

CHARTS

# Why companies like Lyft and Uber are going public without having profits

The last time unprofitable companies went public at this rate was in 2000 – the year the dot-com bubble burst.

By Rani Molla @ranimolla Mar 6, 2019, 2:41pm EST

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Javier Zarracina/Vox

Lyft filed paperwork to become a public company last week, with a valuation of \$15 billion. But the ride-sharing company is still deeply unprofitable.

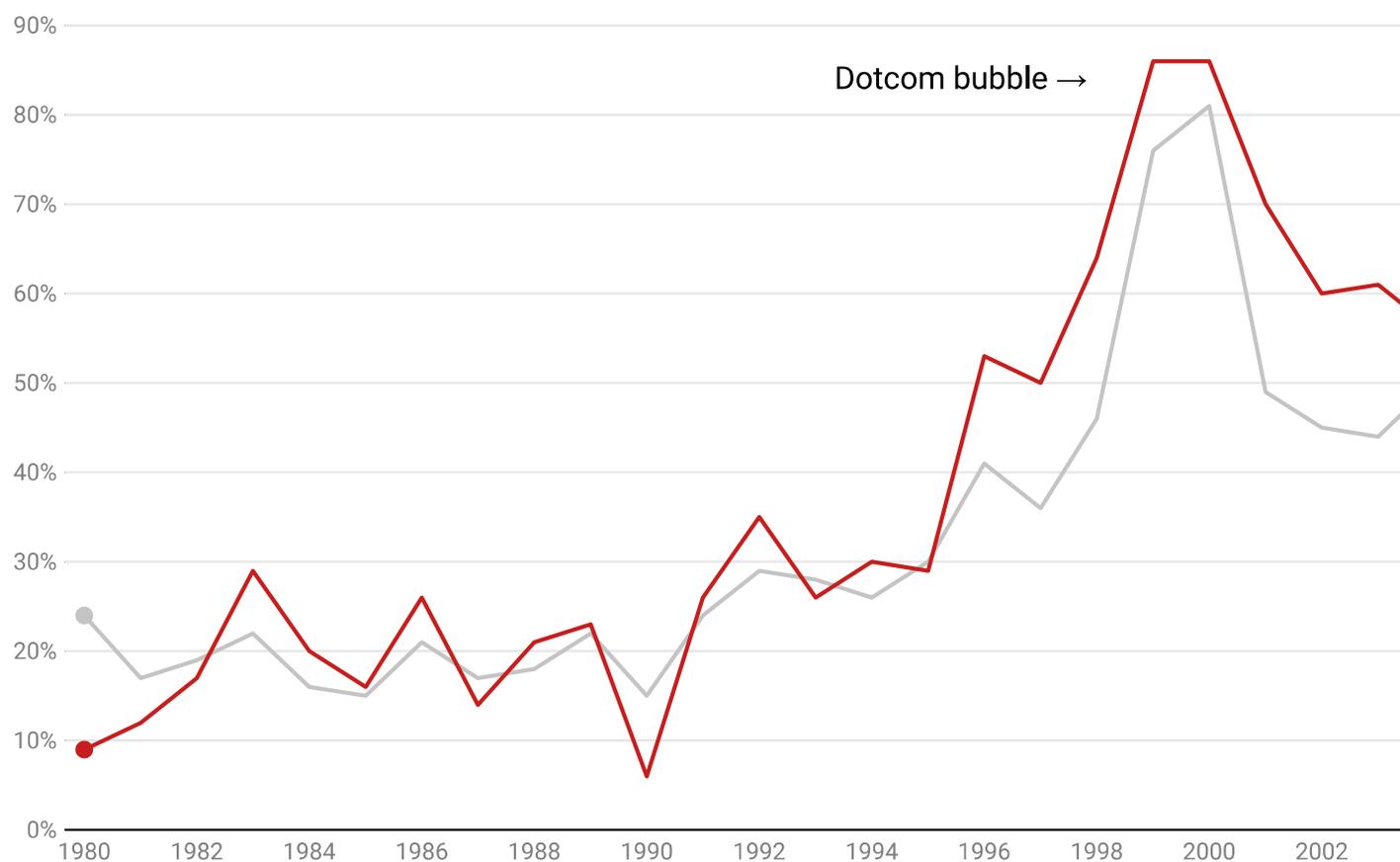
The company had a net loss of nearly \$1 billion last year. To put it another way, Lyft lost about \$1.47 for every ride\* it gave in 2018. Lyft's main competitor Uber, which is poised to file for an IPO as well, is also posting losses on a per-trip basis (though it's tricky to estimate how much since Uber includes Uber Eats deliveries and Uber Freight shipments, in addition to taxi and scooter rides, in trip estimates). Uber's valuation is expected to be anywhere from \$76 billion to \$120 billion.

