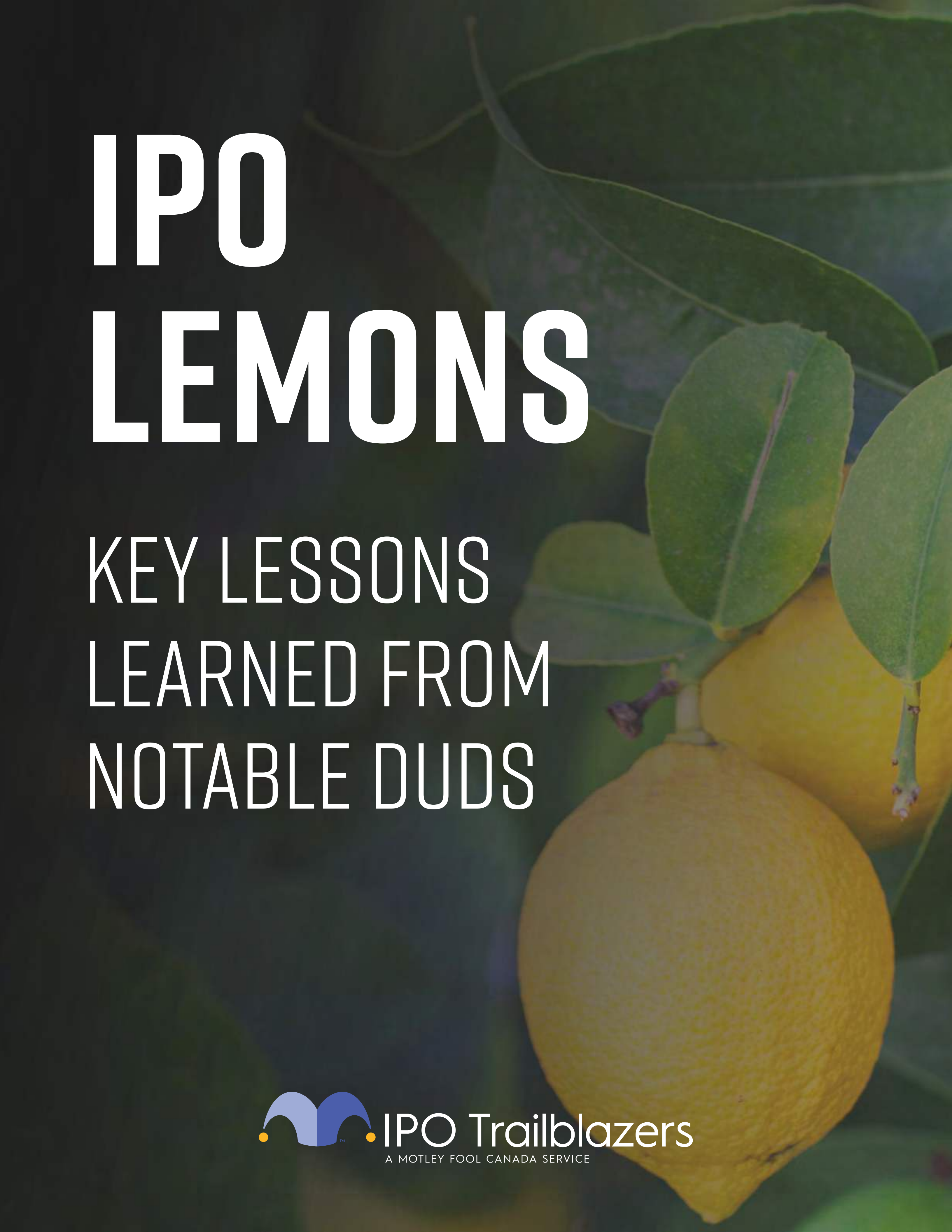

IPO LEMONS

KEY LESSONS LEARNED FROM NOTABLE DUDS

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IPO LEMONS

Key lessons learned from notable IPO duds

Initial public offerings give investors a chance to get in on the ground floor of investing opportunities in some of the most exciting, innovative, and fastest-growing businesses around. IPOs also come with huge amounts of hype and fanfare, and that can make it difficult to make unemotional investment decisions about whether to buy newly public stocks. For every IPO stock that jumps out of the gate and keeps on consistently climbing, you can find several IPO duds that quickly flame out, lose their upward momentum, and eventually fall out of favor — producing big losses for those who fall prey to their charms.

Fortunately, we've discovered that there are signs you can look for to tell whether a particular IPO is worth pursuing. When you look at successful IPOs, you can see some traits they all tend to have in common. And failed IPOs share some common characteristics you can see as warning signs. By recognizing these patterns, you can learn which IPOs deserve your attention and which ones you should avoid. Below, we'll highlight five lessons we've learned from the most notable duds from the IPO universe.

LESSON 1

Look at the ownership structure to see if the company's interests are aligned with yours

You can tell a lot about an initial public offering by looking at who already owns shares of the company. When you buy shares of an IPO, you're essentially becoming a partner in the business with your fellow shareholders, so making sure that your interests are aligned with those of the people you'll be working with is critical.

