

# Snapchat IPO – – Don't Confuse Popular With Profitable

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Snap Inc's recent IPO gives us a golden opportunity to examine the tenets of value investing. To much fanfare, Snapchat (as I'll refer to the company in the rest of this article) went public last week. During its first week of trading it jumped to a high of \$28.84 and today is trading around \$25 a share. That gives Snapchat a valuation of about \$32 billion. (Update: Between writing this article yesterday and publishing it today, the stock dropped to \$23.77 a share, valuing the company at roughly \$24 billion.)



Snap Inc. IPO at the New York Stock Exchange, March 2, 2017 in New York. Snapchat surged in its...  
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Now let's try to value the company. Any fundamental investor (in contrast to speculators) should view the purchase of a partial interest in a company the same as buying it lock, stock and barrel. In other words, would we be willing to shell out \$24 billion for Snapchat? If the answer is no, we have no business investing in a single share of the company.

The starting point to our valuation is the company's Form S-1 Registration Statement filed with the Securities and Exchange Commission. An S-1 includes the company's audited financial statements. I always start with a company's balance sheet.

With Snapchat, there's a lot to like about its balance sheet. It has virtually no debt. Its current assets (cash and other assets expected to be converted to cash within 12 months) exceeds its current liabilities (debts or portions of debt due in the next 12 months) by a factor of eight. It also has over a billion dollars in cash and marketable securities. It won't go broke this year, always a bonus when evaluating a potential investment.

There is, however, one glaring pimple on this otherwise pristine balance sheet. Its net worth (assets minus liabilities) is just \$1.5 billion. By itself that's not a problem. But when compared to its \$24 billion price tag, Snapchat has "some splainin to do." While a company's intrinsic value often exceeds its book value, a market value some 15x higher than its net worth raises questions.

Perhaps its income statement will clear things up. Here the pimple flares into full blown acne. It's never made a profit. In fact, in its most recent fiscal year ending December 31, 2016, the company lost \$500 million. And don't look for trends to save it. It lost \$372 million the previous year. The company didn't even turn an operating profit.

Would you pay \$24 billion for an asset, any asset, that loses \$500 million a year? Fundamental analysis values a company based on the current value of future cash flows. That's a tall order when a company has never turned a profit. Now we are faced with daunting task of justifying an investment in Snapchat based on projections. Prognosticators are close cousins of astrologers, and equally effective at predicting the future.

The company increased its advertising revenue by more than 6x from 2015 to 2016. Whether it will continue to grow and at what pace is anybody's guess. It also significantly increased its expenses and losses from 2015 to 2016.

We could look to Snapchat's Spectacles. The company launched its first product last fall. The glasses enable Snapchat users to record short videos. As of the end of last year, however, sales of Spectacles were not material to the company's financial statements, according to its S-1. While I have grave doubts that consumers will want to add yet another gadget that needs recharged to do what their smartphone already does, perhaps Snapchat's Spectacles will prove me wrong. But are they worth risking \$24 billion?

And therein lies the problem. We have no idea how much the company is worth. It may turn out to be worth far more than \$24 billion. Or perhaps far less. But if we cannot value a company, at least within a reasonable

range, we have no idea at what price it would be a good investment. And without that information, we have no business investing in Snapchat.

Moving away from the company's financial statements doesn't improve the valuations. The company sold non-voting shares to the public. The company has three classes of shares, A, B and C. The A shares sold to the public have no voting rights. The B shares, held by certain executives of the company and early investors, each have one vote per share. And the C class shares, held exclusively by the co-founders, each have 10 votes per share. The net result is that the co-founders control 88.5% of the voting rights, according to recode.

This by itself is a showstopper. The co-founders view this company as their own. It's not. It now belongs, at least in part, to public shareholders. When management fails to recognize that they work for the shareholders, bad things happen. It's common when founders run the company without meaningful accountability. The lack of voting rights creates just such a toxic environment.

None of this is meant to suggest that Snapchat is a bad company. Just a bad investment.

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