BerkeleyLaw
UNIVERSITY OF CALIFORNIA
Berkeley Center for
Law and Business

Berkeley Center for Law and Business
University of California, Berkeley
School of Law
Boalt Hall #7200
Berkeley, CA 94720-7220

The Startup Bubble Deflation: A Story of Disproportionate Valuations

By Grace Tepley J.D. Candidate 2022 | October 7, 2019

The recent deflation of the startup bubble may be explained by Wall Street investors' growing reluctance to buy into huge startup valuations. Recent IPO debut flops of hot companies with high valuations (Uber, Lyft and Peloton) have other companies like WeWork rethinking going public anytime soon. Peloton alone managed to lose $900 million of private investor wealth after their recent IPO. Similarly, with a price of $45 per share, Uber reached a valuation of $82.4 billion in their IPO, substantially less than its' most recent $120 billion private valuation.

The reason these highly valued companies are struggling on the public market has to do with a new trend in venture capital (VC) investment. VC firms are increasingly flooding young startups with seemingly endless capital. Speculations as to which companies have the highest growth potential has resulted in VC firms dolling out enough money to keep young startups afloat. This holds true for startups lacking fundamentals such as the ability to turn a profit, maintain experienced leadership, and establish well-developed business plans.

Young companies that receive billion dollar valuations – once deemed "unicorns" for their rarity – are the new norm in the startup community. VCs betting on future growth and market dominance rather than current and sustainable profitability has resulted in the overvalued bubble seen today. In fact, these practices have resulted in 49% of VC-backed unicorns boasting valuations far above their market value.

Public investors are increasingly becoming skeptical of these huge valuations because, despite creating massive revenue, some companies, like Uber, fail to make a profit. Overall, less than one fourth of all recent IPOs are from profitable companies. The IPO flops of Uber, Lyft and Peloton suggest that public investors may be shifting back to preferring tangible profitability as opposed to the path to profitability narrative that is being sold today.

However, there are notable exceptions to this flop phenomena that indicate public investors are still interested in interacting with unicorn-status companies that have their fundamentals in place. For example, Pinterest and Chewy sufficiently impressed public investors to survive their IPOs without losses. Likewise, Airbnb's recent acquisition of talented leaders marks a clear investment in its business model that may welcome public investors.

It is likely that the recent deflation in the startup bubble is the market's way of correcting itself from disproportionate valuations. Whether or not highly valued companies will continue to seek public investments may now depend on the reliability of their future profits. What is clear, is that the discussion of overvaluation is increasingly important to both public and private investors, as well as the startups intending to raise capital from these sources.