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The Valuation and Governance Bubbles of Silicon Valley

By Jesse M. Fried and Jeffrey N. Gordon October 10, 2019

1 Comment

The rise and fall of The We Company IPO bubble is one of those events that, like the subprime mortgage bubble that preceded the financial crisis, calls for an examination of market structures that could have produced such a precipitous turnabout. Indeed, the two bubbles share similar features, namely, structural features that favor the expression of positive sentiments and make it difficult to express negative sentiments. We call this "one-sided market sentiment."

Some of the most famous moments of the financial crisis, memorialized in print and film, turned on how intrepid traders determined that impenetrably complex mortgage-backed securities were overvalued (because based on mortgages issued to parties who were unlikely to repay) and then figured out a way to bring that negative sentiment to the market. Unless you can see how to make money on your contrarian pessimism, what's the point of the investigation?

One of the most notorious events of the financial crisis, the so-called "Abacus" offering put together by Goldman Sachs that packaged toxic MBS tranches into a securitization sold to European institutional buyers, was actually designed as a mechanism for hedge fund manager John Paulson to short the subprime market. Paulson bought the short side of the Abacus CDO that Goldman tailored to his specification. The advent of the ABX index in 2007 – which reported average credit default spreads on the various tranches of MBS debt – offered perhaps the first routine channel for expressing negative sentiment about the subprime market (since a party might be able to take the short side of a derivative that used the ABX index as "the underlying" – the security or benchmark on which the derivative is based). Economist Gary Gorton has argued that this new channel precipitated the subprime panic and repo runs of 2007.

The takeaway is this: A market that makes it difficult and costly to express negative sentiments is prone to a bubble and thus an abrupt collapse when negative fundamentals finally become too pervasive to ignore. Historically, stock markets have been bubble-prone because short-selling was mechanically difficult and expensive. Many think that the dot.com bubble of the 1990s was exacerbated by such potent barriers to short-selling. One decided positive about valuations in today's public equity market is that the rise of index funds has significantly lowered the cost of short-selling because index funds are eager participants in the stock-lending market. Short-selling apparently accounts for one-third of current public equity market trading. So, one might conjecture, today's stock market prices may better represent the balance of negative and positive sentiment about a firm's prospects and the general economy.

What's the We-translation? First, note that We's prospective IPO underwriters were pitching an extraordinary valuation for the post-IPO company, $65 billion, for a company that lost money and burned cash at an impressive rate. The last round of private financing for We implicitly valued the company at $47 billion. Yet valuation estimates today in the wake of the failed IPO are closer to $20 billion, even $15 billion. That's a valuation bubble and a collapse!

We was also seized of a governance bubble. The underwriters had permitted charter terms that ceded an extraordinary level of control rights to then-CEO Adam Neumann. The contemplated equity structure called for three classes of common stock, with Neumann holding shares of a super-voting class with 20 votes per share and another class of stock with zero votes per share that could be used to raise additional equity. The arrangement would have locked Neumann and his heirs into an unassailable control position until the end of time. Post-IPO failure, Neumann was fired as CEO, family members were excluded from the board, and his stock was reduced to 3 votes per share, stripping him of uncontestable control. That's a governance bubble and a collapse.

Our view is that the We bubbles of valuation and governance were in significant part the result of the one-sided sentiment that is a feature of the market for high-tech start-up finance that has evolved in Silicon Valley. What are the economic incentives facing venture capital firms ("VCs")? They make their money the new-fashioned way, by assembling pools of capital from institutional investors and wealthy individuals or families and using this capital to invest in promising new business ventures. The VCs earn management fees on the collected funds and share in the value-appreciation of any investments. The

VCs may also invest alongside the managed funds. The key to big time success in this world is access to the start-ups with the highest chance of home-run returns, a la Google or Facebook.

