The Tech Bust of 2015

Maybe instead of a tech bubble, we're in a tech bust. No one seems to fervently believe tech valuations are cheap, so it'd be somewhat surprising if we were in a bubble. In many parts of the market, valuations seem too cheap. In the part where they seem too high, maybe they aren't really valuations at all, because the deal structure has changed to become more like debt.

Many of the small cap public tech companies have taken a beating this year. Companies like Yelp are trading at less than 4 times trailing revenue.

The tech mega-caps are monopolies and have deservedly high valuations. But even then, I would not be willing to short a single one of Apple, Google, Amazon, or Facebook against the S&P. Apple in particular trades at a single-digit ex-cash forward P/E.

2015 has seen the lowest level of tech IPOs as a percentage of all IPOs in seven years. The S&P Tech P/E is lower than the overall S&P P/E. Neither of these facts seems suggestive of a tech bubble.

On the private side, people complain all the time about early-stage valuations (and to be fair, they've felt high to me for four years). But if you invested in every single YC company over the past three years at their Demo Day valuation (average Demo Day valuations haven't moved much in the past three years) you'd be very happy, even though investors complain that YC is the worst example of overpriced companies.

The mid-stages also seem generally reasonable, though of course there are notable exceptions. These exceptions get all the attention—not the hundreds of companies doing remarkably well, but that handful that have raised money at high valuations and are struggling or dead.

On the whole, it seems harder than any time in the past four years to raise mid-stage rounds. This is also not suggestive of a bubble.

So where is the problem? Late-stage private valuations. But perhaps the answer is that these “investments” aren’t really equity—they’re much more like debt. [1] I saw terms recently that had a 2x liquidation preference (i.e. the investors got the first 2x their money out of the company when it exited) and a 3x liquidation cap (i.e. after they made 3x their money, they didn’t get any more of the proceeds).

This is hardly an equity instrument at all. [2] The example here is an extreme case, but not wildly so. Investors are buying debt but dressing it up close enough to equity to maintain their venture capital fund exemption status. In a world of 0 percent interest rates, people become pretty focused on finding new sources for fixed income.

There is a massive disconnect in late-stage preferred stock, because if you’re using it to synthesize debt it doesn’t matter what the price is. The closer the rounds get to common stock (a less-than-1x liquidation preference, for example), the more I think the valuation means something. Unsurprisingly, the best companies usually have the most common-stock-like terms (and “the best companies” are never the ones that seem overpriced for long anyway).

Some of this debt is poorly underwritten. Some unicorns will surely die (and those are the ones everyone will talk about). That doesn’t make it a tech bubble. It’d be more accurate to say it’s a tech bubble if no unicorns die in the next couple of years.

To summarize: there does not appear to be a tech bubble in the public markets. There does not appear to be a bubble in early or mid stages of the private markets. There does appear to be a bubble in the late-stage private companies, but that’s because people are misunderstanding these financial instruments as equity. If you reclassify those rounds as debt, then it gets hard to say where exactly the bubble is.

At some point, I expect LPs to realize that buying debt in late-stage tech companies is not what they signed up for, and then prices in late-stage private companies will appear to correct. And I think that the entire public market is likely to go down—perhaps substantially—when interest rates materially move up, though that may be a long time away. But I expect public tech companies are likely to trade with the rest of the market and not underperform.

But no matter what happens in the short- and medium-term, I continue to believe technology is the future, and I still can’t think of an asset I’d rather own and not think about for a decade or two than a basket of public or private tech stocks.

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[1] There are real problems with these distorted "valuations". Employees these companies hire often think of them as real valuations. It also often makes the company think of itself as much bigger than it is, and do the wrong things for its actual stage. Finally, too much cheap money lets companies operate with bad unit economics and cover up all sorts of internal problems. So I think many companies are hurting themselves with access to easy capital.

[2] Even before the shift to debt-like rounds, the disconnect between how much people will pay for 5% of a company in preferred stock vs. 100% of a

company in common stock was massive (and for good reason--the downside protection alone with preferred stock makes it much different than common stock). As this delta has accentuated, the public/private disconnect has gotten worse, and caused a number of problems for companies accustomed to valuations always going up.