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Grow fast or die slow: Why unicorns are staying private

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Technology companies worth more than $1 billion—and many worth $10 billion—have fewer reasons to go public than they did in the past. Here's what that means for them and their investors.

Since 2013, an increasing number of technology companies have achieved "unicorn" status: valuations upward of $1 billion in private markets. As of the end of last year, 146 private tech companies were valued at that level, according to CB Insights—more than twice the number a year earlier. In addition, 14 private companies were "decacorns," with valuations exceeding $10 billion.

Yet public tech markets haven't matched this exuberance. In fact, many tech companies that undertook initial public offerings (IPOs) in the past three to four years have performed poorly. More than 40 percent of the unicorns that went public since 2011 are flat or below their final private-market valuations, according to a November 2015 study by Battery Ventures. (For more on the disconnect between private- and public-market valuations, see "The 'tech bubble' puzzle," May 2016, McKinsey.com.) And for late-stage investments, we're even seeing signs of a cooling in private markets as some asset managers mark down their stakes in unicorns by anywhere from 10 to 50 percent.

So what's going on? New dynamics may be in play, given the significant uptick in the number of high-valuation private software companies, combined with down rounds—new funding that values these businesses at lower levels than previous rounds did—and post-IPO losses. Our research, drawing on 35 years of financial data covering around 3,400 software companies across the globe, led us to three conclusions:

- Software companies are indeed staying private longer.
- This new dynamic calls for different investment models for early- and late-stage investors, as well as different funding approaches for companies.
- IPOs can and should be used as a strategic lever to accelerate growth.

