There is once again a gold-rush atmosphere in the IT sector. Parallels are thus increasingly being drawn between the booming equity prices currently being seen and the infamous dot-com bubble at the turn of the millennium. This is a short-sighted perspective. Admittedly, an euphoric mood in the US on the venture capital market as well as high valuations for initial listings is observed. However, we disagree with the statement that global IT equities as a whole are in a price bubble.
Dot-com bubble 2.0?
October 2019, Tobias Hochstrasser

Hardly a day passes at present without new price records being set for IT equities. For a considerable time now, five IT firms have been heading up the list of the world’s most valuable companies: Microsoft, Apple, Amazon, Alphabet1 and Facebook. Many investors may think that they have seen this scenario before. After all, technology stocks already soared to unparalleled levels around the turn of the millennium.

Critical minds may therefore rightly raise the question of whether history is currently repeating itself again. The answer is “yes and no”.

A look back at past events
In the years prior to the turn of the millennium, extraordinary events were observed on the US financial markets. A long economic boom was reflected on the equity markets in the form of considerable price gains. This aroused the interests of a host of mostly inexperienced private investors. In light of the continuous rise in equity prices, it seemed anybody who invested could become rich. This investment mania centred around young Internet-related technology firms that had gone public. There was talk of a “new era”.

A closer analysis of these extraordinary market dynamics clearly reveals symptoms that are typical for the formation of equity price bubbles:

1. Investor euphoria
2. Declining company quality
3. Excessive equity valuations

Equity investors were extremely active around the turn of the millennium. The emergence of “day traders” – primarily private investors wishing to gain wealth through daily trading transactions – led to a situation in which the average holding period for US equity investments had more than halved in 2000 compared to 1990. According to numerous surveys, investor sentiment was generally euphoric. For value-oriented investors, this is a warning sign, as euphoria can quickly turn to disappointment if high expectations are not met on all sides. The exaggerations become even more apparent if we look at IPO activity. This is especially true for the US technology exchange Nasdaq, where an extremely high number of IPOs were recorded in 1999 and 2000. It was not only the number of initial market listings that accelerated rapidly during the 1990s, but also their size. In 1999, for example, no fewer than 370 IT firms went public, more than three times the average seen in the five preceding years.2 Fantastic first-day gains were a clear sign of exuberant euphoria and a craving for “new economy” equities. In both of the boom years, an IT IPO would on average yield the lucky investor 89% on the first day of trading.3

During the course of the boom years, the quality of the “average” IT company also declined markedly. A look at the IPO market during the 1990s also brings something astonishing to light: during the first half of the decade, the average IT company would go public around eight years after its foundation, with 75% of these IPOs proving to be profitable. Around the turn of the millennium, however, technology companies were on average just four years and five months “young” at the time of their IPO and only 14% of initial listings made a profit. Due to its inglorious decline, the company pets.com remains in the memory in many respects. Founded in 1998, the online retailer for pet food and accessories went public in spring 2000, primarily invested the proceeds in extravagant advertising and filed for bankruptcy in November of the same year. In other words, its customer base was simply not yet

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1 Alphabet is the holding company of Google.
3 Ljungqvist and Wilhelm (2003) – IPO-Pricing in the Dot-Com Bubble
prepared to buy pet food online. However, exaggerations such as this did by no means stop at established companies. For a time, it appeared that every firm wanted to become an Internet company. A textbook example was provided by the mega merger worth USD 350 billion of AOL, which at this time was the world’s biggest Internet provider with more than 30 million customer, and the media conglomerate Time Warner. The objective was to create a “new media group” in order to dominate the dawning golden age of the Internet. The dream quickly disappeared. Following years with record write-downs, restructuring measures and strategy changes, shareholders were left with only a fraction of the company’s former value. Investments made in the energy service provider Enron even ended in a total loss. However, visionary company directors used fraudulent accounting tricks to lead investors into believing for a number of years that profits were rising. In reality, many projects, such as the enormous investments made in a comprehensive fibre-optic network, proved to be a pipe dream and ultimately left behind nothing but losses and a huge mountain of debt.

