The Economist

Silicon Valley and the technology industry

The new tech bubble

Irrational exuberance has returned to the internet world. Investors shoul beware

May 12th 2011 | from the print edition

SOME time after the dotcom boom turned into a spectacular bust in 2000, bumper stickers began appearing in Silicon Valley imploring: "Please God, just one more bubble." That wish has now been granted. Compared with the rest of America, Silicon Valley feels like a boomtown. Corporate chefs are in demand again, office rents are soaring and the pay being offered to talented folk in fashionable fields like data science is reaching Hollywood levels. And no wonder, given the prices now being put on web comp

Facebook and Twitter are not listed, but secondary-market trades value them at some $76 (more than Boeing or Ford) and $7.7 billion respectively. This week LinkedIn, a social netw professionals, said it hopes to be valued at up to $3.3 billion in an initial public offering (IF next day Microsoft announced its purchase of Skype, an internet calling and video service, frothy-looking $8.5 billion—ten times its sales last year and 400 times its operating income those are all big-brand companies with customers around the world. Prices look even more excessive for fledgling firms in the private market (Color, a photo-sharing social network, v recently said to be worth $100m, even though it has an untested service) or for anything in China. There has been a stampede for shares in Renren, hailed as "China's Facebook", and Chinese web giants listed on American exchanges.

Same again, only different

So is history indeed about to repeat itself? Those who think not point out that the tech land has changed dramatically since the late 1990s. Back then few people were plugged into the internet; today there are 2 billion netizens, many of them in huge new wired markets such China. A dozen years ago ultra-fast broadband connections were rare; today they are ubiqu And last time many start-ups (remember Webvan and Pets.com) had massive ambitions bu revenues; today web stars such as Groupon, which offers its users online coupons, and Zyr social-gaming company, have phenomenal sales and already make respectable profits.

The this-time-it's-different brigade also points out that the 1990s bubble expanded only aft numerous web firms were floated on stockmarkets and naive investors pumped up the price their shares to insane levels. This time, there have been relatively few big internet IPOs (th that is likely to change). And there is no sign of the widespread mania in the high-tech wor occurred last time around: the NASDAQ stockmarket index, a bellwether for the tech indust been rising but is still far below its peak of March 2000.

In one respect the optimists are right. This time is indeed different, though not because the boom-and-bust cycle has miraculously disappeared. It is different because the tech bubble- making is forming largely out of sight in private markets and has a global dimension that it predecessor lacked.

The bubble is being pumped partly by wealthy "angel" investors, some of whom made their fortunes in the late-1990s IPO boom. Their financial firepower has increased and they are b one another for stakes in web start-ups (see article). In some cases angels are skimping or diligence to win deals. When it comes to investing in more established companies like Face and the bigger web firms, traditional venture capitalists now face competition from private- companies and bank-led funds hunting for profits in a bleak investment environment. Gucci leveraged-buy-out kings may appear to be more sophisticated than the waitresses buying c shares a decade ago—but many of the newcomers are no more knowledgeable about techn

This boom also has wider horizons than the previous one. It was arguably started by Russia investors. Skype was born in Estonia. Finland's Rovio, which makes the popular Angry Bird smartphone game, recently raised $42m. And then there's China. Renren and Youku, "China YouTube", supposedly offer investors a chance to profit both from the country's extraordina growth and from the broader impact of the internet on commerce and society. Chinese web start-ups often command $15m-20m valuations in early financing rounds, far more than the peers in America.

These differences will have important consequences. The first is that the bubble forming in private market could be pretty big by the time it floats into the public one. Facebook may t to be the next Google, and LinkedIn has a fairly solid revenue plan. But they will be followe less robust outfits—the Facebook and LinkedIn wannabes—with prices that have been dang inflated by the angels' antics.

The froth in China's web industry could also lead to unrealistic valuations elsewhere. And it be China that causes the web bubble eventually to burst. Few of those rushing to buy Chine shares have thought through the political risks these companies face because of the sensiti their content. A clampdown on a prominent web firm could startle investors and prompt a b sell-off, as could a financial scandal.

And after the angels have fallen?

With luck the latest web bubble will do less damage than its predecessor. In the 1990s inte euphoria caused a dramatic inflation in the price of telecoms firms, which were creating the infrastructure for the web. When internet firms' share prices plummeted, telecoms investors suffered too. So far, there has been no sign of such a spillover effect this time around. But globalisation of the internet industry means that many more people could be tempted to da web stocks in the current boom, adding to the pain of the bust.

When will that be? This paper warned about both the last internet bubble and the American property bubble long before they burst. Irrational exuberance rarely gives way to rational scepticism quickly. So some bets on start-ups now will pay off. But investors should take a deal of care when it comes to picking firms to back: they cannot just rely on somebody else paying even more later. And they might want to put another bumper sticker on their cars: "Thanks, God. Now give me the wisdom to sell before it's too late."

from the print edition | Leaders