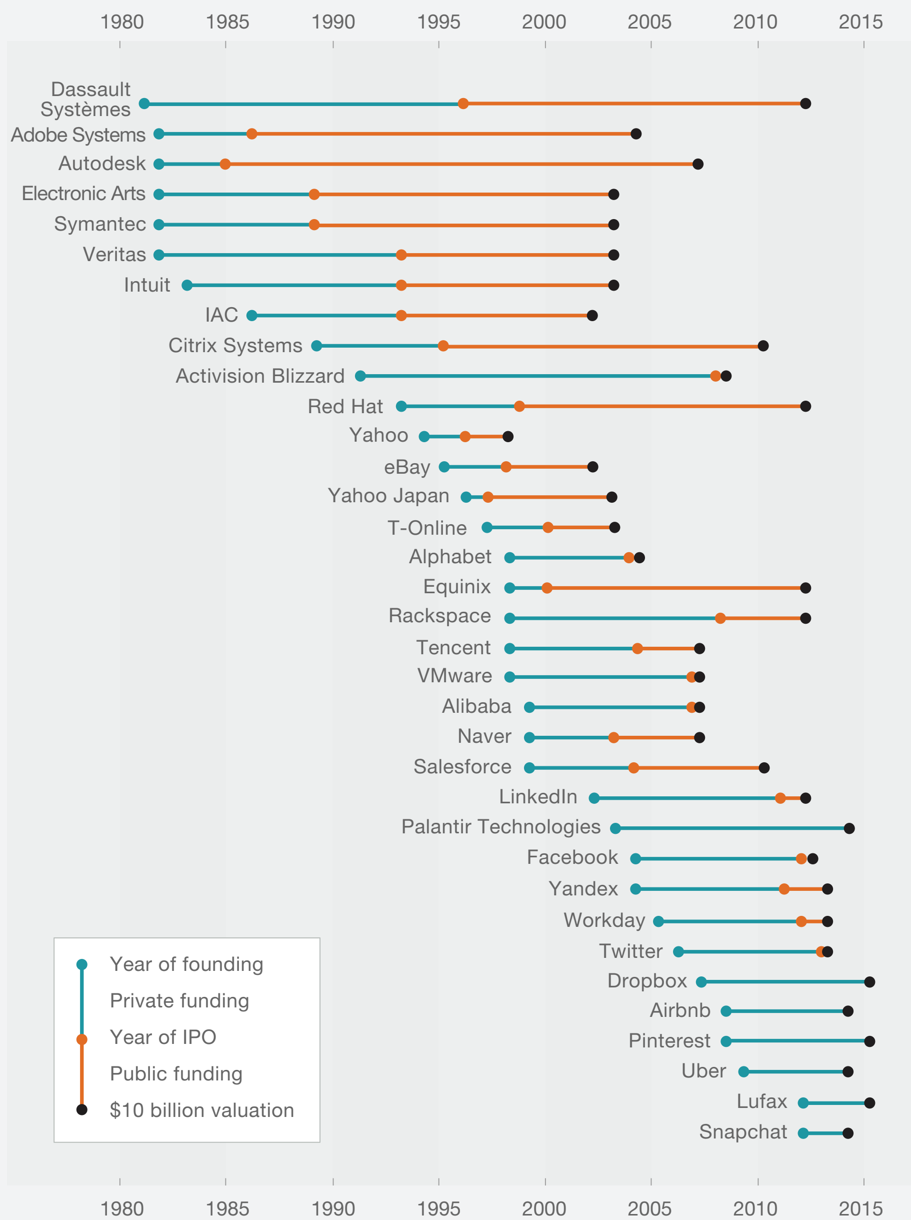
Companies are staying private longer

The average age of US technology companies that went public in 1999 was four years, according to Jay Ritter, a University of Florida professor who studies public markets.[1] Of the more than 35 public software companies that reached valuations upward of $10 billion from 2004 to 2015, only six achieved that level before going public. The rest reached it an average of more than eight years after their IPOs (Exhibit 1).

[1] See "To fly, to fall, to fly again," *Economist*, July 25, 2015, economist.com.

Exhibit 1

Software companies are increasingly reaching $10 billion in value without going public.



Note: Only lists companies founded after 1980; 2015 data are preliminary; some companies excluded from analysis if bankrupt or acquired.

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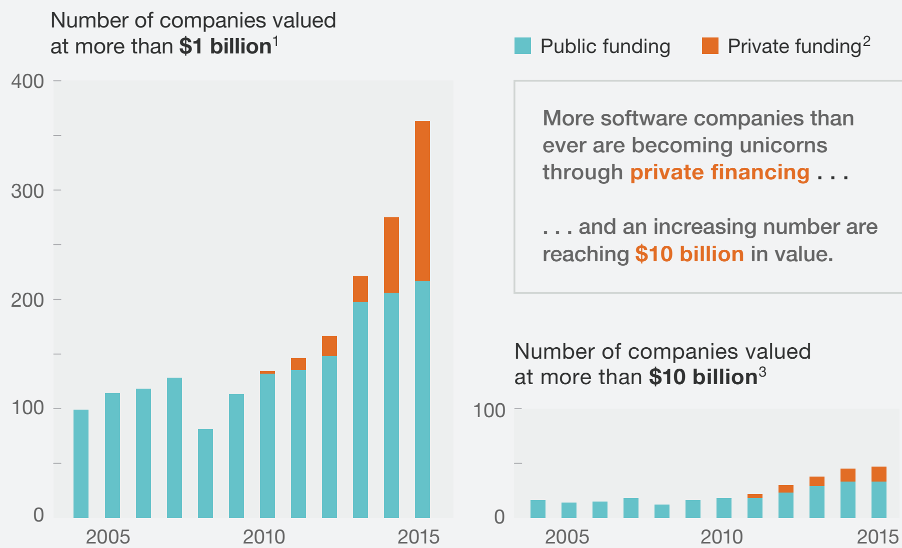
Times have changed. Ritter's research shows that the average age of technology companies going public in 2014 was 11 years, and private funding rounds have generated an increasing number of decacorns and unicorns (Exhibit 2).

Exhibit 2

Technology unicorns are no longer rare.



[1]Represents count as of start of year; companies excluded from analysis if bankrupt or acquired.
[2]No data available for 2004–09.
[3]2015 data are preliminary.

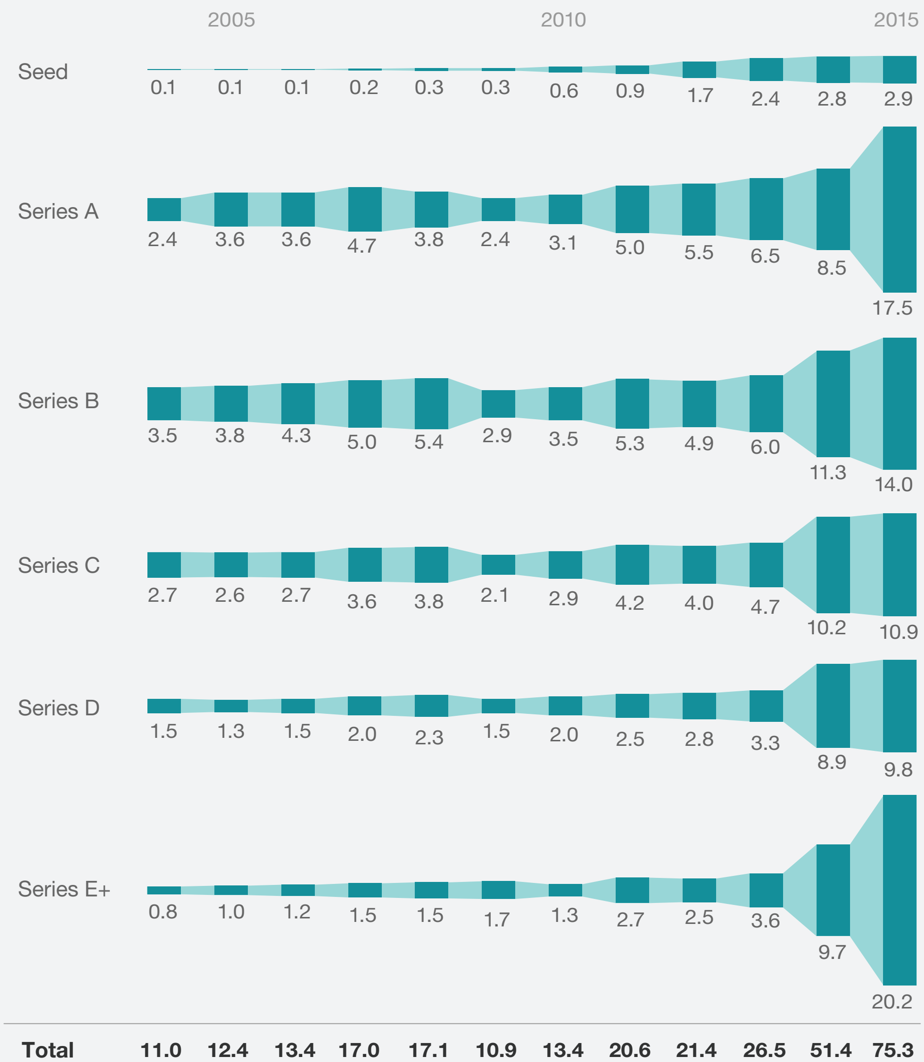
McKinsey&Company | Source: CB Insights; McKinsey analysis