The third indicator of the bubble was the rapid rise in equity valuations. The exaggerations were once again pronounced on the IPO market in the US.

In 2000, public shareholders purchased newly issued Internet equities at the end of the first day of trading at a median price/sales ratio of 49.5. In contrast, both prior (1990–1997) to the boom years and thereafter (2002–2017), investors only paid a multiple of five times annual turnover. No less absurd was the rise in prices recorded for the equities of established IT firms. Led by the so-called “four horsemen”, as the “hot” stocks of Microsoft, Intel, Cisco and Dell were referred to, the valuations of IT equities multiplied during the boom years. At the turn of the millennium, this resulted in a price/earnings ratio of a remarkable 98 for the MSCI World IT Index. The multiple expansion of the S&P 500 from a figure of 15 to more than 45 during the same period therefore appears pretty unspectacular.

A growing number of initial listings at the end of a long economic and equity market cycle is nothing unusual per se. From a company perspective, it is rational to use a phase in which valuation levels rise to sell company shares to public shareholders. The described exaggerations of these boom years are, however, clear symptoms of irrational exuberance and therefore important warning signs for value-oriented investors.

Present

In light of the high price gains posted by IT equities in recent years and a marked increase in IPO activity this year, many commentators see a repeat of the dot-com bubble. An analysis according to the above framework and empirical values sheds light here:

Number of Tech-IPOs at the Nasdaq per year

Source: Ritter (2018) - Initial Public Offerings: Technology Stocks IPOs

* The index tracks the performance of IT companies from the industrialised nations.
There are currently different signals with respect to investor sentiment. The global investor community is sceptical. According to State Street, institutional investors worldwide are more negative on the outlook for equities than has been the case for years. Furthermore, there is no evidence of widespread euphoric participation in the equity market by private investors, as confirmed by a look at the IPO activity of IT firms over recent years up to the end of 2018. This is at least according to Nasdaq statistics. Following the financial crisis, between 21 and 53 new IT firms were listed each year from 2010. Average initial share price returns of 15% are also by no means a cause for concern. However, 2019 stands out. Not only the number of IPOs has increased considerably, but also their size: for example, upon going public, Uber was valued at a princely figure of USD 75 billion. This underlines the growing importance of venture capital and, in particular, the rise of “growth capital” in recent years. Such investment vehicles invest in private companies of already considerable size, often with a view to financing their international expansion. The best-known example is likely SoftBank and the associated Vision Fund (invested funds of USD 100 billion!) with large holdings in Uber, WeWork and many other “unicorns”. It is not only the exorbitant valuations at which the vehicle has invested that give cause for concern, but also the fact that these were financed to a significant extent using borrowed capital. While the price development of Uber since the IPO has disappointed to date, more than half of this year’s technology IPOs have enjoyed a price gain of more than 50% during the first half of the year. In short, certain activities, both in the venture capital scene – especially in the area of growth capital – and on the IPO market are sending clear warning signs of a bubble in these areas. We believe that without the unprecedented low interest rates and the enormous surge in liquidity on the global financial markets, the Vision Fund would not be possible on such a scale. Furthermore, it would not be a surprise if SoftBank/Vision Fund falls into difficulties at some point and later goes down in the history books as a symbol for the end of an extraordinary era on the venture capital market. For us, however, it is key whether there are exaggerations on the public markets. We do not see any signs of this.