The Silicon Valley high-tech start-up market is flooded with money looking for high-end returns. VCs will naturally disagree as to which projects are most interesting. The diversity of views naturally means that start-ups are funded by those who are most optimistic about their prospects. If you don't believe in the opportunity, you don't invest. If you think the valuation implied by the investment terms is too high, you don't invest. The point is that, in this financing environment, Silicon Valley start-ups will be disproportionately funded by those who are most optimistic about the firm's prospects. This bias is true not only in the early-stage investment moment but also in successive rounds of VC finance. The tendency to overvaluation is thus akin to models of bidder overpayment, in which winners in a competitive auction are disproportionately likely to be overly optimistic.

Except it's worse. Unlike in bidder overpayment models, where each bidder thinks she's paying a reasonable price, VCs may knowingly overpay for shares in late-stage hot startups so they can "logo shop": list them on their portfolio page. This can help the VCs raise a new, larger fund – with bigger management fees. VCs may also have an incentive to overpay for high-variance startups when their existing portfolio companies are underperforming and, absent a few big wins, the VCs are unlikely to generate carry.

There is no way in the Silicon Valley economic ecosystem to "short" an excessively valued start-up. That is one consequence, some would think a virtue, of being a private company rather than a public company that has to contend with short sellers, who will not necessarily be pure-minded fundamental value traders. Yes, there is a secondary market in limited partnership interests, but this is not an effective way to communicate firm-specific negative sentiment.[1]

This structural feature would account for valuation bubbles. What about governance bubbles? The dynamic is similar. For greatest success, a VC needs access to the best opportunities. In an environment of surplus finance, the entrepreneur will have many potential funders to choose from. Obviously there are many other elements that influence the entrepreneur's decision about which VC is best (particularly the VC's track record at helping other start-ups succeed), but one critical factor will be how much control the entrepreneur will retain, especially at the moment of the IPO. In the private stage, there will be jostling between the entrepreneur and the VCs, which will be bounded by the entrepreneur's skill and early success as well as by the VC's desire to maintain a reputation of being helpful to entrepreneurs. When the firm goes public, the VC recedes and the entrepreneur wants raw control. A reputation for willingness to exit on these terms may well be one important way that VCs compete for entrepreneurs' favor.

On governance, the parties can point to Google's success – but was that because of or despite the unusual control structure? Microsoft/Gates and Amazon/Bezos succeeded without dual-class stock. Apple's eventual success may have required the exile and return of Steve Jobs, a redemption story that dual-class common could have disrupted. Uber and now We present a decidedly cautionary tale, as perhaps does Facebook in its response to growing public policy concerns.

Is there a remedy for one-sided market sentiment? The private label mortgage backed securities market has yet to recover. Perhaps the Silicon Valley valuation bubble will be self-correcting. The remedy for bidder overpayment in mature markets like oil leases is repeat-play by sophisticated parties, who build in internal checks against excessive optimism. Fiascos like the We IPO withdrawal and IPOs with negative returns like Uber and recently Peleton may exert some market check.

Following a suggestion of our colleague Gabriel Rauterberg, we could also imagine the introduction of a Silicon Valley valuation index that, like the ABX, would offer a derivatives-based avenue for expressing general short interest. An index provider like IHS Markit could infer valuations of the latest funding rounds from preferred stock terms found in publicly available charters (if VCs would not provide explicit information). One could argue that such an "SVX" index vehicle could well serve the VCs' long-term interests by reducing the risk of a boom-bust cycle that would damage the VC financing channel even if it might suppress current valuations.

One of us (Gordon) thinks that the governance bubble may provide an argument for a mandatory rule against dual-class common structures (or at least limitations on their potency; for example, the ratio of voting rights or its duration). VCs face a collective commitment problem. Net welfare would be better off if they could agree on limiting entrepreneurs' governance grasping, but in the absence of the capacity to agree, the resulting equilibrium predictably produces a low-quality governance bubble. Some regulator could produce a higher value result. The "regulator" might well be the exchanges through a listing standard or the stock index providers, though exchanges (Hong Kong, for example) are moving towards accepting disproportionate voting structures rather than tightening standards.