Many of our most successful investments have come from businesses with visionary founders who are passionate about what their companies are doing. Those founders remain heavily involved in the day-to-day operations of the business, inspiring everyone associated with the business toward achieving greatness. It's especially promising when these founders have held onto a significant stake in their companies, because then we know that our financial success as shareholders is completely aligned with their financial success in building up their companies to meet their full potential as game changers in their industries.

Conversely, companies of which venture capital firms own the vast majority of outstanding shares and leave founders with little or no stock ownership raise red flags. Very few VC investors share the ultimate long-term vision of their companies' founders to create lasting businesses that can shape the future, instead having much shorter-term aspirations for producing share-price gains and then selling out to free up capital for their next big investment. The strategies that VC-controlled companies use toward these ends are often badly misaligned with the goals long-term investors in a company have. Even when a company's founders are still associated with the business, they often find that their VC partners have very different ideas from theirs about the best way to move forward. The resulting frustration can create internal dissension that can hurt productivity, morale, and ultimately financial performance.

You can see a painful example of how this can play out in **The Container Store Group** [NYSE: TCS]. The organizational goods retailer impressed us with its service-focused conscious capitalism model, and co-founder and former CEO Kip Tindell's success in growing The Container Store as a privately held company inspired us to want to go along for the ride. Yet at the time of the IPO in 2013, a single private equity firm owned roughly 60% of the company. Eventually, Tindell moved off as CEO and then retired as chairman, moves that changed the investment thesis that excited us about buying into The Container Store shortly after its IPO. Ultimately, we ended up selling shares at a significant loss.

A more recent example is **BJ's Wholesale** [NYSE: BJ], the membership-only warehouse club chain, which returned to the public markets in June 2018 with heavy venture capital investment that ultimately led to a tremendous amount of downward pressure on the stock when many cashed out. All in all, it's wise to do your due diligence about who owns the shares and who is making the decisions and to understand just how aligned they are with long-term shareholder interests.

LESSON 2

Watch whether IPO proceeds go toward investing in the business — or cashing out early investors

IPOs give new investors a chance to participate in great investment opportunities, and we always appreciate when promising young companies decide to invite us to invest in their shares. But it's important to remember that the IPO process isn't meant just to do investors a favor. Companies also have something to gain from going public, and understanding their motivations can tell you a lot about how those companies see their future prospects playing out.

In our experience, the best reason for doing an IPO is when a company needs substantial amounts of capital to expand its business in ways that it otherwise wouldn't be able to pursue as quickly. For instance, an upstart company might have a promising idea, and with venture capital funding, it might be able to do research and develop the concept in the form of a prototype in order to prove that it has real prospects for long-term success. However, it might take far more investment capital to build out full-scale production capacity, market the concept to customers, and provide ongoing support to clients — all the while continuing to do further research and development toward the next big innovation in the business. Getting equity capital in an IPO avoids the dangers of debt financing and brings on a whole new set of investors to promote the company's efforts.

IPOs that use their proceeds for other purposes are often much less inspiring. Traditionally, venture capital and private equity investors have used IPOs as their opportunity for cashing out, essentially signaling that they believe they've made as much profit from their early positions in the company as they expect to make. When company founders also use IPOs to sell off big portions of their holdings, it's especially disconcerting, as it suggests that the people responsible for creating the business are no longer fully engaged and perhaps are already looking forward to pursuing other ideas elsewhere.

We saw that phenomenon at social media gaming pioneer **Zynga** [NASDAQ: ZNGA], which saw its stock sink rapidly after its late-2011 IPO. Hype from its popular *FarmVille* and *Words With Friends* games drove interest in the offering, but it soon became apparent that tensions between Zynga and **Facebook** [NASDAQ: FB] — where Zynga's games were most successful — left the video game company vulnerable to competition. Contributing to the decline was the fact that selling insider shareholders sold 15 million shares in the IPO and almost 43 million shares just a few months afterward.

Similarly, after the IPO of plant-based meat alternative pioneer **Beyond Meat** [NASDAQ: BYND], shares skyrocketed, only to fall back significantly once lock-up provisions expired and insider shareholders were able to sell their stock on the public market.

LESSON 3

Avoid the hype and do your own due diligence

Initial public offerings always get a lot of attention, and many companies immediately have many investors excited about their prospects as soon as they announce their IPOs. Moreover, in certain parts of the market, investors are willing to pay what appear to be ridiculously expensive valuations just for the chance to get in on a ground-floor opportunity in a particularly hot industry. If you just decide to buy shares of a hot IPO and hope things go well, you're setting yourself up for disappointment.

Smart investment decisions take the emotion out of investing, and as difficult as it can be with a popular IPO, it's crucial to take hype out of the equation and look rationally at the business prospects of a soon-to-be public company. That means looking at all the registration statements and other information that companies are required to disclose through the U.S. Securities and Exchange Commission before doing an IPO and keeping up to date on any changes or amendments that those companies file along the way. It also means looking at how potential competitors have fared, especially if they're already publicly traded, and understanding what will distinguish the IPO candidate from the other players in the field.

