BARRON'S COVER

Tech Stocks: Sizing Up the New Bubble

Investor worries about another dot-com-style stock crash miss the point. The bubble is in the private market.

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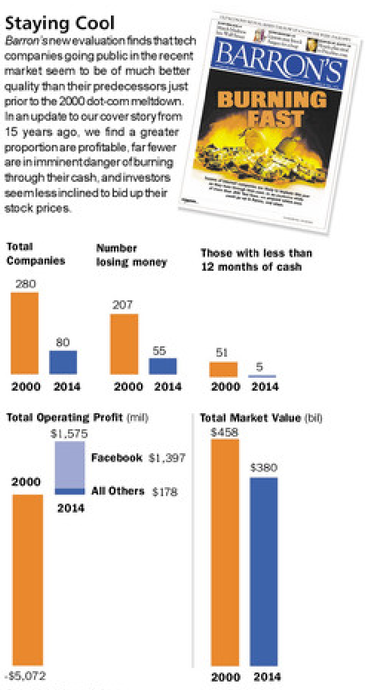
Barron's shook stock markets around the world nearly 15 years ago with its "Burning Fast" cover, showing that many of America's highflying, unprofitable Internet stocks were about to run out of cash. In the month following our story, the Nasdaq fell 31%. That was the start of a two-year 78% slide that became known as the Dot-Com Bust.

In recent months, as the Dow Jones Industrial Average and the Standard & Poor's 500 repeatedly hit new highs, and the Nasdaq finally looks poised to vault past its all-time high of 5049, fears have been raised about the possibility of yet another market collapse. While we agree that some overvalued, money-losing companies like Twitter (ticker: TWTR), Workday (WDAY), and Splunk (SPLK) do recall the dot-com mania of 15 years ago, the situation today is fundamentally different. We say this knowing that the most dangerous words on Wall Street are "This time it's different."



What's never different, whether on Wall Street or Main Street, is that a company eventually needs to earn a profit to stay in business. That was the basic truth behind our March 20, 2000 "Burning Fast" story, and it's the first factor we considered in evaluating today's market, particularly social-media plays.

Judged by profits, the stock market is much more reasonably priced than it was in 2000. The Dow now trades at 15 times next year's expected earnings, versus 18 times back at the peak of the boom. The S&P 500 trades at 17 times earnings, versus 30 times. And perhaps most telling,the Nasdaq trades at 22 times earnings, against 102 times back in 2000.

To assess the health of today's market, we turned to Greg Kyle, a senior securities analyst at Bates Research Group in New York, the very fellow who analyzed Internet stocks for us 15 years ago. What Kyle found is that today's newly public tech and social-media companies are not only bigger, stronger, and more seasoned than their counterparts from 2000, but they're also more profitable. "Newly public companies today have better balance sheets and generate fewer losses than they did in 2000," Kyle says.

IN OUR ORIGINAL STUDY, 51 Internet companies were on track to run out of money within a year, including names such as drkoop.com, Healtheon, and eToys. (See Table, The Original *Barron's* List: A Prelude to the Dot-Com Bust.) In the latest analysis, just five companies look like they will run of cash in a year's time. And all of them are quite small, each valued at less than $360 million. Indeed, you may never have heard of these little cash burners: CafePress (PRSS), Cyan (CYNI), Silver Spring Networks (SSNI), E2open (EOPN), and Audience (ADNC).

For the new study, Kyle analyzed the 80 Internet and technology infrastructure names that have gone public in the past three years. They carry a collective market value of $380 billion. Fifty-five of them, or 69%, are posting losses.

That's not great. But the situation is far better than it was in 2000, when 74% of the 280 companies Kyle surveyed were unprofitable.

The total operating profit of today's 80 newly public companies was $1.6 billion in the most recent quarter, though it's important to note that Facebook (FB) accounts for the bulk of those profits. Exclude Facebook, and the companies' operating profit still totals $178 million. Compare that with 2000, when our Internet stocks were collectively losing $5.1 billion per quarter.

Kyle didn't include Alibaba (BABA) in his survey because it trades as an American depository receipt. Alibaba earned $708 million in the latest quarter, which would have boosted the group's profit figure still higher.

So why are well-known venture capitalists like Bill Gurley and Marc Andreessen warning of a new bubble? The answer lies behind closed doors, where the market for privately owned companies has become today's version of the Nasdaq in

1999. As of September this year, according to Dow Jones Venture Source, the median late-stage venture-capital-backed company was valued at $250 million, a record high and far larger than in the bubble days, when the median private-company valuation peaked at $89 million.

