UNICORNS VS. DINOSAURS – WHO WINS IN THE DEBATE OVER GROWTH VERSUS PROFITABILITY?

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***Ed Note**: This piece was originally written and submitted to Benchmark Mineral Intelligence for publication in their quarterly magazine in late August 2016. This explains why some of the data may look off in places.*

"Getting to profitability is the only way to build a sustainable business…"

-UBER CEO Travis Kalanick in response to UBER's merger with Didi Chuxing

As convergence across industries continues apace and business models evolve, Mr. Kalanick's statement above is a reminder to investors in early stage companies. As startups across various industries attain unicorn status – a valuation of at least USD $1 billion - the argument around growth at all costs versus profitability has become louder. There are over 170 unicorns in existence today, so the hunt for the "next big thing" is indeed on. With an abundance of cheap capital looking for yield, many investors appear to have set aside a preference for profitability in favor of parabolic growth. Here are the 20 largest unicorns (all privately held):

Company	Country	Valuation in B USD
Uber	USA	68
Xaomi	China	46
Didi Chuxing	China	36
Airbnb	USA	30
Palantir	USA	20
Lu.com	China	18.5
China Internet Plus	China	18
Snapchat	USA	18
WeWork	USA	16
Flipkart	India	16
SpaceX	USA	12
Pinterest	USA	11
Dropbox	USA	10
DJI	China	8
Spotify	Sweden	8.5

Source: CB Insights

Given these valuations, is this preference for growth over profitability wise? How do you appropriately value a disruptive business model against traditional industries? This piece examines in greater detail how companies grow in this brave new world and which is an optimal investment strategy – pursuing growth or pursuing profitability.

There is a paradox in global commerce today where young companies (the primary job creators) are eschewing profitability in favor of gaining market share or scale. Uber is one such example, having lost approximately $1.2 billion USD in the first half of 2016 trying to gain market share in China. This is a company with an estimated $60 billion valuation. Any of the unicorns listed above would likely also follow the same model – hemorrhaging money in a bid to take market share from industry incumbents. While this model isn't new, the lofty valuations for unproven business models are reminiscent of the dot com boom. That didn't end well.

S&P 500 companies (ex-financials) had a cash balance of $1.45 trillion in 2015 according to FactSet which was the largest cash total in ten years. In many cases, this cash is sitting on the balance sheet and companies are issuing cheap debt to finance share buybacks or dividends in many cases. This is the new wealth creation paradigm in capital markets – invest in a unicorn and generate a high return but sacrifice liquidity or invest in an established company and generate returns through a "sit and wait" strategy of dividends and share buybacks. I would argue both strategies are unsustainable.

A NEW TECH PARADIGM TO THE RESCUE?

The reasons for this investing paradox are multiple but have a lot to do with the ubiquity of technology. The past decade has seen a technological shift unlike any the world has seen since perhaps the advent of the Industrial Revolution in the mid-Eighteenth Century. The ensuing technological age has increased the average citizen's quality of life (QOL) exponentially.

In the New York Review of Books, Economist William Nordhaus stated:

"*According to the economic historian Bradford DeLong, from the first rock tools used by humanoids three million years ago, to the earliest cities ten thousand years ago, through the Middle Ages, to the beginning of the Industrial Revolution around 1800, living standards doubled (with a growth of 0.00002 percent per year). Another doubling took place over the subsequent period to 1870. Then, according to standard calculations, the world economy took off."*

Mr. Nordhaus is discussing Robert Gordon's recent tome titled "*The Rise and Fall of American Growth: The US Standard of Living Since the Civil War*"

Investors are betting that some of the en vogue technologies of today such as could computing, electric mobility, or renewable energy can deliver similar productivity gains to society and continue to make life "better" for the average citizen.

Looking at the largest companies in 2016 on the NASDAQ would indicate that market participants have placed their faith in technology companies to create wealth (and value) going forward:

Company Name	Market Capitalization in USD B
Apple Inc	584.7
Alphabet	539.2
Microsoft	452.4
Amazon.com	362.6
Facebook	360.9

Source: Bloomberg

50 years ago some of the largest companies included General Motors, Ford Motor Company, Exxon Mobil, General Electric, and Chrysler. Clearly, times have changed and while companies like General Motors still exist and successfully compete on the global automotive stage, investors are placing a premium on the dynamism and growth in the technology sector relative to others.

But where will the next Apple or Amazon.com come from? Furthermore, what is the optimal business model to look like? If history is our guide it's likely to originate with two roommates in a dorm room with an idea and capability to scale quickly. With a mixture of cheap capital and ubiquitous technology it's more likely than not that the largest companies in the world ten years from now will be a different list than the ones listed above complicating investment strategy somewhat.