So why aren't the public markets more concerned about these negative-balance-sheet behemoths?

Because IPOs by money-losing companies are more common than ever. In 2018, 81 percent of US companies\*\* were unprofitable in the year leading up to their public

offerings, according to data from Jay Ritter, an IPO specialist and finance professor at the University of Florida. That's a statistical dead heat with the rate in 2000, the year the dot-com bubble burst, plunging the US economy into recession. It's the only other time unprofitability was this high, according to Ritter's data, which goes back to 1980.

## Share of US IPOs that aren't profitable



Profitability data for the year leading up to IPO

Source: [Jay Ritter](#)

**recode**

Much of the rise in unprofitability has to do with the proportion of biotech companies going public. These companies for the most part don't have a product, let alone profit, when they sell stock to public shareholders. Instead, they use IPOs to raise money for their expensive clinical drug trials. Biotech companies are a big gamble and are frequently duds, but the success cases pay off well and can be acquired by big pharmaceutical companies. Investors in these companies also tend

to be specialists in the biotech industry so, presumably, they know what they're getting into.

But even without those biotech companies, investors have shown a growing comfort with unprofitable companies, Ritter's data shows. About half of non-tech, non-biotech companies that went public in 2018 were unprofitable in the year leading up to their IPO.

Some 84 percent of tech companies that went public in 2018 were in the red. Typically, investors expect them to be profitable within a year or two, depending on the company.

### **Why would people invest in unprofitable IPOs?**

"The rise in unprofitable IPOs reflects the general preference in both public and private markets for growth over profitability," Paul Condra, lead analyst of emerging technologies at startup research firm PitchBook, told **Recode**.

"As we've seen during most of the recovery period since the Great Recession, investors are not so margin-focused, but continue to put a premium on businesses with long-term future expansion or disruption potential."

In other words, investors are willing to buy in now in order to subsidize and grow a company that could make lots of money later. They believe that the companies' future profits will eclipse these current losses.

Let's call this the Amazon archetype. The retail giant has been notorious for taking in little profit relative to revenue in order to grow its business and invest in new initiatives for future profitability — a strategy that has worked wonders and that many companies are trying to replicate. It should be noted, however, that Amazon also has Jeff Bezos as well as a more diverse revenue stream than some companies attempting the same model.

