PRIVATE INVESTORS HAVE PUT $362 BILLION INTO STARTUPS OVER THE PAST FIVE YEARS, PUMPING UP THE PAPER VALUE OF SO-CALLED UNICORNS. NOW THE BROKEN TECH IPO MARKET IS CRATERING. WHO WILL SURVIVE THE RECKONING?

BY WILLIAM D. COHAN
ILLUSTRATION BY GORAN FACTORY

OF ALL THE SILICON VALLEY IPOs in the past couple of years, Lending Club's might have been the surest bet of all. ¶ The San Francisco peer-to-peer lender is a star in the world of "fintech," a growing sector made up of financial technology companies bent on disrupting the traditional banking sector. Its backers include venture capital royalty such as Kleiner Perkins and Union Square Ventures, not to mention Google and Alibaba. The startup's gold-plated board of directors includes luminaries such as John Mack, the former CEO of Morgan Stanley; former Treasury Secretary Larry Summers; and Mary Meeker, the one-time doyenne of Internet IPOs who is now a Kleiner partner. In other words, Lending Club had assembled a very smart-money crowd. Its much-buzzed-about offering was viewed, understandably, as a slam dunk.

In December 2014, led by underwriters at Morgan Stanley and Goldman Sachs, Lending Club priced its shares at $15, above the high end of the proposed range of $12 to $14. The IPO was 20 times oversubscribed and instantly gave the company a market value of nearly $6 billion. On the first day of trading, Lending Club's stock jumped almost 70% before pulling back to close at $23.42 a share, a one-day pop of 56%. For shareholders who got out quickly, it went in the books as another very successful offering.

Then reality set in. Lending Club's stock peaked about a week after its IPO, at nearly $26 a share, and has been retreating ever since. Never mind that the startup delivered extraordinary financial results in its first year as a public company: Lending Club's operating revenue was up more than 100% in the first nine months of 2015 compared with the same period in 2014, and its Ebitda, a measure of earnings before subtracting expenses such as interest and taxes, was up more than 200%. The stock recently traded around $8 a share, nearly 50% below its $15 IPO price.

Naturally, Lending Club CEO and co-founder Renaud Laplanche wishes the stock price were higher. But he's trying to look past short-term vicissitudes. "Part of the main reason for going public was to continue to establish Lending Club's brand and credibility," he says. "We're building a big company. It's going to take a very long time, but we want to do it in the public eye with full transparency. I think from that standpoint, we got rewarded. I think the Lending Club brand is a lot more established now than it was a year ago."

That may be true with customers and bankers, but ask any retail investor who made a bet on Lending Club at around $20 a share about the company's brand today, and the response is likely to be a grimace followed by a torrent of vitriol.

Unfortunately the Lending Club story is not an isolated case. Time and time again during the current IPO cycle, Wall Street underwriters—egged on by ambitious CEOs, hungry venture capitalists, and favored institutional investors—have hyped one technology IPO after another. The bankers price the offerings for perfection, watch them soar on the first day of trading to deliver the coveted first-day spike, and don't stick around to offer an explanation after the shares plunge below the first-day price. (Morgan Stanley and Goldman Sachs declined to comment for this story.)

Welcome to the world of zombie tech stocks—once-highflying IPOs wandering aimlessly in the wasteland of the public equity markets and understandably unloved by investors. Many have familiar names, such as Zynga (down about 75% from its IPO price), Twitter (down 30%), and Groupon (down 85%). Online craft marketplace Etsy recently traded 56% below last year's price at IPO and 77% under its first-day close. Others that are less well-known—like Nimble Storage (67% below IPO price)—have been just as disappointing.

To be fair, some major tech IPOs have soared in recent years, among them LinkedIn, Tesla Motors, and, after a rocky and controversial start, Facebook. But these are the exceptions. The detritus far outnumber the success stories, raising the question, Is the method by which companies go public as broken and inequitable as it ever was? That would certainly seem to be the case. And the problem is especially acute when it comes to tech companies for which relentless forward momentum is key not only to pleasing investors but

Lending Club CEO Renaud Laplanche on the floor of the New York Stock Exchange on the day of his company's IPO in December 2014. The stock got a first-day pop of more than 50%. It now trades well below the IPO price.

