The tech offering spree goes on: Dropbox goes public with a sensational IPO

Dropbox Inc. (NASDAQ:DBX) – market cap as of 13/04/2018: €11.8bn

Introduction

Founded in 2007, Dropbox is the leading pure-play cloud storage and collaboration platform. Its mission is to "unleash the world's creative energy by designing a more enlightened way of working". Dropbox is focused on reducing the amount of time people spend on tedious tasks such as searching and organizing content, switching between applications, and managing workflows.

About Dropbox

Dropbox is a cloud platform for storing documents, songs, videos, and spreadsheets. The service allows users to upload ("drop") documents in a designated place (the cloud), and then modify them personally or collectively with designated users. The service can be accessed from any internet-connected device (mobile phones, computers, tablets) and has expanded its offerings to include a wide-variety of collaboration, editing, document management, and synchronization tools. Dropbox believes its service has become more valuable to users for sharing and collaborating rather than a service for storage.

Dropbox claims having 500 million users, 11 million of which are paying subscribers. Approximately 30% of paying users use Dropbox for work on more than 300,000 Business Teams (groups ranging from 3 to several thousands of users), while 50% of paying users use Dropbox for work on an individual basis. In terms of geographical distribution, revenues are split nearly equally between International and US customers, while no country outside the US represents more than 10% of sales.

As of December 31, 2017, Dropbox had 1,858 full-time employees across offices in San Francisco (headquarters), Austin, Seattle, New York, Ireland, London, Tel Aviv, Sydney, and Tokyo. The company leases datacenters located in California, Texas, and Virginia and utilizes Amazon Web Services facilities in the US and Europe.

Dropbox managed to achieve impressive growth in revenues, namely 40% in 2016 and 31% in 2017. Revenues generated totaled $603.8m, $844.8m, and $1,106.8m in 2015, 2016, and 2017 respectively. This resulted in a $111.5m net loss or negative $ 0.38 per share. Additionally, the company was able to generate positive free cash flows (defined as net cash provided by operating activities less capital expenditures), amounting to $ 137.4m and $ 305.0m in 2016 and 2017 respectively. Interestingly, management cash bonus compensation is linked to revenues and FCF.

Business Model

Dropbox uses a so called "freemium" business model: a basic account is offered for free and users might opt for a paid subscription to increase storage space or get additional features of the account. Currently, the company offers a range of paid subscription plans, from Plus and Professional for individuals, to Standard, Advanced, and Enterprise for Dropbox Business teams.

The company was able to scale up quickly and efficiently through a referral system granting users additional free storage space for recommending the app to other people: such a strategy was a key driver of its viral growth. Nonetheless, the business performance of the company is driven by company's ability to retain and further increase the number of paying users and not merely increase the user base per se. Its key operating metrics – number of paying users – amounted to 6.5, 8.8 and 11 million users in years in 2015, 2016 and 2017 respectively. The figure is growing despite constituting only 2% of the total number of registered users.

In an attempt to monetize the services offered, Dropbox shifted its focus from individual to business users and started to offer new products dedicated to businesses, such as group collaboration tools or file synchronization software. The company profited greatly from a "bottom-up" adoption within organizations, as many individual users started to use Dropbox also for work purposes. For instance, in 2017, more than 40% of newly set up Business Team accounts included a subscriber who was previously an individual user.

IPO Structure & Analysis

After the first week of March, when Dropbox initially released data on the estimated price range for the IPO, it was announced it would be between $16 and $18. In the following weeks, the range was moved up, as the advisors sensed a strong appetite for the stock. At first, it was raised to $18 – $20, only to ultimately increase up to $21 per share. The offering was a success and the first day of trading the stock closed at $28.42, a staggering 35% increase vs the subscription price. Comparing it with the industry, last year Snap started with an offer price of $17 and closed its first day at $27.2 with an increase of almost 60%, but these are record numbers that are rare out of the tech sector.

Like the Snap IPO last year, Dropbox went public with a multi-class share structure. The founders and other significant shareholders, such as the venture capital firm Sequoia and other institutional investors will retain control of the company thanks to the Class-B shares accounting for 10 votes each, while the issued shares are Class-A, granting the right to just 1 vote each. The overall amount floated consists in 36,000,000 Class-A common shares, of which 26,822,409 newly-issued shares and 9,177,591 sold by pre-existing stockholders. Furthermore, the underwriters were given the right to purchase an additional 5,400,000 shares of Class-A common stock at the IPO price of $21 per share. This was not a "greenshoe option", as it was not intended to stabilize the price by offering more shares, but they were issued as a sort of bonus for the banks, with an attached 180-days lock-up period before they can be sold back to the market. On April 3, they exercised the right to buy the additional shares in full, confident in the stability of the stock price nearly a week after the floatation, which indeed reached $30 and has remained stable at that level until recently.

