AMERICAN REALTY ADVISORS
INSTITUTIONAL CAPITAL MANAGEMENT

ARA Research in Brief

An Uber Lyft to the Economy:

Looking Beyond Today's IPOs for Tech's Role in the Economy

The rate of growth and innovation in tech is unrivaled compared to the other sectors in the U.S. economy. The tech sector generates significantly more GDP output per employee than the broader economy, and this has resulted in above average rates of highly-paid employment and wage growth. These companies also tend to have higher profit margins and this allows them to pay the rents associated with higher quality buildings demanded by the highly educated employee base on which the industry depends. Due to this and the greater supply constraints often associated with markets having higher tech sector concentration levels, returns in markets with elevated tech sector concentration levels tend to be higher.

Interim Volatility

While we favor the tech sector in the long-run because of its superior value creation, growth, and resulting demand drivers for real estate, it is a more volatile sector. 2019 is set up to be a pivotal year for tech IPO's with many widely recognized tech newcomers in the process of going public, and, while these companies demonstrate great growth potential, they also have profitability challenges, raising concerns of another 2000 tech-wreck in the making.

We believe the sector is better positioned today than 20 years ago to deal with potential volatility. The near-term profitability issues these companies face isn't indicative of the overall health of the industry, but rather tends to be magnified out of proportion by the popular media. Examples of this include Tesla, which has had a high-profile string of successes and failures recently, and Uber and Lyft.

1. Can Tesla Find the Road to Profitability?

Tesla certainly has had an up and down past six months. The recent drama seemingly started with a tweet from Elon Musk on August 7th, 2018 that claimed he was considering taking Tesla private at $420 a share and that he had funding secured, a claim quickly determined to be unsubstantiated[1]. At the time, it seemed that the mistake was relatively minor and would have few lasting consequences, but it ultimately prompted a fraud charge from the SEC. The company came under even more press scrutiny than usual in the following months, with broad publicity of its wins and struggles as a public tech company.

The good news is that Model 3 initially appears to have had a successful debut as sales of the car totaled 32% of all small and mid-size luxury car sales in December 2018[2], and overall the company sold roughly 250,000 cars in the same year. The bad news is that, despite the record number of sales, Tesla failed to turn a profit in

2018. The company also made a scheduled \$920 million bond payment[3], something that would typically be more mundane for another \$50 billion company, but cash has been tight, and Musk himself said that Tesla was, at one point, "single digit weeks from dying."[4] The company has also laid-off roughly 8% of its staff since the end of February[5], announced it was closing most stores only to back-track[6], and raised the price of three car models.[7]

Weakness in Tesla by itself would have a very limited impact on broader real estate fundamentals in the markets where it operates but a big growth name getting into trouble could damage sentiment and create the perception that things are worse than their underlying fundamentals.

2. Cheers or Jeers for Uber and Lyft from Public Markets?

Uber and Lyft planned IPOs in 2019, with Lyft jumping first in late March 2019. While Uber is the larger and better funded of the two, both have a very similar strategic focus and underlying business model, and both are in similar financial situations. They are growing rapidly, but costs continue to exceed revenue, and although cost growth is slowing so is revenue growth. It isn't clear either company is on the path to profitability anytime soon with Uber losing \$1.07 billion in Q3 2018[8] and Lyft posting a loss of \$911 million in 2018[9]. In Lyft's prospectus, the company warned potential future investors it may never be profitable, "We have a history of net losses and we may not be able to achieve or maintain profitability in the future."[10] Blue Apron, the food subscription company, made a very similar claim when it filed its pre-IPO prospectus[11]. At the time of this writing Blue Apron's stock is down 89.9% since its IPO.