RICHARD DREW—AP

also to attracting talent and keeping their competitive edge.

This set of facts doesn't bode well for the current wave of talked-up technology companies in the IPO pipeline—the so-called unicorns, or private startups valued at $1 billion or more by their investors. This once-rare species of startup has proliferated lately in Silicon Valley and beyond—from headliners such as Uber and Airbnb to lower-profile newcomers like Apttus and HelloFresh. Last year *Fortune* identified more than 80 unicorns for a cover story on the phenomenon; by our most recent count, that number has grown to 173. (See "The [New] Unicorn List" in this story.) According to CB Insights, a research firm that tracks venture capital investments, private investors have plowed some $362 billion into startups in just the past five years.

That means that a tremendous backlog of potential technology IPOs is building up just as the stock market is beginning to look very wobbly after its nearly seven-year bull run. Indeed, U.S. stock indexes began 2016 with their worst first-two-week period in history. The S&P 500 fell 8% in the first 10 trading days, and the S&P tech sector underperformed the broader market by a full percentage point.

For an already weakening tech IPO market, the turbulence in stocks is a punch to the stomach. In mid-January, IPO research specialists Renaissance Capital put out a special report called "Exploring the Disappearing Technology IPO." The trends it identified were not encouraging. From 2012 through 2014, according to Renaissance, there were an average of 36 venture-backed tech IPOs per year. But in 2015 that number dropped to 23, and only seven of those offerings happened in the second half of the year, partly because of a stock market correction in August. Though the average time from founding to IPO reached a high for tech deals in 2015, the profitability of the typical technology company going public has plunged into negative territory over the past couple of years. The median Ebitda for tech companies going public in 2015 was –$9 million.

All signs point to a continued slowdown in tech IPO activity in 2016, says Kathleen Smith, a principal at Renaissance and the company's manager of

THE [NEW] UNICORN LIST

When we published our inaugural unicorn list in February 2015, we counted slightly more than 80 privately held, venture-backed companies worth $1 billion or more. That number has since exploded: By our count there are now 173 unicorns, collectively worth more than $585 billion. But the pace of anointing new unicorns is slowing, and ongoing economic uncertainty is pressuring the group to justify their lofty valuations. *—Andrew Nusca*

