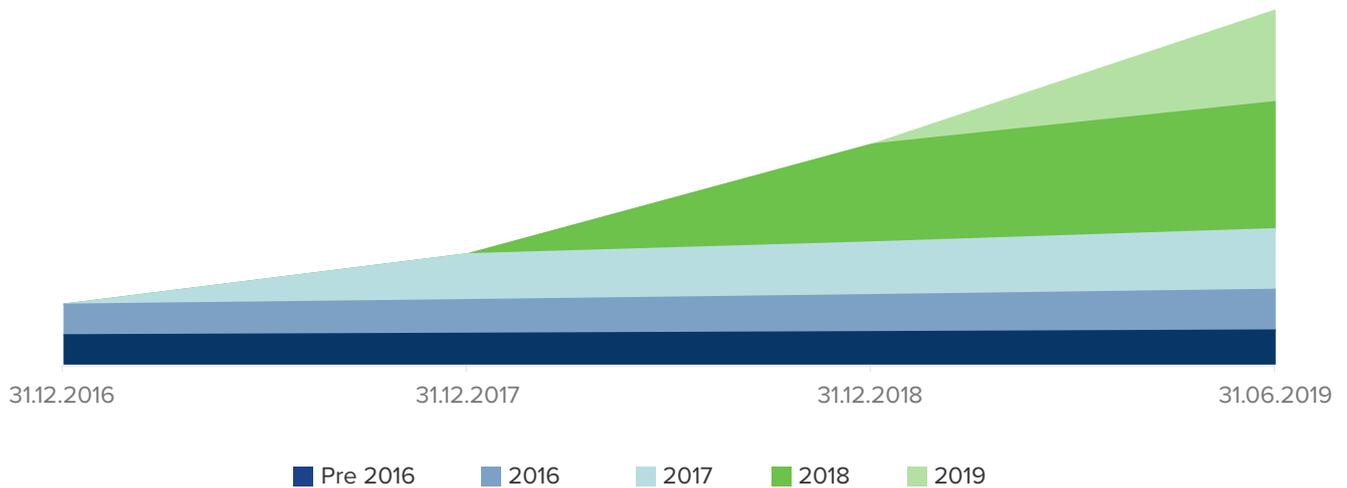


Sources: CB Insights, How Does WeWork Make Money?, 2019

The underlying business model is rent arbitrage. WeWork rents space in a building from a property manager in a high-density urban area, reconfigures it and adds a variety of worker-friendly value-added features. It then turns around and rents out offices and desks in the new-and-improved space to a mix of freelancers, solopreneurs, start-ups, as well as medium- and large-scale businesses. The key to all of this is that WeWork is able to fit more tenants in the same space as its competitors. In short, the company's business model looked superior and different from a regular co-working company. While some of it turned out to be unfounded, certain claims such as the community aspects were reflected in customer feedback. In addition to a good story, the company showed attractive customer metrics. Its acquisition costs per customer were at around \$250 and the contribution margin of the average customer was around \$225 per month, meaning it would break even on a per customer basis if they managed to keep the customer around for just two months. With an average lifetime of 11 months, they managed to reach a lifetime value of well over \$2,000. Their net revenue retention (i.e. the rate at which they lose revenue by losing customers minus the increase in revenue by expanding or upselling existing accounts) was even negative as they managed to gain more revenue through upsells and expansions than they lost through customer churn. To emphasize the importance of such a high customer retention, going back to the comparison with an additional machine in a production business is helpful. In case of a customer retention that is over 100 percent, that machine would not only run virtually to eternity, but it would also increase its output every single year. In reality of course, existing customer expansion will be limited when all desks are occupied. It therefore comes as no surprise that the best strategy seemed to be to grow their customer base as fast as possible.