Dropbox also raised additional $100m in a private placement of shares to Salesforce, selling directly 4.7m shares to the leading provider of online business applications.

The overall number of shares sold in 46m, of which only 33.5m are free-floating (considering the agreed 180 days lock-up period for the underwriters and the ones in Salesforce's hands).

The goal of the IPO itself was to raise $500m, apparently hard to reach according to the initial valuation of $7bn and $7.9bn (based on the $16 – $18 price-range). However, the market eventually valued the company at $21 per share and is now trading at around $30, making its current market cap equal to c. $12bn. The result of the market's optimism is that Dropbox well exceeded its expectations, cashing in $ 776.7m of total gross proceeds, while the selling stockholders received $192.7m.

The business itself is very promising and displays a lot of potential, but it still hasn't managed to deliver the expected results. Looking at other unicorns, it is clear that profits seem not to be the primary focus of investors so far, especially in the short run. However, initial enthusiasm sometimes turns out to be over-optimism in reality. For instance, last year's listing of Snap was incredibly successful, obtaining a market valuation of over $25bn, only to sharply fall later on down to a valuation of around $17bn. This is a reminder that, if Dropbox is not able to reduce costs and increase its paying user base, the enthusiasm may ease and its 10x EV/Revenues valuation could easily go south towards the region of 6x, where current comparable companies lie.

Rationale

The primary purpose of the offering is to increase financial flexibility of the company. Even though Dropbox is one of the famous 'deca-unicorns' (i.e. private tech companies valued at more than $10bn) since it was founded in 2007, on an annual basis it has incurred constant net losses, translating into an accumulated deficit of $1,049.7m as of December 2017. Therefore, portion of the proceeds (at least 5%) is going to be used to repay revolving loans.

More importantly, Dropbox is in a great need to raise capital in order to pursue its strategy of expansion and scaling the business. These are the necessary steps that the company must undertake in order to keep up with the strengthening competition on cloud storage market, which is rapidly changing in the recent years: Dropbox indeed competes directly with Amazon, Apple, Google, and Microsoft, all of which are striving to penetrate the market with their own cloud platforms. Furthermore, they not only have greater name recognition, but they also have greater resources, thus posing a significant threat to Dropbox's market share.

In an attempt to generate and secure a stable earnings base, the company intends to use part of the IPO proceeds to increase its technical infrastructure as well as increase research and development expenses (mostly through hiring additional staff in engineering, product and design teams). Furthermore, the company runs specifically targeted marketing campaigns based on analyses of usage patterns, to encourage users to upgrade their subscription plans. In its filing, Dropbox disclosed that it estimates 300 million of currently registered "free" users to have the characteristics making them more likely to eventually purchase a subscription plan in the future.

Dropbox also revealed that it intends to retain any future earnings to finance further expansion, which may also involve potential acquisitions. No dividends are thus going to be paid in the near future.

Investor Response and Market Reaction

The company has warned that such an IPO structure could hit its valuation, because it will prevent the company from being included in key stock market indices such as the S&P 500, Russell 200 or S&P Midcap 400, as well as many ETFs and index funds. This is due to the dual class share structure, criticized in the financial community because it allegedly reduces the owner-manager accountability towards the other shareholders. However, this structure is common among tech companies coming from a start-up origin, like Snap or TripAdvisor, because the founders try to retain as much control as possible, with the idea of remaining dynamic. However, a Harvard study brought up some evidence that, overtime, this structure may backfire leading to significant inefficiencies.

When Dropbox was eventually launched on the NASDAQ on March 22, the shares peaked at $31.60 before closing at $28.42, an impressive 35% jump over the already-increased initial price. The stock was incredibly well received by the market as it stabilized at $30 per share, almost double the most conservative initial estimate of $16. This means that, despite the overall bad performance of all the main indexes in the IPO date, the market was really interested in the Dropbox stock.

Underwriters

Goldman Sachs and JP Morgan acted as joint lead bookrunners. Deutsche Bank, Allen & Company, Bank of America Merrill Lynch, RBC Capital Markets, Jefferies, and Macquarie acted as joint book-running managers. Canaccord Genuity, JMP Securities, KeyBanc Capital Markets, and Piper Jaffray acted as co-managers for the offering.