Technology companies can grow quickly (in the case of Apple) making capital allocation decisions around growth versus profit challenging. The iPod/iPhone franchise became so successful that company management needed an activist investor in Carl Icahn to force the company to spend and attain a higher valuation. Given that iPhone sales are now on the decline, watching to see what Apple does to innovate through a build versus buy strategy will be telling for the future of the company.

BUILD OR BUY?

Growth can be organic (think iPhone introduction) or it can be bought. It would seem that the latter is more popular right now amidst industry shifts in the automotive sector in particular. There are an increasing number of companies in the automotive/tech sectors that are buying growth including:

- Samsung Electronics equity infusion in BYD for $450 million and talks to by Magneti Marelli from Fiat-Chrysler
- Ningbo ShanShan in talks to purchase a stake in Chilean lithium powerhouse SQM
- Total SA, an oil and gas super major, purchasing French battery maker SAFT for $1.1B USD
- Uber China merging with Didi Chuxing
- Delphi Automotive and Mobileye collaborating to develop a fully autonomous driving system
- General Motors investing $500M USD in ride sharing company Lyft

This is an admittedly short list, but the point is that established disparate businesses (automotive, natural resources, technology) have seen how their industries are being disrupted. A mix of new

entrants and consumer choice and are forcing changes and these companies are responding through investment rather than total reinvention. Because of this, most unicorns will become acquisition targets of existing businesses – as long as they can demonstrate profitability.

GROWTH VERUS PROFITABILITY – KNOW WHEN TO SAY WHEN

It is entirely justifiable that startup companies shouldn't be expected to generate cash flow early in their life cycles; however, as multiples grow and comparisons to mature companies become common, an expectation of "when" a company will be profitable is entirely justified. Exponential growth early in a company's life cycle should lead to profitability which in theory is be plowed back into the business to innovate and drive further growth – a virtuous cycle. But how long should investors wait before demands for profitability outweigh those of exponential growth?

Perhaps no company today better personifies this debate between growth and profitability than Tesla.

Founded in 2003, the company has sold approximately 140,000 automobiles in its lifetime and is one of the few publicly traded companies that elicits strong opinions from both proponents and haters alike. The dichotomy of opinion likely has to do with the fact that while Tesla has built an incredible product in an electric vehicle, the financials behind this growth look less-than-promising to say the least.

Investors in Tesla must struggle with a fundamental question: Which is more important - building a product that consumers will pay a premium for (though is a money loser), or becoming self sustaining by generating ample free cash flow? Again, Mr. Kalanick's words ring true. Tesla has returned 885% since its IPO in June 2010 while burning billions of dollars and leveraging subsidies and tax breaks to grow its business. That's ok because Tesla is investing in its future through investment in capital intensive activities such as the Gigafactory. However, ultimately Tesla must become profitable on a top line, bottom line, and cash flow basis to be sustainable. Otherwise, when capital availability dries up, investors will run for the exits.

Tesla's success has forced the automotive industry to "wake up" with every major OEM declaring their intentions to electrify their fleets in the coming five years. With dozens of automakers scaling up their own EV capabilities (reportedly 200 in China alone), how long will it be before Tesla's lead in the EV space is eroded? Likely not long and that may be the reason behind the company's proposed take out of Solar City – a strategically sensible, but financially foolhardy move - by Tesla management to diversify its business.

So is the company doomed, tied to the need for endless capital raises to survive? Or still in its growth phase and deserving of its $33 billion market capitalization? Value investors would say no it isn't deserving, but they've missed out on triple digit returns.

CONCLUSION – AS YOGI BERRA SAID "THE FUTURE AINT WHAT IT USED TO BE."

Ultimately, the debate between growth and profitability will be ongoing which makes it such a fascinating topic of discussion. This debate only grows in intensity and depth as established industries continue to clash and converge with new industries, creating new business models and a search for appropriate valuation metrics.

Ultimately, most of the unicorns in existence today will not survive for a host of reasons, but this entrepreneurial drive is what has pushed QOL higher throughout the world for centuries. Despite worries over Tesla's financial sustainability and its inflated valuation, the company ought to be applauded for forcing other industries (automotive, technology, etc) to rethink their existing business models and evolve as new markets are created.

The "churn" we are seeing across industries the automotive, tech, and raw materials sectors is a good thing as it means companies are intent on investing in new markets and driving returns in a low interest rate environment. The fact that many of these companies have large market caps and a history of profitability is positive in that it implies innovation, even though it may be incremental rather than transformative.

High growth rates early in a company's life cycle are important to capture market share, but this market share won't be maintained or grow without profits to drive back into the business. Profit (and by extension cash) drives a business' long term viability.

Any self-sustaining company should be able to generate a return for its investors above the cost of capital and in so doing, generate wage growth, enhancing the overall productive capacity of an economy. This tech convergence is hugely bullish for mankind, but it's not so clear for investors.