GRAPHIC BY NICOLAS RAPP

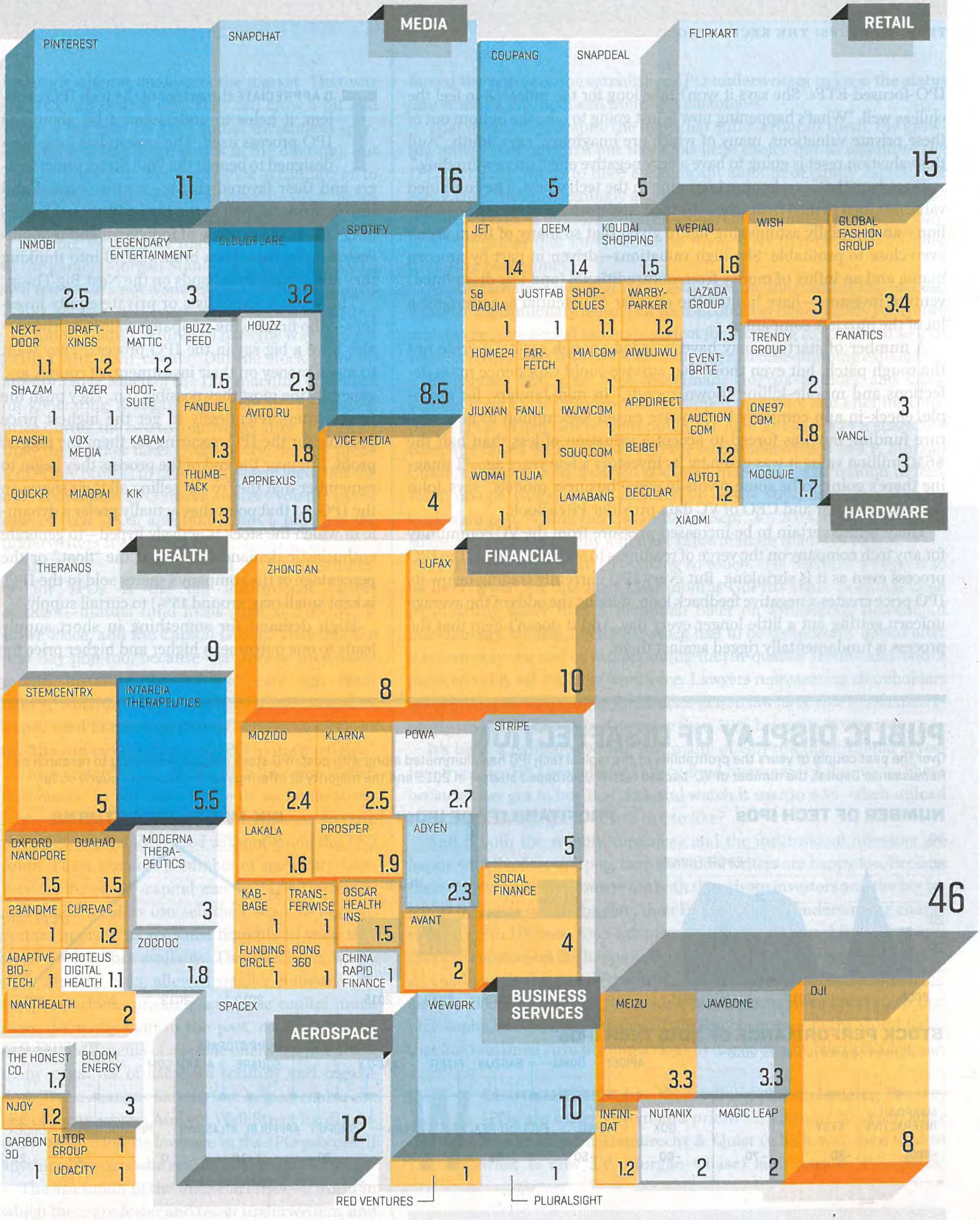


CHART SOURCES: PITCHBOOK; CB INSIGHTS; NEWS REPORTS; FORTUNE

IPO-focused ETFs. She says it won't take long for the unicorns to feel the chill as well. "What's happening now is just going to take the bottom out of these private valuations, many of which are imaginary," says Smith. "And this valuation reset is going to have a very negative effect on new funding."

It appears that a reckoning is coming in the tech world. The combined value ascribed to the 173 unicorns by their investors is a stunning $585 billion—an especially astonishing figure given that so many of them aren't even close to profitable. Sky-high valuations—driven in part by unicorn mania and an influx of money from nontraditional (and less disciplined) venture investors—have limited the number of potential acquirers for a lot of the buzziest companies.

A number of startups may have hoarded enough capital to ride out the rough patch, but even those that survive could experience mass defections and morale-killing "down rounds." In mid-January, for example, check-in app company Foursquare raised $45 million in new venture funding but was forced to accept a valuation of less than half the $650 million value it was given by its investors a few years ago. "I imagine there's going to be some pivots in some business models," says John Gabbert, founder and CEO of VC data provider PitchBook.

There is also certain to be increased pressure from the VC community for any tech company on the verge of readiness to seek the "exit" of the IPO process even as it is shrinking. But every IPO currently trading below its IPO price creates a negative feedback loop, making the odds of the average unicorn getting out a little longer every day. And it doesn't help that the process is fundamentally rigged against them.

TO APPRECIATE the extent of the tech IPO problem, it helps to understand a bit about the IPO process itself. The system has long been designed to benefit the Wall Street underwriters and their favored clients—venture capital and buyout firms, as well as the big institutional buyers of IPOs—at the expense of individual and retail investors, who have been brainwashed into thinking they are getting their hands on the Next Big Thing.