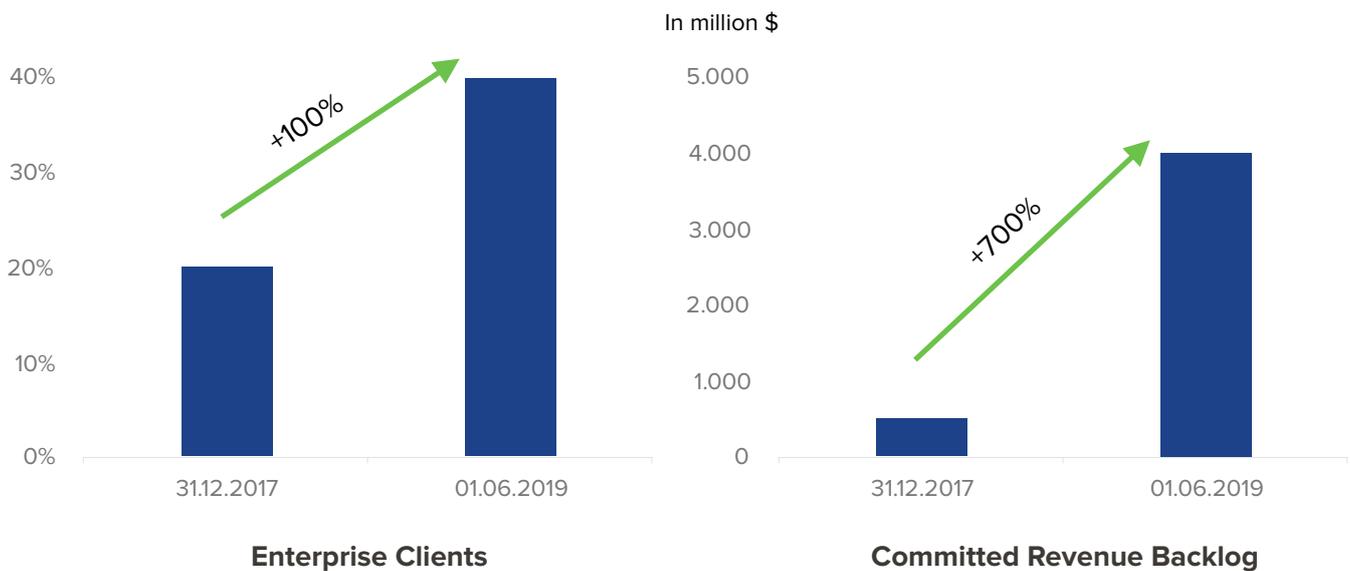
On a location level, WeWork had managed to become profitable for the first time in several prime locations. Data released by the company also shows that it lost less customers in cities where it had multiple locations as customers have more options and locations to choose from, giving even more incentive to open additional locations in cities with existing locations. However, the majority of their customer base was made up of small businesses with short term leases. Thus, in addition to gaining new customers, signing more enterprise customers to maximize the return and reduce risk at the same time was a priority. WeWork managed to do just that. While keeping their percentage growth steady at over 100 percent, their net revenue retention increased to 119 percent in 2018, putting WeWork in the top tier of firms, even in the software as a service sector.

The illustration below shows the customer cohort development (a group of customers that were acquired in a certain timeframe) until 2019. The data shows that newer customer cohorts performed even better than the old ones, again underlining how satisfied WeWork customers were with the offering, at least on paper.



Sources: CB Insights, How Does WeWork Make Money?, 2019

While their average customer acquisition costs increased to \$500, the average lifetime as well as contribution increased, lifting the average lifetime value per customer to over \$5,000. The illustrations below show that WeWork managed to increase the percentage of enterprise clients and had managed to increase its revenue backlog through signed leases significantly from 2017 to 2019.