Company	IPO Year	Loss 12 Months Leading to IPO ($ Millions)	Change in Price Since IPO
Lyft	2019*	-$911	-25%
Groupon	2011	-$687	-83%
Snap	2017	-$515	-37%
Moderna	2018	-$299	-17%
Vonage Holdings	2006	-$275	-44%
Zayo Group	2014	-$263	49%
Redfin	2017	-$245	29%
Pure Storage	2015	-$201	20%

*Announced
Sources: Dow Jones Venture, S&P Global Market Intelligence

Putting it All Together

A skeptical reader might wonder how this is different than the high-flying IPO environment of the previous Tech Bubble, but today's environment is different for a variety of reasons. Chief is that price-to-equity ratios, while elevated relative to long run norms, are well below early 2000s highs (175 vs. 25.8). Additionally, venture capital investment is a smaller part of the U.S. economy today (0.5% vs. 1.4%), and tech firms in general are larger and more profitable than they were in the early 2000s. Today's tech sector has well-established household names that carry A corporate credit ratings or better including Google, Amazon, Microsoft, Cisco, and Apple[12] that make up the bulk of total stock market value. Five are among the ten biggest companies in the U.S. with a market cap totaling $4.1 trillion for those five, up from $1.2 trillion in 2000.

Why It's Different - Tech Sector at a Glance

	2000	2018
Nasdaq 100 TTM P/E Ratio	175	25.8
VC Funding (%) of GDP	1.37%	0.54%
Peak (%) Early Stage VC Funding	33.3%	26.1%
Market Cap of Tech Companies in Top 10 U.S. Companies	$1.2T (in 2018 dollars)	$4.1T

Sources: Nasdaq, Bloomberg, PwC MoneyTree, Fidelity Investments, BLS, Financial Times, Finviz

The tech sector will continue to be the growth engine of the economy and the combination of above average employment and wage growth in the industry has positive spillover effects for most property types. We believe that growth in fundamentals will be the fastest in markets with an elevated presence of tech firms and an educated workforce. While the tech sector can be more volatile in the interim than the economy as a whole, the negative impacts of the periods of short-term volatility can be moderated while preserving the long-term benefits of the sectors superior growth trajectory. When overweighting these markets, we focus on high-quality properties that are leased to credit tenants with long-term leases in place. This provides the durable income streams necessary to modulate the interim periods of volatility.

Footnotes

[1] https://www.reuters.com/article/us-tesla-musk-factbox/factbox-funding-secured-sec-gives-timeline-surrounding-tweet-from-teslas-musk-idUSKCN1M8139
[2] https://cleantechnica.com/2019/01/04/tesla-model-3-sales-32-of-all-small-midsize-luxury-car-sales-in-december-usa/
[3] https://www.cnbc.com/2019/01/30/tesla-says-it-has-enough-cash-to-settle-its-920-million-bond-payment.html
[4] https://www.marketwatch.com/story/tesla-was-weeks-from-dying-earlier-this-year-elon-musk-says-2018-11-25
[5] https://www.businessinsider.com/tesla-layoffs-february-march-report-2019-3
[6] https://www.chainstoreage.com/store-spaces/tesla-not-closing-most-of-its-stores-after-all/
[7] https://www.usatoday.com/story/money/cars/2019/03/11/tesla-stores-tesla-price-cut/3127766002/
[8] https://www.reuters.com/article/us-uber-ipo/uber-makes-confidential-filing-for-long-awaited-ipo-idUSKBN1O702G
[9] https://www.reuters.com/article/us-lyft-ipo-filing/lyfts-ipo-filing-shows-surging-revenue-widening-losses-idUSKCN1QI51K
[10] https://www.nytimes.com/2019/03/01/technology/lyft-ipo-filing.html
[11] https://ftalphaville.ft.com/2017/06/29/2190739/we-have-a-history-of-losses-and-we-may-be-unable-to-achieve-or-sustain-profitability/
[12] Credit rating data from Morningstar

Forward-Looking Statements

This newsletter contains forward-looking statements within the meaning of federal securities laws. Forward-looking statements are statements that do not represent historical facts and are based on our beliefs, assumptions made by us, and information currently available to us. Forward-looking statements in this newsletter are based on our current expectations as of the date of this newsletter, which could change or not materialize as expected. Actual results may differ materially due to a variety of uncertainties and risk factors. Except as required by law, ARA assumes no obligation to update any such forward-looking statements.

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