

Perspectives on giga-sized AI-based companies' IPOs



Your Turn

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Guest columnist

SpaceX, Elon Musk's conglomerate spanning the production of rockets, Artificial Intelligence (AI), space-based Internet service and data centers, and colonies on Mars, recently filed paperwork to raise as much as \$75 billion through an initial public offering (IPO).

Two other AI labs, Anthropic and OpenAI, are expected to follow suit later this year and go public. SpaceX was targeting an initial public valuation of \$1.75 trillion, and the combined target initial public valuation for Anthropic and OpenAI is expected to be almost \$2.25 trillion. OpenAI was valued at \$852 billion when it raised \$122 billion in its latest private round of financing in April whereas the valuation of Anthropic increased to \$965 billion when it conducted its most recent private financing round in May and raised \$65 billion.

The three mammoth AI-based IPOs all are expected to raise substantially more funding in their public debuts than the previous record holder of Saudi Aramco, which raised \$25.6 billion in 2019 when listing on the Saudi stock ex-

change. How should public market investors think about such giga-sized IPOs associated with tera-valued companies (where the prefixes of giga and tera represent 10 to the 9th power or one billion and 10 to the 12th power or one trillion, respectively, in scientific terms)?

Even if an individual opts not to invest in the giga-sized AI-based IPOs directly, they will still end up being impacted by them to the extent that their public investments include broad-based index funds. This is because the three tera-valued AI-based companies will end up being incorporated into stock indices.

Podcast episodes by The Economist offer several reasons for investors to be wary about taking positions in the giga-sized AI-based IPOs. First, there may be a winner's curse associated with companies seeking to invest heavily in developing the dominant AI model. The winner's curse was first noted by petroleum engineers who observed that companies bidding the most in competitive auctions for offshore oil field drilling rights tended to overpay for those rights. This is because competitive auctions awarded the drilling rights to bidders who were the most optimistic about the value of the oil drilling rights, thereby leading to the winning bidders

earning sub-par returns on their secured rights.

Second, as documented by finance scholar Jay Ritter of the University of Florida, most IPOs generate sub-par returns. Ritter, who has compiled an extensive database of IPOs going back to 1975, finds that firms doing an IPO on average underperform the market by 20 percentage points in terms of three-year returns. The underperformance is greater for firms with share prices at the IPO stage that are expensive relative to their current revenues.

This is the case for SpaceX, as the IPO share price associated with a \$1.75 trillion valuation represents a multiple of 90 relative to SpaceX's present revenues. A multiple of 90 relative to a firm's profits would be abnormally large. Relative to a firm's revenues, it is gargantuan.

Third, bankers and the companies who are selling IPO shares want to find the time that is most beneficial to the seller of the shares. The timing is likely not to be optimal for prospective share buyers. What this means is that IPOs are likely to be timed to when firms have achieved the most explosive growth in their valuations. Investors who buy into a public offering thus miss out on the most promising increase in a firm's valuation.

Finally, at least a portion of SpaceX's IPO valuation is based on Elon Musk's vision of being able to monetize the colonization of Mars. The prospects of the company being able to successfully do so given the daunting engineering and biological constraints involved appear to be slim to none. SpaceX's valuation would be more credible if it was partly based on monetizing building a city of one million people on the continent of Antarctica than a similar-sized colony on the Red Planet. Antarctica is much easier to reach and more hospitable to human life than the fourth planet from our Sun.

At its closest, Mars is 34 million miles away from Earth and has an atmosphere primarily composed of carbon dioxide. Antarctica also offers the prospect of colonizers securing a trove of natural resources at least as significant as the one associated with Greenland and coveted by our present presidential administration.

For the four foregoing reasons, the time-tested Latin phrase applies to prospective investors in the SpaceX IPO and the IPOs likely to follow by Anthropic and OpenAI: *caveat emptor*, or buyer beware.

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