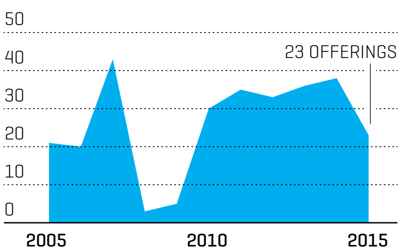
The venture capitalists or private equity investors—who finance the company while it is private—also have a big say in the IPO process. They want to make money on their investment, of course, and generally the most they possibly can. They push the underwriters relentlessly to get the highest price possible for the IPO, securing for them the biggest profit. But near the end of the process they begin to remember that they're not selling all their shares in the IPO. At that point they actually prefer a dynamic in which the stock is actively hyped—to generate enthusiastic demand for it—but the "float," or the percentage of the company's shares sold in the IPO, is kept small (say, around 15%) to curtail supply.

High demand for something in short supply leads to one outcome: a higher and higher price for

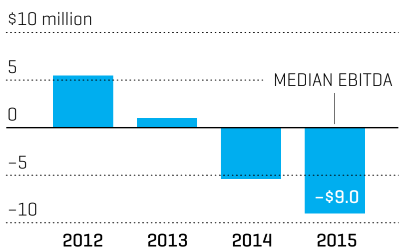
PUBLIC DISPLAY OF DISAFFECTION

Over the past couple of years the profitability of the typical tech IPO has plummeted along with post-IPO stock returns. According to research by Renaissance Capital, the number of VC-backed tech IPOs dropped sharply in 2015 and the majority of offerings have performed poorly so far.

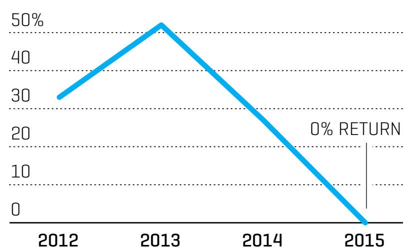
NUMBER OF TECH IPOs



PROFITABILITY OF IPOs

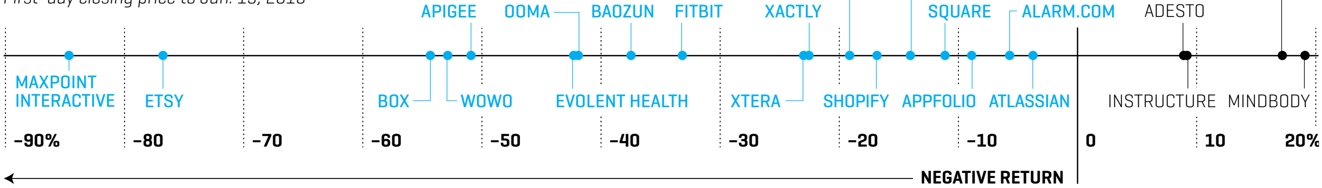


SIX-MONTH IPO RETURNS



STOCK PERFORMANCE OF 2015 TECH IPOs

First-day closing price to Jan. 13, 2016



GRAPHICS SOURCE: RENAISSANCE CAPITAL.

the stock when it finally hits the market. That way the VCs can double dip: They can crow a bit and notch a big gain on their initial investment (perhaps even selling some shares in the offering), but can also know that they were clever in hanging on to most of their stock, especially when the stock moves up smartly on the first day of trading.

The big Wall Street underwriters set the rules of the game. "Morgan Stanley and Goldman Sachs will tell you it's not a successful IPO unless there's a 20% to 30% pop," says John Buttrick, a partner at Union Square Ventures. "That's the way they get graded with their clients: Did the stock trade up after pricing? Much of the IPO machine is focused on generating a sugar-rush spike in the trading price during the two to four weeks after IPO. After that, the market takes over: 'Sorry, not my problem.' They profess to take a long-term view, but the data shows post-IPO stocks are very volatile in the case of tech IPOs, and that is not a problem the underwriters try to address."

Another important constituency for IPOs is the big institutional buyers of them—mutual fund firms such as Fidelity, T. Rowe Price, and the Capital Group. They like the first-day pop too, because that means they make money instantly. Twenty-five years ago Peter Lynch, when he was running Fidelity's Magellan Fund, used to refer to IPOs as "sunset stocks"—as in, "the sun never sets on an IPO in my portfolio."