Sources: CB Insights, How Does WeWork Make Money?, 2019

Just by looking at the raw data of its core business, WeWork looked like a healthy, fast-growing business with satisfied customers and a functioning business model. An article by CB Insights released in 2017 which was based on their analysis of WeWork's \$20 billion valuation at the time, stated that WeWork's valuation was high but not completely unjustified. In their analysis CB Insights had examined previous unicorn valuations including Dropbox, Airbnb, and Blue Apron and compared WeWork's valuation data against those posted by a few of its public-market counterparts. Specifically, they looked at Boston Properties, Vornado, and IWG plc (CB Insights, Room To Grow: Why WeWork's \$20B Valuation Isn't Crazy, August 2017).

In February 2020, Boston Property and Vornado traded at around 7.5 and 6.0 times revenue pre-crisis, respectively. In comparison to WeWork both have low or negative growth but attractive margins. IWG or Regus, the company often referred to when talking about WeWork, traded at a much lower valuation but only had a fraction of the margins. If WeWork had gone public at a targeted valuation between \$20 billion and \$30 billion as Bloomberg reported, which would have been close to their Series G valuation, its revenue multiple would have been in the range of Boston Property. However, much of the important information need in an accurate valuation is still unclear. For instance, analysts and investors do not know what occupancy rate the company needs to break-even and how long it takes for a location to do so. This is critical information when evaluating the risk of the company, especially since it has billions in long-term lease obligations to cover. Furthermore, with new competitors such as Knotel and Workplace Group entering the market, it is unclear where the unique selling point is and how the business model can be defended against its competition. Knotel recently raised \$400M on a \$1.6B valuation. With a forecasted revenue of \$350M in 2020 and 4 million square feet in office space, the company is currently about a tenth of the size of WeWork but a serious competitor, especially because they focus on enterprise customers, a customer segment which WeWork's switched its focus too as well.

Lastly, the company also has not released clear information on how crisis-resistant the business model is, despite the precedent of IWG's bankruptcy in the early 2000s, which happened due to long-term lease obligations and a reduction in demand for shared office space. With Knotel laying off 30 percent of its workforce and Convene, another office space company, laying off 150 employees in March and closing its 28 locations, this crisis-durability will be tested and analysts and investors will keep a close eye on WeWork (Forbes, Knotel, A WeWork Rival Valued At \$1.6 Billion, Lets Go Half Of Its Staff, March 2019). Today the signs are not very positive as Softbank released an earnings report that put WeWork's current value at \$2.9 billion post crisis, down from \$47 billion just over a year ago. However, the question remains whether the core of WeWork's business will outlast this crisis and whether it can recompensate investors such as Softbank in the long run.

Conclusion

There are two different worlds of valuation with public and private investors that clash each time when a company goes public. While both worlds use approaches to analyze the return on invested capital, the evaluation of recurring revenue and future growth potential still causes discrepancies in valuation after the IPO. To align the two worlds, metrics such as the PEG multiple and rule of 40 percent have been used more frequently. Even attempts to use metrics such as EV/Number of users have been presented. At the end of the day, however, the valuation depends not only on the number of users but on how much value is created or can be created with each user. Facebook has gone through that exact process. The company was publicly traded with a very large number of users but few ways to monetize them. It was only later that they found ways to do so which dramatically increased their valuation. This does not mean however, that even another social media company such as Twitter can be compared to Facebook solely based on the number of users. It is the potential value that makes the difference. If a company can show data on a customer lifetime value that far exceeds its competition, which can be due to technological advance or simply a new approach to the market, an investor can do the math as to what it means to invest a certain amount in customer acquisition. In addition, special rights that are given to private investors such as anti-dilution provisions, that are significantly protecting their downside risk, changes in management or voting rights, can influence the price paid in an investment round. However, these contractual terms are usually kept confidential and it is not disclosed in detail when a premium had to be paid to get the management to agree to give up control. This is problematic as both can drive up the price significantly. A key success factor of companies which are about to go public as well as their investors could therefore be improving their communication with the public markets before an IPO.

Without the access to detailed information on extraordinary circumstances and data on customer value calculations, a public market investor will not be able to accurately evaluate the business, resulting in strong concerns that a given valuation before the IPO has a strong and profound foundation.

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