There are several reasons for this new dynamic. The US Jumpstart our Business Startups (JOBS) Act, which passed into law in 2012, increased fourfold the maximum number of shareholders a company can have before it must disclose financial statements. And it's no secret that the private capital available to software start-ups has rocketed in recent years, arguably to unsustainable levels. This acceleration in the amount of capital invested in private companies—an increase that originated with an influx of later-stage capital from nontraditional sources chasing venturelike returns—eventually trickled down to earlier stages. In just the past two years, the capital invested in private companies almost tripled, to about $75 billion in 2015, from around $26 billion in 2013 (Exhibit 3).

Exhibit 3

Investment in tech companies has boomed, almost tripling in the past three years.

Capital invested in tech companies, by series, $ billion



McKinsey&Company | Source: PitchBook; McKinsey analysis

Finally, public markets seem to prefer larger tech companies. Jeremy Abelson and Ben Narasin looked at technology businesses that went public from 2012 to 2015. They found that public markets assign the larger ones a higher multiple at the time of their IPOs and afterward. The stocks of these companies also perform better.[2]

[2] See Jeremy Abelson and Ben Narasin, "Why are companies staying private longer?," *Barron's*, October 9, 2015, barrons.com.

Different investment and funding approaches needed

The influx of capital available to private tech companies and the overcapitalization of many unicorns and decacorns have not been without consequences. In the first three months of this year, several private software companies faced valuation pressure in the form of down rounds. Moreover, the average delay in mounting IPOs forces venture investors to wait almost three times longer to realize returns than they did a decade ago.

These dynamics have several implications for investors and entrepreneurs. Inflated private valuations mean that venture investors, especially those involved in later-round funding, can no longer count on IPOs to make money. Seed and Series A and B investors will be largely unaffected: they invest early enough to see a positive return so long as an IPO locks in a higher valuation than the prices they paid in the early rounds. Nonetheless, the longer time line to going public does affect early investors. Eleven years is quite a while for limited partners (LPs) to realize returns, especially when many venture firms try to raise new funds every two to four years. So private-market activity has ticked up significantly as employees and investors alike seek liquidity. Alongside private markets, the M&A route may become an increasingly favorable alternative for such investors.

Series C and D investors may want to consider alternative forms to finance the growth of companies—alternatives that don't lead to rapid increases in private valuations. Late-stage investors want to hit the sweet spot between having valuations increase during every round and keeping them within reason so that solid eventual returns can still be expected. For relatively stable later-stage companies, venture debt is one alternative for financing growth at this point.[3]

Private companies looking to raise money in the later stages should weigh the benefits of a higher valuation against the risk of a down round. A company's valuation is relatively meaningless until investors want to exit: a down round isn't likely to kill a good company, and the stigma attached to one is now smaller. Nonetheless, when companies are deemed less valuable than they had been previously, brand damage is likely, investors may be underwater (at least on paper), and employees can suffer—especially if the company's value per share falls below the value of their stock options.

A company's founders are an exception. Inflating later-stage valuations and raising tons of capital are often more appealing to them because they generally still do well even in the event of a later-stage down round. (There's an exception if the term sheets are structured to limit the founders' advantages—for example, through liquidation preferences and antidilution provisions.) It's easy to imagine more entrepreneur-unfriendly terms reemerging as investors get increasingly frustrated with down rounds and dollars lost on poor IPO showings.