Interestingly, it's a system that has also defied innovation. In the past decade or so, some clever new ways have been created for companies to raise the equity capital they need without going the IPO route. There are now a number of secondary markets where equity capital can be raised privately and where insiders can sell their stock to new investors in order to get some liquidity in ways that were never before available. The JOBS Act, which took effect in 2013, allowed smaller companies to file prospectuses privately and raise capital much more discreetly than in the past, as a way to get some of the benefits of a public offering without the many negatives of excessive scrutiny and regulation. These changes have in fact helped enable the rise of the unicorns. And yet Wall Street hardly appears to have lost its leverage in the IPO process. If anything, the opposite is true.

The aftermath of the financial crisis—a world in which there are fewer and fewer underwriters, and many of the European banks have all but disappeared from the underwriting market—has reinforced the power of the established IPO underwriters to keep the status quo working for them and their best customers.

That means that despite the hype that still surrounds them, the growing universe of unicorns out there has little choice but to submit to the IPO cartel if it wants to raise a significant amount of equity capital. For every Uber, which seemingly attracts as much capital as it wants in the private market at increasingly stratospheric valuations, there are a hundred companies that must submit to the powers that be when it comes to raising new money.

As an example of how regular investors get the short end of this process, consider the cautionary tale of GoPro, the company behind every adventure athlete's favorite digital camera—perfect for attaching to your head so that you can record your wild-ass snowboarding and base-jumping exploits.

Remember how cool Nick Woodman, GoPro's founder and CEO, seemed in all those interviews that cropped up before and after his company's IPO? When GoPro went public, in June 2014, at $24 a share, the company raised $491 million, and the lead underwriters at J.P. Morgan Chase, Citigroup, and Barclays pocketed more than $28 million in fees. Right on cue, GoPro's stock sprinted up nearly 50%, delivering that all-important pop. Within three months, on Sept. 30, 2014, it was near $95 a share, giving the company a market value of more than $13 billion.

These days Woodman isn't talking so much. (He declined a request to be interviewed for this story.) For months GoPro's share price has been plummeting faster than a mountain biker on a headlong descent. In mid-January, trading in GoPro's stock had to be temporarily halted after the company warned of disappointing fourth-quarter results and said it planned to lay off 7% of its workforce. Lawyers representing shareholders quickly slapped the company with class-action lawsuits. GoPro's shares recently traded for less than $12, more than 50% below its IPO price.

It's been a painful reversal. But many of GoPro's institutional investors from the IPO probably still have fond memories of the stock. That's because they got to buy it at $24 and watch it soar to $36—then unload it for a quick 50% gain. What's not to like?

And if both the venture capitalists and the institutional investors are happy with the first-day pop, then the underwriters are happy too, because their biggest repeat customers are both the private investors and the big institutional investors. To be sure, their high fees—the underwriting charge in the GoPro IPO was 6%—are nice too. But the real goal is making sure that their customers are happy and do business with them again and again. At Goldman Sachs, one of the firm's mantras is to be "long-term greedy," and the IPO underwriting process is a perfect example of how it puts that philosophy into practice. It's one of the few businesses in the world today that has remained virtually impervious to disruption by Silicon Valley.

WILLIAM HAMBRECHT has been talking about changing the way IPOs are underwritten and priced for close to 20 years, since he left his firm Hambrecht & Quist (which was then sold to what is now J.P. Morgan Chase) and started W.R. Hambrecht & Co. in 1998 with the hope of upending the way the Wall Street cartel manages and markets IPOs. One of the firm's high-water marks came early in its existence when it was one of the underwriters of the Google IPO, in August 2004. (There were 31 underwriters in all, led by Morgan Stanley and Credit Suisse First Boston.)

