GLOBAL ALPHA

COMMENTARY

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The vanishing liquidity premium

This weekend, we learned that the much awaited IPO of Square, the San Francisco mobile payment company, founded by serial entrepreneur Jack Dorsey, also founder of Twitter, would go public soon, BUT at a price that is less than its last private equity financing.

Square is one of the most famous Unicorns, these fast growing startup companies valued at more than $1 Billion. The most famous one being Uber, recently valued at $51 Billion and yet to report a profit.

In its last quarter, Square reported a net loss of $54 million on revenues of $332 million, with revenue growth slowing and losses accelerating. In its last financing round ended last month, Square was valued at over $6 Billion. The IPO documents filed show a range of valuation between 4.2 and 6.2 billion.

What is happening? Is this the beginning of the end or something?

What is a private company worth?

Historically, investors paid a discount for shares in private companies, because they don't have as much transparency or liquidity, said David Golden, a partner at Revolution Ventures. As private companies now have a lot of private funding opportunities and start to go public later, the opposite is now true.

"Starting about five years ago, the Valley has essentially created an illiquidity premium -- paying more for illiquid stocks rather than less -- and that inevitably catches up when liquidity arrives," Golden said. "The presence of a liquid market -- whether an IPO or the sale of a business -- is always the best measure of true value."

This introduction lead us to talk about another trend, more worrying. The move by many large institutions to less liquid asset classes such as Private Equity, Unlisted Real Estate and Infrastructure.

In the past, these asset classes offered the potential to capture an illiquidity discount. The theory was that a large investor with a long term horizon, limited short term liquidity needs and higher risk tolerance, could profit from that strategy. That meant that those illiquid assets should be selling at a discount to liquid assets, hence the ability to buy at the discounted price, which would eventually disappear with time or when those assets would either be sold or go public.

The drawback of illiquid assets was they may drop dramatically in periods when liquidity decreases. The best example was the 2008-2009 financial crisis impact and its impact on US university endowment funds as an example. Because they had a high percentage of their assets were illiquid, they had to utilise their liquid assets to finance spending. Then they had to sell illiquid assets at a very steep discount. Harvard endowment sold a portion of its private equity portfolio in 2008 at 50% discount to meet liquidity needs. Its liquid portfolio had become too small to meet its commitments. Here is a quote from last year's annual report: "One factor that continues to impact our performance is a real and visible overhang from underperforming illiquid investments made during the pre-crisis era." (Harvard Endowment 2014 annual report).

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As liquidity improved in the last few years, and with record low interest rates, a worrying trend has emerged Pension funds moving to illiquid assets. Not to capture the discount and accepting higher risk. But in the hope to generate higher returns and benefit from different accounting rules applied to illiquid investments and not have to use fair valuation principles.

Direct real estate, private equity and infrastructure assets are not listed and have a limited secondary market. These assets are more correlated to liquid markets than many would hope to believe. Given their illiquidity they should sell at a discount. The share of illiquid asset classes held by pension funds has increased from 5% in 1995 to around 25% today.

The effect of this change in asset mix and the flow of money into illiquid assets has been that these assets now sell at a premium to their closely related liquid investment.

Private Real estate now sells at a premium to publicly traded reits, a direct comparable. Illustrated by the current rise in M&A and take-private transactions of REITs

In the infrastructure sector, we are observing the same thing. There are over 1000 publicly traded infrastructure companies on developed stock exchanges. Airports like Vienna, Zurich, Paris, Frankfurt, Sydney. Ports, Highways, etc. The latest research suggests over 10% premium for privately owned assets. Again illustrated by recent transactions from private player buying public ones. Recently, one of our companies, Ormat Technologies sold a portion of its geothermal power plants to an infrastructure fund at a 50% premium to its then public valuation.

The same is true with private equity funds, current multiples paid for acquisition of public companies have reached a record in 2015 at more than 10 times EBITDA, with many deals done at much higher multiples, an echo of the boom years before the 2008 crash.

The weight of capital chasing assets is so great it is also reducing returns on these so called real assets.

Are we preparing the next crisis? Only time will tell.

Have a good weekend.

The Global Alpha Team

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