With interest rates low and so much money flooding into the private markets, there's simply no rush for startups to issue stock to the public. "You're commanding a public market valuation as a private company," says Andrea Auerbach, a managing partner at Cambridge Associates, which advises institutional investors.

In what might be Silicon Valley's greatest sea change, founders no longer need the public markets to raise funds to expand their businesses or to get some money out of their companies and into their own pockets. Venture-capital firms provide plenty of late-stage capital, and they're being joined by mutual funds and hedge funds that want in on the private party.

LAST THURSDAY, UBER, the privately held car-sharing firm, confirmed it had raised new funding at a price that puts the company's valuation at $41 billion. That figure would make it more valuable than all but 31 companies currently traded on the Nasdaq. Just this past spring, during its last fund-raising round, Uber had been valued at $17 billion.

The Original *Barron's* List

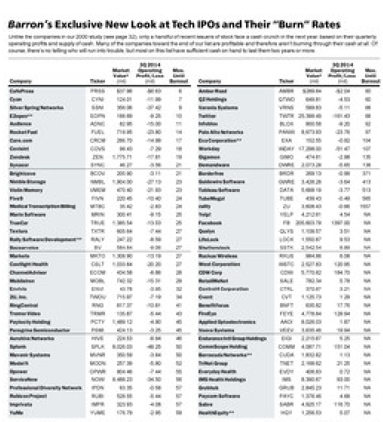
A Prelude to the Dot-Com Bust

And it isn't just an Uber phenomenon. Cloud-storage provider Dropbox is valued at $10 billion as of its most recent round of fund raising. Airbnb, the popular apartment-rental platform, has been valued at $13 billion, according to private-market specialist Triton Research.

Today, there are 60 private companies that carry valuations above $1 billion, according to Bill Hambrecht, a pioneer in technology IPOs and the founder of WR Hambrecht, a San Francisco–based technology boutique. "Those 60 companies would have been public in the '90s," Hambrecht says.

Late-stage investments, which occur well after a company's start-up phase, have become commonplace in Silicon Valley. This is a marked contrast to the '90s, when most late-stage private companies quickly went public. By remaining in private hands longer, companies can refine their businesses out of the public spotlight.

FOR TECH COMPANIES, the average time between start-up and IPO has more than doubled, going from five years near the peak of the bubble in 2000, to 11 years now, according to University of Florida Professor Jay Ritter, who studies IPOs. The longer incubation period is proving valuable. In 1999, the median annual revenue for a tech company going public was $17.2 million; today, it is $92.2 million.



"In 2000, companies were going public as early as they could. It was a rite of passage," says Kevin Landis, the veteran technology investor who ran the best-performing mutual fund in the U.S. leading up to the 2000 tech crash. "Today it's a root canal that you keep avoiding."

In 1999 and 2000, 632 technology companies went public, according to Ritter's figures. Last year, the total was just 43. So far this year, there were just 46 tech offerings.

"If you look at Facebook and Twitter, the next generation of blue-chip stocks may be on their way to becoming that [size] even before they go public," Landis says. "It's a very tempting target for people trying to beat the indexes."

Getting in on the big gains by investing in the private market ahead of the IPO is drawing an increasing number of players, including hedge funds such as Coatue Management, Maverick Capital, and Tiger Global Management. Likewise, mutual fund giants Fidelity Investments, T. Rowe Price, and BlackRock have been active participants in the private market in recent years, though their exposure remains a tiny portion of their overall assets.

All three mutual fund firms have taken stakes in Dropbox, for example. And, in June, Fidelity and BlackRock joined the venture community's $1.2 billion investment in Uber, according to Triton Research.

Says Andy Boyd, head of global equity capital markets for Fidelity: "We're not private equity looking for returns to be doubled in a year; [we're looking] for what outperforms in the long run. It's a down payment on going public." Boyd adds, "We believe that our presence enforces a level of professionalism that helps when [companies] decide to go public. After all, we wear suits to work, not jeans."

But some of the suits are getting turned off by sky-high prices. At the end of last year, T. Rowe Price closed its popular New Horizons fund (PRNHX) to new investors, largely because both the private and public markets were overvaluing early-stage growth companies. Such firms make up about a third of the investments at New Horizons, which has $15 billion in total assets.

"When I looked at early-stage growth—starting in the middle of last year—I just felt it was stretched. That was one of the impetuses to close the fund," says Henry Ellenbogen, portfolio manager of New Horizons.