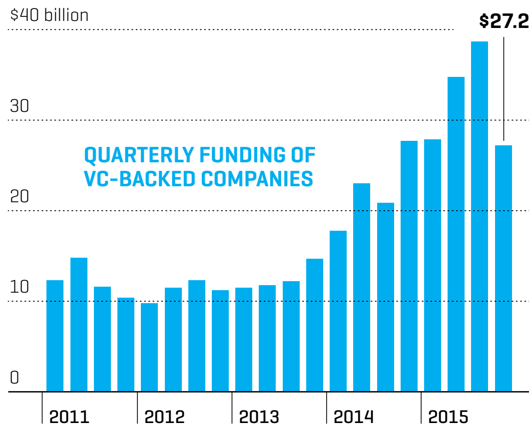
Eleven years on, people may no longer remember how controversial it was at the time for Google to have adopted Hambrecht & Co.'s auction strategy for what became the most important company in a generation. After conducting an online Dutch auction for the Google shares, in which investors named the price they would pay and orders were filled in the order of those who bid the highest price, the underwriters priced the Google IPO at $85 a share, below expectations. The stock closed on the first day at about $100 a share, up 17%. (In the end the lead underwriters didn't strictly adhere to the auction strategy in its purest form.)

Experimenting with a different IPO pricing model certainly didn't hurt Google. The tech giant's stock is up some 1,500% from its IPO, and the company (renamed Alphabet last year) has a market value approaching $500 billion, second only to Apple's. Its stock chart looks like one side of the Matterhorn. But very few other companies have been willing to go public the way Google did, through an auction process. (Some have, including Morningstar, up more than 400% from its IPO, and Interactive Broker Group, up about 50%.) Rather than a turning point, the Google IPO is remembered more as a historical footnote.

Hambrecht thinks the way IPOs are manufactured and sold remains a problem. "It really is a system that is broken," he says. He thinks the "traditional approach" needs to change but knows that the big underwriters won't do it, despite their understanding, intellectually, that the auction approach is a fairer system. They just make too much money as things currently stand. "The underwriters stick to the traditional approach because, first of all, it allows them to discount the pricing," he continues. "It gives them selective allocation to their best customers. And they've tried to keep a knowledge advantage, so it's really a proprietary product through the first six months or a year of the trading. All of those things enhance the profitability to the underwriter."

He says that when, say, Alibaba pops from $68 a share to $115 a share, as it did in the first few months after its IPO, the underwriters cash in because their institutional clients have made a lot of money and pay them back in kind over time. "The people who buy it in the aftermarket are the shareholders who end up, in effect, holding the bag," he says. Hambrecht doubts that the system will ever change unless a reform is forced on the banks legislatively (as was briefly considered after the Facebook IPO) or their vicelike grip on the large IPO business is disrupted. "It's deeply entrenched," he says.

In fact, Hambrecht is so resigned to the inevitable power of the name-brand underwriters that he's decided he won't try to fight them anymore. Instead, he's returned to what he did once upon a time at Hambrecht & Quist: Taking smaller startups public. His latest eponymous firm, Hambrecht & Co., specializes in underwriting for companies that have valuations below the unicorn threshold and garner less interest from the big banks.



IS THE PARTY OVER?

Driven in part by a flood of capital from outside Silicon Valley, venture investing has rocketed in recent years. In the fourth quarter of 2015 it pulled back sharply.

GRAPHIC SOURCE: CBINSIGHTS

DESPITE THE DECK being stacked against them during the underwriting process, some executives at newly public companies say they wouldn't change a thing. In this camp are James Park, the co-founder and CEO of Fitbit, and William Zerella, its chief financial officer.

Last June, Fitbit, a maker of fitness tracking devices, priced its IPO at $20 a share, above its indicated range. Morgan Stanley was the lead underwriter. The stock opened up 52% right away and ended up about that much, giving the company a market value of $6.5 billion and making Park nearly a demi-billionaire. In November the company completed a secondary offering, at $29 a share—below the $31.68 a share where it had closed the day before—in which 14 million of the 17 million shares sold came from its VC financiers. It was, in part, a move to reduce the downward pressure on the stock as the expiration of the six-month lockup period loomed. These days, after a poorly received new-product offering, Fitbit trades below its IPO price.

But despite the stock's roller-coaster ride, Park and Zerella say they couldn't be happier with how the IPO was handled. Zerella credits his bankers for the way they ran the process. "They understood our story and were very helpful in articulating it to the Street," he says, although it also helped that Fitbit is a leader in its space and very profitable.

