Danger Zone: IPO Investors

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and Marketwatch.com

Warning of tech-bubble-like overvaluation in the IPO market, we've previously put recent IPO companies Wayfair, Box, and GoDaddy in the Danger Zone. This week we're turning the tables and putting IPO investors in the Danger Zone as we reveal many of the hidden dangers of IPO investing today.

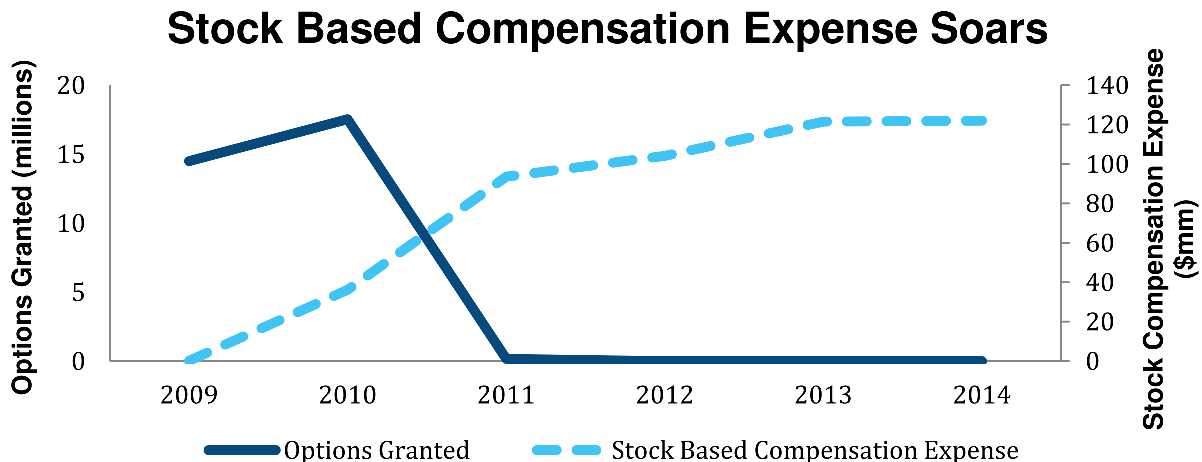
Accounting Loopholes for Pre-IPO Companies

Most investors do not know that accounting rules are different for pre-IPO companies than for post-IPO companies.

Possibly the biggest difference is in the treatment of employee stock compensation, which creates a loophole that enables companies to drastically understate option expense and overstate earnings in their pre-IPO filings. Because there is not yet an "official" value for the company's shares, options grants are recorded at highly understated values, especially relative to IPO prices. For instance, Guidewire (GWRE) reported option expense of $6,680,000 in 2011. One year later, GWRE reported option expense of $18,258,000 after the company went public despite the number of options granted halving over the same time.

Proof of the this misleading practice manifests when, immediately following the IPO, stock compensation expense shoots off the chart as the company has to eventually recognize the more appropriate cost for the pre-IPO stock compensation. As can be seen in Figure 1, Groupon, a previous Danger Zone stock, had stock based compensation expense increase from only $115,000 in 2009, two years before its IPO to $93,000,000 in 2011 after going public. The irony here is that the number of options granted declined precipitously from 14,500,000 in 2009 to 158,000 in 2011. Meanwhile the reported accounting option expense skyrocketed.

Figure 1: Groupon Stock Based Compensation Post IPO



Sources: New Constructs, LLC and company filings

Limited And Conflicted Disclosure Is A Red Flag

Under the JOBS Act, any company with gross revenues below $1 billion is subject to less stringent reporting requirements. "Emerging growth" companies receive the following disclosure "benefits":

1. Underwriters participating in the IPO are allowed to publish research reports and make public appearances regarding the company. Let us remind you that investment banks have a serious conflict of interest when it comes to research in general, and specifically IPO's.
    a. In 2003, 10 Wall Street banks were fined $875 million for maintaining inappropriate influence over research analysts during 1999-2001.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

b. In 2012, Morgan Stanley and other underwriters profited nicely as Facebook (FB) dropped on IPO day.

c. In 2014, 10 Wall Street banks were fined a total of $43.5 million for offering favorable coverage to Toys R Us in hopes of underwriting its IPO.

2. Following the IPO, the newly public company is not required to have an independent accounting firm audit the effectiveness of the company's internal control over financial reporting.
3. Only two years of audited financial statements (compared to three for other companies) are required to be provided to investors.
4. Only scaled executive compensation information for three executives is required and a compensation discussion & analysis is not necessary.
5. The exemption from detailed compensation disclosure continues post-IPO and the newly public company is not required to hold "say-on-pay" voting for their executive compensation arrangements.

These benefits provided to smaller companies are not benefits to investors by any stretch. Rather, they look more like benefits to underwriters. We thought reporting rules were to help investors not underwriters.

"Adjusted Earnings" Paint False Picture

We've previously put non-GAAP earnings in the Danger Zone, and, in a throwback to the tech-bubble days, we're now seeing the practice of marketing non-GAAP results become more prevalent with IPO companies. GAAP earnings are not perfect, (see the 30+ adjustments we make to GAAP earnings here), and non-GAAP or pro-forma moves the focus even farther away from the cash truth. In 2014, according to Audit Analytics, 40 companies went public reporting losses under traditional accounting rules but recording profits using their own adjusted measures, which represented 19% of all U.S. IPO's for the year. The following are just a few examples of adjusted earnings portraying companies in the best light possible.

