Remembering that high risk is not always high return

29th October 2018
Smart investment Management

We wrote a note in August last year in which we discussed whether there were any significant signs of the "euphoria" on which, according to the late Sir John Templeton, bull markets die. Whilst concluding that there were few signs at the time of such irrational investing, we commented on the Snap Inc IPO in March 2017 as an example of something that could arguably fit into the category, so it has been interesting to see the company garnering headlines again this month.

Snap Inc (Snap) is the company behind photo-messaging service Snapchat. The shares were floated at $17 each but rose on the first day of trading to over $24, valuing a company with revenues of just $450m in 2016 and that had made losses over the previous 2 years of nearly $1bn, at over $28bn. Since then, the price has declined steadily and today is trading below $7, a fall of nearly 60%. Now Snap is not the first IPO to struggle, nor will it be the last. However, in a world where technology disruptors continue to impact our lives in general, and technology stocks make up a large and increasing proportion of major stock markets, there are some interesting lessons to take from Snap's struggles.

Firstly, it is important to acknowledge what has happened is not unique to Snap. Investing in a start-up almost always carries higher than average risk, as the business model will not typically have been tested over a variety of market conditions. Furthermore, if a young company has got to the point that it can achieve a successful IPO, it has grown quickly, by definition. The danger is that, with only limited data with which to work, analysts are overly aggressive with the growth rates used when projecting future revenues and profit, which in turn overestimates the value of the company now.

Whilst a new business can be untested, the same can be true of the management. This is especially common in the technology space, where the idea of such companies being run by young entrepreneurs that can see the next big thing is almost part of the pitch. The reality is that not every person that can come up with an idea and grow it successfully is suited to running a multi-billion dollar company. Of course, with some companies the management is very much part of the reason for owning the shares, as investors want exposure to one or more individuals that they believe have exceptional abilities (Elon Musk and Tesla is certainly one such example). However, placing such faith in a single person (or even a small number of individuals) represents highly concentrated key person risk and, whilst it may pay off, it is still a risk.

So what exactly has happened to Snap? Put simply, it is not growing as fast as had been expected, with reports that analysts' revenue expectations for Q3 2018 have fallen by almost 50% from those at IPO. Snap has failed to generate the advertising revenues that it had hoped after initially pitching prices too high. It has now dropped prices but by such a degree that a large increase in volumes is needed just to compensate for the price reduction, with Snap admitting that it will take some time to increase overall revenues. Achieving this goal is not helped by slower than expected user growth. A hugely unpopular redesign of the app in January caused some to question whether 28 year old co-founder & CEO Evan Spiegel, in whom many had placed such faith, had lost his touch. Indeed, with a number of senior management leaving the company and allegations that he ignored warnings about the problems with the app redesign, Spiegel's management of the company is increasingly coming in to focus, with suggestions that he is suffering from 'founder's syndrome' (see Tesla again).

However, the larger part of the user growth problem is more is quantifiable, namely competition. We live in a world in which businesses are using technology to gain access to customers ever more quickly, allowing a company like Snap to grow from launch to IPO in 6 years. However, they discovered that 'first mover advantage' was not enough to protect them when a rival, Facebook, decided to move into their space. They launched Instagram Stories with very similar functionality and, in just 2 years, have achieved twice the number of daily active users as Snapchat.

All of the above means that analysts are now suggesting that Snap could run out of cash before it becomes profitable, which is not the death knell of Snap (as they could raise further capital) but is far from ideal. However, whatever the outcome, what can we take from it all as investors? In summary, the risks of investing in a start-up are little changed, even if the company is a technology company and in spite of the enormous success of companies like Facebook and Amazon. In fact, technology has arguably exacerbated the risks, as the speed with which the start-up can grow shortens more than ever the data set on which investors can base a decision, whilst the same technology can be used against the business if it has anything less than robust barriers to entry. Therefore, proper due diligence is still required and possibly stricter than ever. Most importantly, if you invest in a high risk/high return investment (and Snap's numbers at IPO made it overtly that), do not let recent headlines about the growth of companies that have succeeded make you forget that high risk brings the possibility of high return, not the certainty.

For further information please contact:

Michael Langton
T: +971 (0) 56 8958 507
E: michael.langton@praemium.com

Barry Honeyman
T: +44 (0) 777 182 2529
E: barry.honeyman@praemium.com

SIM/25102018/FP202