With respect to the quality of the listed IT companies, a differentiation also has to be made. On the one hand, it by no means comes as a surprise that the five most valuable companies at present all come from the IT sector. These are clear market leaders in their respective markets, have solid balance sheets and are all highly profitable. Since the bursting of the dot-com bubble, the world has changed. Hardly any companies can function without a large number of different software solutions. There are now very few consumers who can go a day without their smartphone. It has even become the most normal thing in the world to purchase pet food online. In short, the infrastructure and tools for the digital economy are a reality. Due to the nature of the product, first-class software can now be distributed globally with very little friction and in a highly profitable manner. This combination has the potential to create enormous value for shareholders, suppliers and customers within a very short period. However, not every company can become the new Microsoft. While in 2018 the average IT company was already more than ten years old at its IPO (no warning signs here), only 14% of that year’s vintage were profitable. This is undoubtedly also due to the fact that a large number of the newly listed companies adopt the capital-preserving business model of software firms. For these companies, it can be insignificant if they do not record any profits for a time provided their cash flows are rising.

Nevertheless, the high share of loss-making companies bears thinking about. We are increasingly concerned about the quality of some unicorns that have recently gone public. In our view, for example, the current business model of Lyft and Uber is unsustainable. Both competitors lose money with each arranged journey. As they scale their businesses, the losses are rising steadily. The business model has only been sustainable to date because large sums of venture capital have always plugged the financial gaps. It is absolutely possible that the development of additional services will one day more than compensate for the losses in the core business. However, we are clearly distancing ourselves from investments in such speculative business models. Based on its convictions, Albin Kistler only invests in companies that have demonstrated they can generate surpluses on a sustainable basis.

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5 Privately held companies with a valuation of more than USD 1 billion are referred to as unicorns.

6 The earnings yields of, for example, Fiverr (+90%), CrowdStrike (+71%) and Chewy (-59%) were impressive.
A differentiation must likewise be made with respect to equity valuations. Such extremely high valuations certainly exist, in particular, for IT equities that have only recently had their IPO. Professor Jay Ritter, a proven specialist for initial listings in the US, noted with concern in August that the average price/sales ratio has been in excess of 15 for IT IPOs during the year to date, which is high relative to the long-term average. The equities of first-class business models, such as that of Zoom Video Communications, are even currently trading at a ratio of around 35. This is enormously high despite the high growth potential. A look at the valuation levels of established IT companies reassures us, however. Over the course of the current economic cycle, a price expansion has been observed, with the MSCI World IT Index currently trading at a price/earnings ratio of 24. This is higher than the ratio of the MSCI World Index at 19. We deem this as fair since the IT sector will likely also exhibit higher growth rates as well as a higher level of profitability over the medium and long term.

Conclusion for investors

Our analysis suggests that value-oriented investors should adopt a careful approach with respect to their allocation in IT equities. The activities on the US IPO market as well as exaggerations in segments of the venture capital market advise caution in connection with “hot” initial listings. In particular, where shares of companies with questionable business models have been placed on the market with an extreme valuation, we strongly recommend against investing. The recent developments surrounding the failed flotation plans of WeWork, a provider of office space, make us optimistic. The investor community responded to its listing intentions with great reluctance and thus made clear that not every business model and valuation will be accepted. It is impressive how a one-time valuation of USD 47 billion vanished within days of the publication of the stock exchange prospectus and the IPO was subsequently cancelled. However, if the company quality as well as the price of a share are right, we are happy to invest. We believe this to be the case for many global IT equities. At present, we are observing a healthy level of scepticism among investors in many areas, a fact which speaks against the theory of a general exaggeration for IT securities. Furthermore, we are convinced investors in companies such as Microsoft, Accenture and Ansys. All three companies are clear market leaders in their sectors and are benefiting from the global structural investments in the IT infrastructure of companies in all industries. They also all operate with solid balance sheets, report a high level of profitability and are generating growing earnings. The equities are therefore fairly valued in line with their growth potential. The same also applies, for example, to the local niche provider ALSO, the leading distributor of IT hardware and software licenses in Europe.

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7 According to calculations by Professor Jay Ritter, the average price/sales ratio for technology IPOs between 1980 and 2018 following the first day of trading was 6.9.

8 The valuation of USD 47 billion arose from a transaction between WeWork and the Vision Fund of SoftBank and is bereft of any logic compared to that of its main competitor IWG. Some commentators are now even sensing fraud on the part of WeWork.