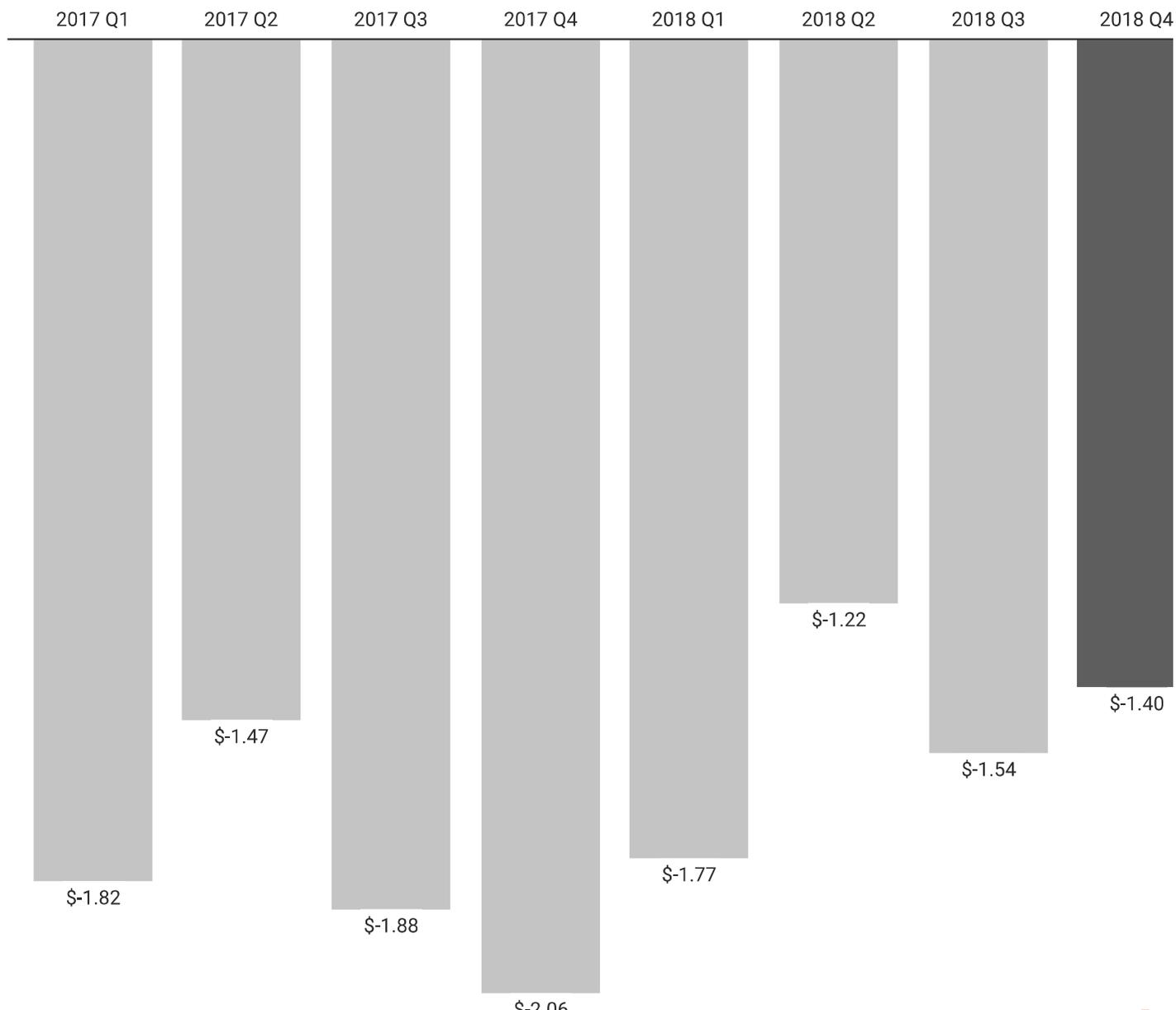
It's also important to remember that just because a company doesn't report a profit doesn't mean it couldn't be profitable.

"A lot of these companies, if they cut R&D and hiring, could be profitable," Ritter told **Recode**. "But venture capital and public market investors are saying, 'We want

growth. We don't want to focus on short-term profits."

If Lyft didn't spend any money on sales and marketing or R&D, it would have turned a profit last year. The flip side is that without those expenses, Lyft's customer base wouldn't grow and Lyft could kiss the idea of driverless cars — and the potential profit they represent — goodbye.

### Lyft's loss per ride



In the meantime, these companies are using IPOs to achieve profitability. And investors seem to be willing to go along for the ride.