With valuations getting bid up so much in the private market, IPO investors aren't getting as many moonshot gains or being exposed to as many subsequent losses as they were in 1999 and 2000. Some investors say it's part of a healthy evolution, with private players taking on the biggest risks. "Retail markets don't get to see companies until the private actors are done playing around," says Dave McClure, founding partner of 500

More Seasoning

The IPO process has gotten more selective with fewer, older, and bigger companies making the leap.

Year	Number Of Tech Offerings	Median Company Age	Median Trailing Sales
1998	113	6	32.0
1999	371	4	17.2
2000	261	5	16.8
2013	43	9	107.6
2014	46	10	92.2

Source: Jay Ritter, University of Florida

Startups, a venture-capital firm with $125 million in assets. “I don’t know that it’s bad for the ecosystem.”

Back in the bubble days, Mark Hantho was directing technology investment banking for Morgan Stanley. “Before 2001, [the industry] was taking concepts public before their time. We floated business plans without core execution,” says Hantho, who is now global head of equity capital markets for Deutsche Bank Securities. These days, “the private market has weeded out failures in advance. The growing private market is more of a sign of an investing sea change than any bubble.”

AT SOME POINT, THOUGH, venture capitalists will be looking to exit their private-market investments, very likely through public offerings. That’s when retail investors have to be mindful about some of the substantial increases in previous, private-market valuations.

Traditionally, late-stage private investors aim to make at least three times their investment, says Cambridge Associates’ Auerbach. By that measure, Uber could attempt to go public at a market value of more than $100 billion. And Dropbox and Airbnb would need to come public at some $30 billion each. If these businesses issue stock at such lofty valuations, investors would be wise to steer clear.

Big Asset Managers Stepping Up Earlier

A number of giant mutual fund companies familiar to retail investors have become players in the private market, providing money and counsel to fast-growing start-ups that may some day become public entities. Here's a sampling of firms and their investments.

Firm	Notable Investments
T.Rowe Price **Total AUM:** $692 billion	Cloudera, Airbnb, Dropbox, New Relic, Houzz, Evernote, Atlassian, Lookout, MongoDB, Domo, Castlight Health, Eventbrite
Black Rock **Total AUM:** $4.3 trillion	Uber, Dropbox, New Relic, Apigee, Turn, Lending Club
Fidelity **Total AUM:** $1.9 trillion	Uber, Pinterest, Dropbox, MongoDB, Pure Storage, Domo, New Relic, Turn, Roku

Source: Triton Research

“Obviously, if you go public, you’re priced for some element of increase in your valuation. That’s how it should be,” Auerbach says. “And there should be more gas in the tank for the next set of owners, which is the public shareholder. But is the return potentially exhausted? I don’t know.”

Another problem that could push stock valuations up to unsustainable levels: There is more money chasing fewer stocks today. Due to mergers, failures, and leveraged buyouts, the number of listed U.S. companies fell to 5,008 at the end of last year, from 8,823 in 1997, according to Triton Research.

IT’S EASY TO BECOME nostalgic for the excitement of the dot-com IPOs, but the system has never worked particularly well for the typical investor. Ritter, the University of Florida professor, analyzed every IPO from 1980 through 2012 and found that IPOs have woefully underperformed. The average three-year return for an IPO bought in the market on its first day of trading was 22%. That’s 19 percentage points below the broad market over the course of a comparable three-year period. The smaller the company, the worse the performance. Those going public with greater than $500 million in annual sales returned 39.5% in the first three years, outpacing the market by four percentage points.

Rett Wallace, founder of Triton Research, thinks IPOs are likely to be even worse bets in coming years. “That’s because much of the growth has been claimed. The formative years of a company’s life have been captured by venture capitalists and a handful of investors willing to brave the opacity of the private market for outsize returns,” Wallace says. “Airbnb is America’s largest hotel company. It’s still private.”

Whether you view the growth of the private market as an example of institutional investors’ greed run amok, or as a healthy evolution in the capital markets, the good news is that retail investors are fairly well insulated from the most excessive valuations in technology and social-media stocks—at least for now. That could change once outfits like Uber, Dropbox, or Snapchat try to foist their shares off on the public at crazy prices.

We’re not saying the stock market will never suffer serious declines. It always has and always will. That’s the way capitalism works.

Maybe the next crash will be caused by unrest in the Middle East, an Ebola pandemic, further slowing in China’s economy, some unforeseen fallout from the collapse in oil prices, or a bellicose maneuver by Russia’s Vladimir Putin. But right now, to us at least, it doesn’t look like Internet stocks will be the culprit.

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