Using IPOs strategically to accelerate growth

With ample private funding available and technology companies facing challenges in public markets, no wonder more and more software companies are choosing to gain scale as private entities. Remaining private does have a number of benefits. These include allowing

[3] For more on venture debt, see Brian Feinstein, Allen Miller, and Craig Netterfield, *Ten Questions Every Founder Should Ask before Raising Venture Debt*, Bessemer Venture Partners, bvp.com.

companies to focus on long-term strategy rather than short-term quarterly earnings, retaining the competitive advantage that comes from not disclosing business details, minimizing the time and resources that management spends on shareholder-facing activities, and protecting companies from activist investors and hostile takeovers.

Despite the benefits, few software companies can stay private indefinitely. Unless they become acquisition targets (which is challenging at sky-high valuations), most that survive and thrive in the private market should eventually expect to go public. Two factors often make an IPO inevitable. First, if a company exceeds the maximum number of shareholders allowed as a private entity, it will be forced to go public. Previously, the US Securities and Exchange Commission (SEC) required companies that had more than 500 shareholders to disclose their financial statements. (For example, the 2004 IPO of Google was triggered when it crossed the 500-shareholder limit.) In 2012, the US JOBS Act raised the threshold to 2,000 investors, enabling many companies to remain private (employees in stock-compensation plans and "crowdfunding" investors are excluded from the shareholder tally). The second forcing function comes from shareholders—investors as well as founders and early employees—who seek liquidity. Investors typically want to provide returns to their LPs on a seven- to ten-year time frame and therefore often push for IPOs.

Yet before shareholder limits or restive investors push a company into one, it should consider what time line best supports its strategy. When companies go public, they ought to have a stable and proven Act I, with sufficient runway to maintain strong growth for the next year or two. (For more on sustaining a strong growth trajectory, see "Grow fast or die slow: Pivoting beyond the core," April 2015, McKinsey.com.)

Mounting an IPO too early may lead to a post-IPO dive. Facebook, for example, went public in part because it crossed the SEC's maximum-shareholder threshold. However, at the time of its IPO, its core desktop offering had plateaued and it needed to pivot quickly to mobile—instability that helped drive down its stock price by 57 percent in the first three months after it went public. Eventually, Facebook solidified its Act II with a successful mobile strategy, and the company's stock price has increased 500 percent from its low of more than three years ago.

On the flip side, delaying an IPO is also risky. Pivoting to an unproven or undefined second act too soon after going public can shake the confidence of investors and often pushes down share prices. For example, GoPro went public in June 2014, and six months of strong growth saw its stock price more than double. However, as the market began to saturate, revenue growth slowed—and GoPro didn't have its second act ready. The result has been an 87 percent decrease in the company's stock price since its high of late 2014.

If a company is in a stable window of growth, an IPO can offer several strategic advantages:

- Get financing to scale up the business. A distinct benefit is access to the large amounts of capital available in the public markets. Companies can use new cash on the balance sheet to acquire new assets (for example, smaller competitors or "acqui-hires," where a company is bought primarily for its staff rather than its products or services) or to pursue organic growth. The capital raised through Atlassian's IPO, for example, was in part devoted to acquiring other businesses.

- Improve credibility. For a new brand that needs to compete with larger, established incumbents, going public can be a way to build standing. Because Lending Club's competitors were so large and well established, for example, the company's executives believed that an IPO was a must to compete with those household brands.

- Attract and retain key talent. Once a company has gone public, motivational levers and incentives change. An IPO can be a good time to attract new talent and to retain key executives and engineers. For example, in the months following its successful IPO, in 2013, Veeva Systems recruited Alan Mateo (formerly of JD Edwards, Medidata Solution, and PeopleSoft) as executive vice president of global sales and added Paul Sekhri (formerly of Novartis, Sanofi, and Teva Pharmaceutical Industries) to its board.

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Today's software environment reflects a new dynamic between private and public markets: more companies than ever reach valuations of $1 billion through private financing. To thrive in this new era, entrepreneurs and investors must reevaluate their strategies for delivering attractive returns to LPs. In the early stages, they may, for example, have to push to realize returns through mergers and acquisitions; later on, it may be necessary to raise capital more conservatively, at modest valuations, or to use alternatives such as venture debt.

When a software company does decide to go public, it should do so on the foundation of a stable Act I. In this context, an IPO offers several benefits, such as the financing needed to execute and scale up existing operations, to improve and legitimize a company's brand, and to attract and retain key talent.

Given the recent tightening of private funding and the performance of tech equities, there is speculation about whether winter is coming—or is already here. Regardless of the market outlook, getting the timing right for the transition from private to public helps set up software companies for long-term success. □

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