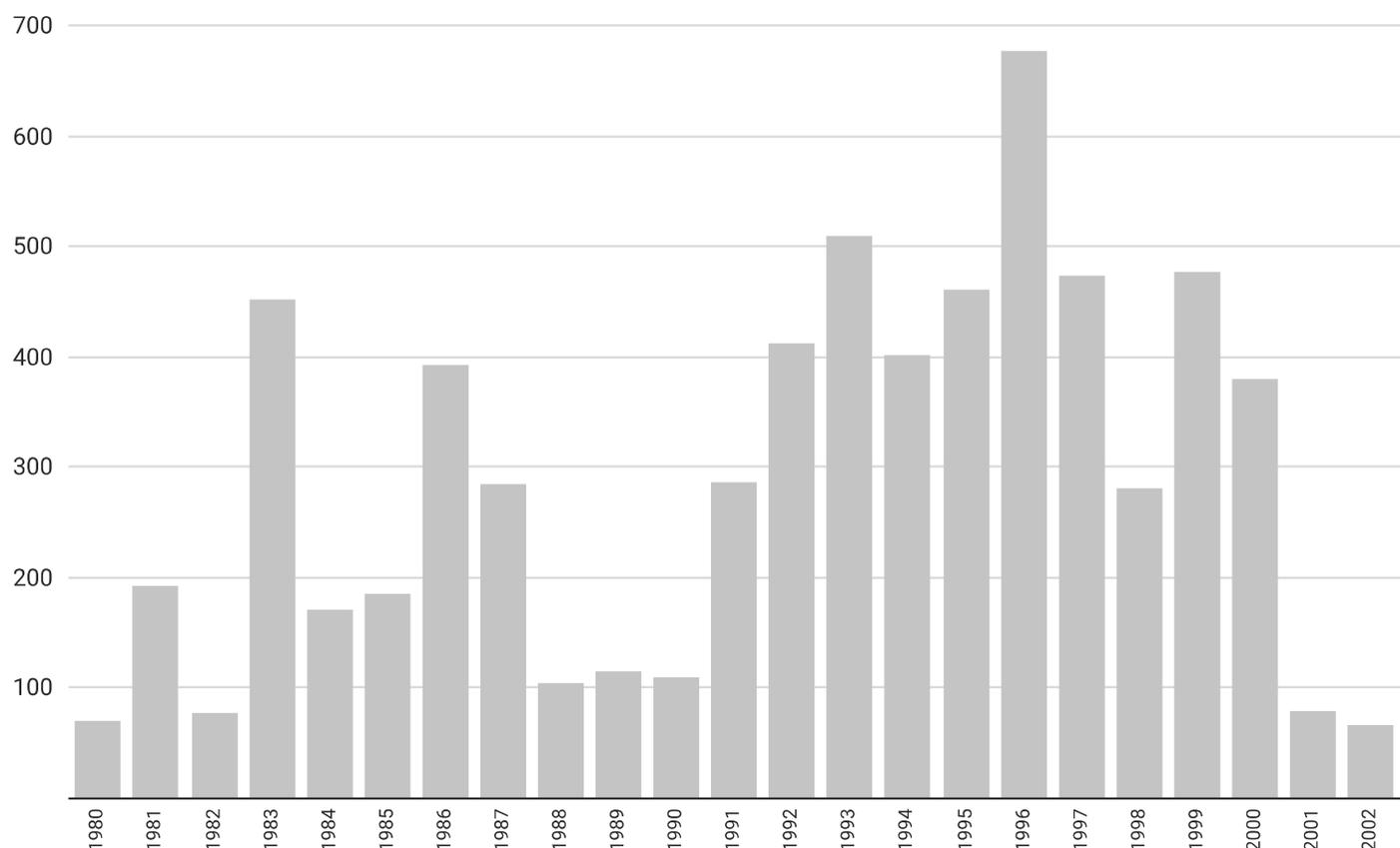
“They’re not defying a principle of physics — they’re well-funded,” David Ethridge, leader of US IPO services at professional services company PwC, explained. “They’re living off of the capital they’ve raised until such time as they can generate more cash than they’re spending.”

Investors are looking instead for companies that have a *path* to profitability.

This usually means they see the total potential market for the company as much bigger than it is now. In the cases of Lyft and Uber, that means a future with lower car ownership and with fleets of autonomous vehicles. The share of people with driver’s licenses in the US is declining thanks in part to more people living in cities where they can rely on public transit as well as on Lyft and Uber. Many, including car companies, see a future in which we share cars or rely on vehicles that drive themselves.

Investors are also eager for these new IPOs since companies are staying private longer and the number of companies that are going public has been low by historical standards. This scarcity makes people invest in companies they might not have if they’d had more options.

## Number of US IPOs by year



*Includes IPOs listed on major exchanges. Excludes REITs and blank-check companies.*

Source: [Jay Ritter](#)

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In tech stocks, there can also be a novelty factor at IPOs. When it's possible for the first time to invest in, say, a meal-kit company or a ride-sharing company, investors get excited at owning something new. Without an established set of criteria to consider in a new business, investors tend to be more open-minded regarding a new business's finances.