The other of us (Fried) would object to such intervention, on the grounds that regulators are unlikely to know better about the desirability of a dual-class structure at a particular firm than the sophisticated players in U.S. markets. Indeed, only a minority of VC-backed IPOs are dual-class, suggesting that investors like (or are at least willing to accept) that structure for some firms but not for others. If dual-class structures prove to be problematic, their use will decline.

Bubbles may be easier to identify than to resolve.

ENDNOTE

[1] Although venture capital and private equity are commonly lumped together as "private" as opposed to "public" finance, these considerations help us appreciate the differences. A PE sponsor critically depends upon third-party debt finance in its funding model. A failed PE portfolio company could well produce a bankruptcy that imposes significant losses on creditors. These losses – unlike equity losses – could not be recouped by a roaring success on

another company, because debt payouts are fixed and because PE equity claims and PE debt claims are held in different portfolios. A successful PE firm needs repeated access to debt markets and thus would try to avoid debt defaults. We've seen PE firms inject additional equity into failing firms to avoid a bankruptcy – meaning, risk throwing good money after bad despite the lack of legal obligation – to protect the on-going access to moderately priced debt finance that is critical to their business model. Thus the PE funding model should offer a lower propensity to valuation bubbles than the VC funding model.

This post comes to us from professors Jesse M. Fried at Harvard Law School and Jeffrey N. Gordon at Columbia Law School.

1 Comment

ilyabeylin

It was satisfying to read this clear eyed, critical and institutionally-engaged appraisal of the startup market. A few thoughts:

1) Absence of capacity to short is, as you explain, a problem. It would be difficult, however, to develop a solution — though Gabriel's idea is more than fascinating. Ideally, the short would be on specific VC portfolio companies — and there's just no way to get liquidity for that sort of contract. Maybe the SEC could host something like a reverse fantasy league where (perhaps anonymous) users can post as to which companies will fail and why? This would be a fun way of re-adapting Reg CF ideas regarding crowd-sourcing wisdom on investments? To add some spice, Reg D fees could be raised a bit and a portion of the fees shared with those making accurate predictions, though the predictions would primarily remain fueled by bragging rights. I'm only sorta joking.

2) Some time ago, Gabriel and I were thinking about getting startups onto exchanges earlier, thus enabling more liquidity (and incidentally supporting shorting).

3) Although Fidelity and other VC tourists may be funneling "naive" dollars into startups, there are relatively few unsophisticated investors participating in these markets. How much do we really care that sophisticated individuals' savings are being burned to warm the hands of customers and employees?

4) I think there is entirely too much optimism about the capacity of shorting to fix exuberance. Look at U.S. public equity markets for the last year at least. Analysts say they are supported by confident consumers, while at the same time analysis shows the U.S. population is grossly under-saving (thus implying a coming cut-back in consumption, and with it a fall in share price, necessitating further cutbacks, etc. in the usual circle). Ultimately, savers need to save and there are only so many assets (esp. when looking past debt due to concerns about inflation). I realize it's heresy to think that demand for investment opportunities can drive asset prices at scale, but I am beginning to think that's where we are.

5) What's most important is not said, perhaps because it is obvious. But it really should not be that obvious. We have a lot of people in positions of power that are comfortable promoting opportunities that they (should) know better than to advise anyone to take. This relates to the corp gov component. Every bad startup, every bad deal, . . . that does not quickly blow up justifies those that have abdicated their independent judgment and moral responsibility and marginalizes those with a critical point of view or moral compunctions about taking other people's money to enjoy being a founder or VC (and it is enjoyable on a lot of dimensions). But this of course is not limited to the startup space. What about the papers professors write? The charities we see fundraising? The policy ideas politicians are selling? . . . And where does a market correction come from (and what does it look like) in those spaces? The problem is that many of us have been selfish and inconsiderate. That's the part that should not be so obvious and should be said plainly more often. Corporate governance matters where there is something needing governance, i.e., the individual(s) involved are not governing themselves.

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