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#twitterIPO

#FollowingValue

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You must have heard in the news recently about Twitter's Initial Public Offering. Why would a company like Twitter want to go "public" and how is the value of its shares determined? We won't even pretend that we could answer these questions in 140 characters or less.

An initial public offering or IPO, as it is also known, is the process that a private company goes through in order to raise money and be traded on a public market exchange such as the TSX, NYSE or NASDAQ.

The US IPO market is substantially larger than its Canadian peer. For example, according to PwC's survey of the Canadian IPO market, approximately $1.8B was raised in 2012. The US IPO market, on the other hand, generated volumes in excess of $47B according to the Wall Street Journal.

The two primary reasons a company would go through this process are:

<u>Raise money:</u> Although private companies are able to obtain equity investments and bank debt, it can be easier and cheaper to raise capital if the company is publicly traded. When a company is public, large institutional investors who can invest larger dollar amounts at a more attractive cost to the company, can be influential in the process. In the case of Twitter, they raised approximately $1.8 billion issuing 70 million shares at an IPO price of $26 per share.

<u>Create Liquidity:</u> Another key reason for an IPO is to provide liquidity to the shareholders. Selling shares of a private company can take time and despite best efforts may not result in a transaction. If you have the right kind of company that will attract the attention of the masses and media, being publicly traded creates an automatic market for the shares. The key is attracting the attention and generating consistent volumes of trading. Twitter has already developed a profile in the marketplace, which should result in an active market for trading. Volume on its first day of trading reached 118 million shares and has averaged 24 million shares per day since opening.

How do You Value Twitter for an IPO?

The answer to this question depends on a number of different factors. Usually the underwriters (more commonly referred to as the investment bankers) set the price for the IPO and they utilize a number of different methods to price the shares, including, but not limited to:

1. Market demand: Like any product or service, there has to be demand for the share offering. This is exactly why in soft equity markets, such as that experienced after the financial crisis in 2008, you will not see many IPOs. Advisors will try to conduct the IPO process in periods when there is strong demand for either equity investments in general or specific industries (i.e. social media).
2. Market comparable companies: Some bankers will look at comparable companies and use common benchmark valuation multiples identified through their respective IPO and use those specific benchmarks in their offering. For example, in the case of Twitter, other social media companies such as Facebook's IPO, would most likely have been considered as part of the process to determine the offering price. This obviously has some risk associated with it – in particular, if the market demand for such an offering has changed. So it is possible that two identical companies would achieve two different prices for their shares.
3. Traditional valuation analysis: Most bankers will also conduct their own valuations by looking at forecasts and conducting a discounted cash flow analysis. This Is particularly difficult in valuing a company like Twitter that historically has not generated positive cash flow. This analysis usually involves a multiple-year forecast that would factor in a number of assumptions, some of which could be highly contentious. For example, assumptions such as revenue or probability growth rates could be a source of disagreements between advisors and the marketplace, which sometimes drives the price up or down after the IPO, as was the case with Facebook.

Value is Based on More than Just Revenue

Based on market demand, comparable companies and some element of traditional valuation analysis, Twitter began trading on the NYSE at $26 per share, valuing this tech giant at over $14 billion. If you compare this valuation to some Canadian companies, such as National Bank of Canada ($14.9B) or Loblaw's ($13.4B), it's easy to see how much impact Twitter has in the marketplace despite that it has yet to earn a profit. This example shows that there is more to the valuation of a public company than its revenue and earnings history. Some of the factors that the investment bankers, investment advisors and the general public will have to consider in Twitter's value will include but not be limited to:

1. Twitter's relationships with Platform Partners and Advertisers. Platform partners include publishers, media and developers who develop and distribute content using the Twitter platform. Advertisers use Twitter to reach a targeted audience to advertise their products and expand the reach of more traditional advertising campaigns. Both platform partners and advertisers are key contributors to the company's future growth. The more partners and advertisers Twitter is able to secure, the more profitable the company can become. Although, the company doesn't make money from all platform partners, they do provide content which in turn attracts more users to Twitter. More users attract more advertisers, generally a higher rate for the advertising space and ultimately more advertising dollars.

2. Growth of mobile and advancing mobile functionality. According to the prospectus, as of 2012, there are 2.4 billion internet users and approximately 1.2 billion smart phones. More and more users are gravitating towards mobile applications. Companies providing strong content or reliable services via mobile applications are in more demand in the public markets.
3. Consistently providing followers with new product or service offerings. Providing more relevant content to its users is challenging. In regards to Twitter that's what drives people to their service. It will be absolutely critical for Twitter to constantly evolve to increase its user base and therefore their revenue potential.
4. Restrictions on use by foreign governments. There have been instances in the past where access to Twitter has been blocked by foreign governments wishing to censor certain topics. This could be an issue for the company if it is trying to grow its user base in emerging or new markets to meet its growth plans.
5. Twitter has yet to earn a profit. According to its prospectus, in its last fiscal year 2012, the company generated revenues of $317 million but suffered a net loss of $80 million. In the first six months of 2013 it suffered additional losses of $69 million.

The last factor presents the most difficult challenge in valuing the shares of Twitter. How do you value a company that has yet to generate earnings? The answer lies in its future prospects. While it may not have generated earnings in the past, investors will be betting on the prospects for positive cash flow in the future.

Twitter has changed the way we communicate with one and other. Jimmy Fallon and Justin Timberlake recently released a Youtube video showing what a "twitter conversation sounds like in real life": #Hashtag this, #Hashtag that. It has reached over 18 million views and, with humour, illustrates the influence Twitter has had on its 200 million monthly active users. #200millionusers, that's 15 characters. Perhaps those 15 characters alone answer the question as to how to value the shares of Twitter. So we were able to answer our question in under 140 characters after all!

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