Sometimes doing your due diligence will lead you to decide that buying shares in or shortly after an IPO is the best way to participate in a company's long-term growth, regardless of the risks involved. Other times, you might conclude that waiting until the hype dies down and cold reality sets in is likely to give you a better chance to make a more profitable investment.

Investors have seen that wait-and-see dynamic play out well with **CrowdStrike Holdings** [NASDAQ: CRWD]. We quickly identified CrowdStrike as a potentially successful player in the red-hot cybersecurity arena, but we were concerned with just how quickly the stock's valuation climbed following its IPO. We initiated a small starter position, but then when the stock price fell back to earth, we jumped in with a much larger investment and identified CrowdStrike as one of our highest-conviction Firestarters — promoting it to full-fledged Trailblazer status at a much better time for investors.

Another example is Beyond Meat, the plant-based burger company that many investors flocked to, driving the share price and valuation to nosebleed levels and even beyond the total addressable market. That's enough to keep us comfortably on the sidelines, and there's nothing wrong with waiting for the hype associated with IPOs to level off before diving in with an investment.

LESSON 4

Avoid IPOs with questions about the sustainability of their business models or competitive edges

The best IPO candidates take a novel approach toward solving a problem or addressing the need of a large potential customer base. Often, these young upstarts are challenging much larger existing companies in their industry, hoping to disrupt the way business has traditionally been done and improve the customer experience.

To be successful, though, these companies have to do more than just come up with a good idea. They also have to execute on that idea well, creating business models that will help them grow. The rise in popularity of subscription-based businesses is one sign of how important this aspect is, as the recurring revenue from companies that see subscription growth can go toward further promoting and building up the scope of the business to bring even more new customers on board.

In addition, newly public businesses have to demonstrate that they have lasting competitive edges. Hype can give a business some short-term momentum, but eventually, the fundamentals of the business have to prove it can stand up to competitive threats. If they don't, the numbers will eventually reflect it, and investors will quickly lose confidence in the company's ability to stay on a sustained growth trajectory.

Sometimes companies get bad news on the competitive front even before they can complete the initial public offering process. That happened to meal-kit delivery pioneer **Blue Apron Holdings** [NYSE: APRN], which had originally gotten a lot of interest in the run-up to its 2017 IPO based on the early success of its subscription-based service. When **Amazon** [NASDAQ: AMZN] announced that it would purchase premium grocery store chain Whole Foods Market, would-be Blue Apron investors got cold feet, fearing that the e-commerce giant would find a better way to deliver food to customers. In the end, Blue Apron had to cut its IPO price from an initial range of $15 to $17 to a much lower $10 to $11 range. Since then, the meal-kit company has struggled, with the stock price still lower even after a 1-for-15 reverse split.

LESSON 5

Recognize that first-day returns can be deceiving

One of the strangest aspects of IPOs is how much attention goes into how the stock price behaves on its first day of trading. Investors love to see share prices jump out of the gate, even though that suggests that the company didn't get nearly as much cash in exchange for its shares as it could have. Conversely, they hate to see a stock that essentially goes nowhere or falls on the first day, even if that indicates that the company received full value for the stock it offered in its IPO.

The cold, hard truth is that IPO investing can be a tough nut to crack. Our study of results showed that less than half of new issues make money over the long run, and the median performance is a 38% loss. Furthermore, less than 5% have historically generated 100% of all economic returns in IPOs over the year. It's especially difficult to make money from IPOs when the market's valuation is high and several companies are trying to go public all at once. Moreover, there's no real correlation between how well or poorly a new IPO does on its first day of trading and whether it goes on to succeed or fail.

Long-term investors understand that it takes years for the infusion of cash that a company receives in an IPO to have its full effect on its business prospects over the long haul. So whatever the stock price does in a single day reflects something completely different — and ultimately irrelevant.

Facebook's opening experience is a great example of this. The social media giant's stock initially priced at $38 per share, and it quickly jumped to $45 per share early on its first day of trading. Yet the opening rally didn't last, and Facebook closed its first day at $38.23 — just barely above the offering price and below where its first trade had occurred. After that first jump that lasted just hours, Facebook's share price continued a decline that eventually culminated in its losing half its value just months after its IPO. Investors pointed to the failed offering as evidence that the IPO system was fundamentally broken, suggesting the demise of the stock market as a vehicle for regular investors to invest.

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Of course, years later, we know that the Facebook story had a happy ending, as the social media giant's stock rebounded from its first-year plunge to become one of the largest companies in the market. Just as a first-day jump won't necessarily produce continued gains, so too should investors hesitate to conclude that because an IPO performs poorly in its first several months on the market, it's doomed to underperform forever.

The key point of all of these lessons is that investors can gain a lot from taking a well-reasoned approach toward IPO investing. By looking past the hype and gaining insight from the successes and failures among well-known initial public offerings, you'll improve your chances of avoiding future mistakes — and homing in on the companies that are mostly likely to produce life-changing returns in the years to come.

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