STARTUP SURVIVOR

Which unicorns have the business fundamentals to back their hype? Here are three likely to stumble—and three worth wagering on. —*Andrew Nusca*

PINTEREST CEO
BEN SILBERMANN

THREE TO BET ON

PINTEREST

The San Francisco photo-sharing startup took years to focus on revenue. It finally has—and advertisers are spending. Pinterest has escaped share-price markdowns from its mutual fund investors by handily beating its ambitious revenue targets as it lays the groundwork for an IPO.

ADYEN

The Amsterdam-based payments startup processed $50 billion in online and mobile sales last year, with (shock!) actual profits on its $350 million in revenue. Valued at $2.3 billion, Adyen is a steal compared with Stripe, which is worth twice as much but reportedly processed less than half as much in sales.

DOCUSIGN

Electronic documentation, or "e-signing," isn't the most exciting business—but it's growing fast. DocuSign, based in San Francisco, is the category leader and serves several *Fortune* 500 clients.

INSTACART CEO
APOORVA MEHTA

THREE TO BET AGAINST

INSTACART

The other shoe is expected to drop for on-demand delivery services this year, and San Francisco grocery-delivery service Instacart is the category's poster child. Venture capitalist Bill Gurley compared Instacart's challenging unit economics to "handing out dollars for 85¢."

WEWORK

Investors value WeWork, a wildly ambitious office-subletting business, like a software company. For WeWork to live up to its $10 billion valuation, it faces the daunting task of scaling like a software company—but with people, long-term leases, and office furniture.

DROPBOX

There are numerous reports of revenue-growth pains at this Redwood City, Calif., cloud-computing startup. But if that's not convincing, just look at the stock performance of its competitor Box: It went public at a 29% discount to its last private valuation, and today its shares are down a further 54%.

Park says that he and his management team were excited by the IPO and by being on the floor of the New York Stock Exchange when the stock first traded. He has no regrets about not pricing the IPO higher to get more of the offering proceeds for the company. Park says he understands the players at the table have to get their cut. "I think the worst outcome would have been for it to trade below the offering price [in the days after the IPO]," he says. "It was a delicate dance, and I feel that we struck the right balance in the price of the deal. And the pop on the first day really gave the company a lot of great momentum in the press and with employees."

Other perks: Park says the Fitbit IPO let the world know just how profitable his company is—with Ebitda margins of around 23%—and how, despite some formidable competition from Apple and others, Fitbit remains the industry leader. He points out that Fitbit now has a currency to use for potential acquisitions and says that going public has given the company's employees something to root for together—its stock price. "It's been a great event," he says. "It really cements us as a world-class company."

LAPLANCHE OF LENDING CLUB, for his part, tries to put his company's IPO experience in the most charitable light. But he can't help scratching his head about how the stock has traded since those hype-filled early weeks after the IPO. He says that if the stock hadn't jumped past $25 a share and had just traded at around $15, there would have been less disappointment, especially for the retail investors. "That being said, if they made a long-term investment, then I'm very confident that we're going to continue to deliver great results," he says.

No thanks to the standard IPO process. One of the reasons behind the volatility of Lending Club's share price is the simple matter of supply and demand. The underwriters at Goldman and Morgan Stanley argued for a float of between 10% and 15% of the shares outstanding, and in the end it was around 15%. That created scarcity value initially, leading to the coveted opening-day pop. That's the good news. The bad news came at the end of the six-month lockup period, when the Lending Club's VC investors started selling their shares into the market.

Whether it's a coincidence or not, Lending Club's share price moved from about $19 in early June 2015 to a low of around $11 three months later—in effect tracking the increase in supply of stock during the year as the venture capitalists started unloading their stakes in the company.

Laplanche, of course, understands these supply-demand dynamics. But he's not sure less sophisticated investors appreciate the subtleties of lockup periods and floats. "It can be a bit frustrating, particularly for people who wonder, Okay, what's wrong with the company? Is there something there that drives the stock price?" he says. "I think we're a good case study for it because we continue to report good news after good news, so there's really no fundamental you can point to to explain the stock performance. Really, all that's left is supply and demand of shares."

All indicators point to Lending Club being more than strong enough financially to soar past its post-IPO doldrums. In an increasingly tough environment for tech companies, some of its peers may not be.

SILBERMANN: KIM KULISH—CORBIS; MEHTA: BENJAMIN RASMUSSEN