One worry is that not all the companies that are being funded like tech companies are capable of paying off like tech companies.

"This is the effect of everybody trying to cloak themselves as tech companies," said Carol Roth, a former investment banker and creator of the Future File legacy planning system. She referred to the case of Blue Apron, a meal-kit delivery company that went public in 2017 at tech valuations but which she considers to be more of a consumer goods company.

“The thesis with tech companies is that when you bring in capital spending, eventually you can enjoy the scale and profit down the road,” Roth said. “A lot of companies shouldn’t be given that leniency.”

### **Is this different from the dot-com bubble?**

Two decades ago, investors were chasing everything internet. This led to a lot of speculative bets on unproven companies. The stock market rose and rose until it had a huge crash, with the Nasdaq declining nearly 80 percent from peak to bottom and losing \$5 trillion in value in two years.

Many of the internet companies that came up in that cycle no longer exist today. Indeed, many of these businesses — Pets.com, Kozmo.com — are used as cautionary tales in the business world. It’s difficult not to think of the current boom of internet stocks within a similar framework.

There are, however, notable differences.

“Back then lots of companies that went public were early-stage, more of a concept, or there were 12 companies in the same space, or no one made money,” Ritter said.

Today’s crop of IPOs have generally been around longer than their dot-com predecessors and produce higher revenues — some might even be currently profitable if they set aside their growth ambitions.

“The types of companies and maturity of the internet companies and even the maturity of the market are different now than a decade ago,” Roth told **Recode**. “It’s not, ‘Hey I’m Pets.com and I’ve got a great sock puppet.’”

Today’s tech companies, private and public alike, also enjoy better infrastructure and consumer acceptance, Roth said. She believes that even dot-com failures like the grocery delivery company Webvan would have performed better had they hit the market today. “They were a victim of timing, in some respects.”

Company valuations are also not as overblown as many were during the dot-com bubble.

“Looking a little further back into the first three quarters of 2018: Companies have been willing to go public at valuations the banks said would work,” PwC’s Ethridge said. “Usually the telltale signs are 30-40 percent [of companies] pricing above their range, trading at some silly amount. Usually when that happens, B- companies are getting A+ valuations. I wasn’t seeing that.”

In general, the trend of unprofitable IPOs lately hasn’t fazed him.

“I don’t know that I view it as anything more than just a very strong IPO market where investors have done well by virtue of investing in these companies at the stage they’re investing in them,” he said. “I don’t see something careening off the tracks right now in terms of the IPO market.”

However, most economists are predicting a recession within the next two years. When that happens, businesses of all stripes suffer, whether they’re profitable or not.

### **What happens in a recession?**

Future growth and profit are not at all guaranteed for new — or any — companies. When a recession hits, current profit will become more important.

In the case of IPOs, institutional investors tend to buy the vast majority of the stock when it goes public, meaning they have higher exposure to the stock if it heads south. However, well-known tech companies tend to be more popular among lay investors than other stocks.

Following the dot-com bubble, institutional investors were “looking for more defensible operating models in a difficult market,” Ethridge said. That meant, for example, preferencing companies with government and other long-term contracts.

In all recessions, defaults go way up.

The type of goods sold could greatly affect a company’s recession survival. “Luxury goods are more susceptible than consumer staples,” Ritter said, citing how McDonald’s and Walmart performed well during the last recession while upscale brands fell by the wayside.

“There will certainly be fallout,” Roth said, as we approach the end of the market cycle. “I don’t believe it will be the same level of fallout you saw in 2000.”

Of course, companies that have been profitable all along will also have less to worry about when a recession comes.

Airbnb, for instance, another tech disruptor that plans to go public this year, has been profitable for two years.

Whether Lyft and Uber make it through a recession will depend on how much of the market they’ve managed to win when it happens and how dispensable ride-sharing is as a product.

\* Lyft defines rides as the “total number of rides completed using our multimodal platform, across all modes of transportation we offer that directly contribute to our revenue,” so scooter rides would be included in this calculation as well.

\*\* Ritter’s data excludes a number of atypical company types, like real estate investment trusts and special purpose acquisition companies. His methodology can be found here.



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