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The Tech IPO Well Has Run Dry. It's Likely to Stay That Way.

By
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Members of the Alphabet Workers Union hold a rally outside a Google office in February.
Ed Jones/AFP/Getty Images

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After a banner year for initial public offerings of technology companies in 2021, the number of new issues dropped precipitously last year. The stock market correction of 2022 saw the largest tech stocks decline by a greater percentage than the S&P 500. The fall in investor appetite for even the most established tech stocks was a key reason for the dearth of new issues. The correction signaled an end to the era of free money, and the deep compression in valuations made it difficult for private companies to get a clear picture of their public market value.
All of the tech-company IPOs of 2021 came to market having demonstrated revenue growth often exceeding 20% in the year prior to their debuts. But virtually all of the tech IPOs that we added to our *Battle Road IPO Review* generated losses leading up to their IPOs. Not only were the companies unable to turn a profit, virtually all recorded even *greater* losses over the prior year, as if the companies were being urged by their shareholders to indulge in a final feast to

drive top-line growth. Many of these companies promised that after their IPO, they would embark on a steady diet of reduced operating expenses, in order to demonstrate a reasonable path to profitability.

One reason for executives and private round investors to justify the spending binge lies in the faith in the Rule of 40, which holds that any combination of revenue and earnings growth summing to 40% will be the best determinant of sustainable demand for a company's public market valuation. In theory as well as in practice, a company could have a 20% revenue-growth rate, for instance, and operate at a substantial loss. The formula worked for several years leading up to last year's tech stock rout. But the stress test of last year's market correction debunked the Rule of 40. Even the fastest growing companies had their market capitalizations cut to the bone in a year of growth-stock compression.

The demand for growth stocks has undergone a sea change in the last six months. Technology behemoths Microsoft, Google, Amazon, Meta Platforms, and Salesforce, among many others, shed staff in the aftermath of an unsustainable rise in demand for their services, coupled with over-hiring during the pandemic. The decision to reduce operating expenses by companies that were already profitable is a sign that the terrain has shifted away from revenue growth at any price, to growth with a sustainable level of profitability.

Before answering the question why does profitability matter, it is worth asking whether companies with aspirations to go public in 2023 have the discipline in place to show not only top-line growth, but a pattern of steadily narrowing losses. My hunch is that many do not. The message that growth at any price will no longer cut it, is however, being learned the hard way. Many private companies have had their valuations slashed to reflect the lower valuations of their public-company peers. Indeed, venture-capital funding fell to a nine year low in the fourth quarter of 2022, The Wall Street Journal reported. Managing a business profitably will ultimately be rewarded, but the number of companies able to do so may remain limited.

Profitability matters because it demonstrates that a company has the potential, if not the power, to determine its own destiny. Conversely, operating losses are an indication that a company has yet to prove a working business model. The concern is that a company that loses money today will need to be bailed out tomorrow with future stock offerings or convertible debt, which in turn will dilute the interest of existing shareholders. It also means that a company will be unable to repurchase shares to offset equity issuance, a favored form of tech-company compensation which, if not held in check, results in shareholder dilution.

A company incapable of generating earnings today—no matter how promising its top-line growth prospects—may not yet be ready for the rough and tumble of the stock market. And if an unprofitable company does slip through the IPO window, it will likely need to be bailed out by a new round of investors, public or private. Until private companies and their financial backers realize that the terrain has shifted away from growth at any price in favor of growth along with profits—or at least a near-term path to break-even—the tech IPO well is likely to remain dry.