In 2011, during the run-up to Groupon going public, the SEC requested the company remove an adjusted measurement, which Groupon called "adjusted consolidated segment operating income," or ASCOI from its S-1. This adjusted measurement of a GAAP approved metric, consolidated segment operating income, removed acquisition costs, stock based compensation, and most importantly, subscriber acquisition expenses. Groupon's CEO at the time defended the removal of marketing expenses related to subscriber growth because "they are an up-front investment to acquire new subscribers that we expect to end when this period of rapid expansion concludes." Not surprising, ASCOI showed Groupon earning $81.6 million in the first quarter of 2011 while GAAP net income showed a loss of $117 million.

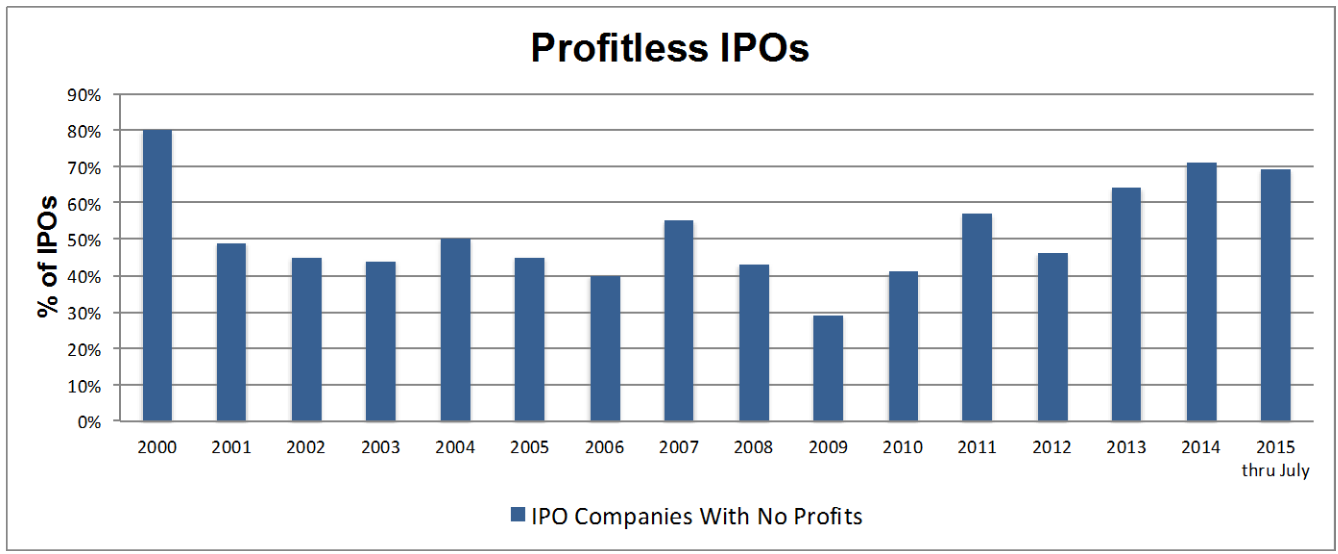
We've previously written about the issues at Twitter and their use of adjusted EBITDA during their IPO process should have made investors think twice. Twitter reported a GAAP loss of $79 million in 2012 compared to an adjusted EBITDA of $21 million. Aside from depreciation and amortization, Twitter chose to present its adjusted EBITDA after the removal of over $25 million in stock based compensation expense. The company essentially removed the cost of paying its employees to appear profitable. Unfortunately for Twitter and early investors, business doesn't work that way and Twitter's share price has recently reached all time lows.

In early 2014, Zoe's Kitchen (ZOES) received a request from the SEC much like that of Groupon above. In its S-1, Zoe's featured its "adjusted EBITDA" in the MD&A section before providing earnings that followed standard accounting rules. Under this adjusted EBITDA, Zoe's reported a profit of nearly $11 million in 2013 despite a GAAP net loss of nearly $4 million. In calculating adjusted EBITDA, Zoe's removed equity based compensation, management and consulting fees, and expenses related to opening new restaurants. Much like the two examples above, Zoe's was removing significant costs of doing business to appear profitable.

IPO Investors Don't Care About Profits

In what may be the most saddening theme of all, it's becoming obvious that most IPO investors don't care whether new IPO's even make GAAP or non-GAAP profit. As can be seen in Figure 2 below, over the past three years, we have witnessed over 60% of all IPO's involving companies with no GAAP profits. The last time levels were this high was back in 2000, and we all remember what happened that year.

Figure 2: Percentage of IPOs Without Profits



Sources: Prof. Jay Ritter, University of Florida, New Constructs, LLC and company filings

IPO investors need to be careful. IPOs are one of Wall Street's most profitable activities. There's no substitute for good diligence and informed investment decisions.

New Constructs is now covering all major IPOs. We plan to publish a special report on Planet Fitness (PLNT) tomorrow. Look for more reports on IPOs from us in the future.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.
Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

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