The Next Internet Bust?

C.P. Chandrasekhar

When Facebook announced last month that it was acquiring WhatsApp for $19 billion, analysts were all asking: “What’s up?” Besides the fact that the sum was a huge price to pay for a financially small start-up, however successful it was among users of the App, it made little sense given the absence of revenues to back that valuation. This strengthened fears being expressed for the last couple of years that the world is witnessing another Internet-related bubble like the dotcom bubble of the late 1990s.

There were also less visible indications of such a bubble, illustrated by firm likes Snapchat and Pinterest. Snapchat, had developed a photo-sharing application with time-limited access, which permits the sharing of pictures in relative privacy. This benefit of privacy ensured that by the end of last year Snapchat users were sharing more pictures every day than users of Facebook and Instagram combined. That popularity attracted the attention of venture capital firms. It also encouraged Facebook to propose a $3 billion buyout offer, three times the price at which it bought out Instagram. Snapchat’s promoters refused.

The current bubble in the making shares a number of features with its 1999 predecessor. First, as in the years before 2000, firms that have no clear revenue model are being valued at billions of dollars. So long as a firm is able to attract a large number of users (as in the case of apps) or viewers (as in the case of websites) it is being considered a potential revenue earner, even if the route to such revenues is unclear. Second, any start-up winning attention becomes the object of attraction for a number of potential acquirers, leading to a bidding war that makes the valuation even more difficult to explain. Finally, at the end of the game, valuations are at levels where they imply astronomical and irrational price earnings ratios that are difficult to justify. Investors are betting on growth of a king which is an exception rather than the rule.

There are two factors that can explain the high valuations. The first is evidence, from the experience of companies such as Facebook or Google, that when revenues do begin to accrue (largely from advertising) they grow at incredibly rapid rates, at times quickly rendering the firm comparable even in terms of revenue size with some of the large global companies. In a world where many big companies measured by sales have been languishing in terms of sales growth, or have even experienced a decline in sales, investors seem to be betting on growth. The second is that already successful companies may see competitive benefits in acquiring a particular start-up (such as WhatsApp), resulting in a willingness to pay high prices for acquisition to beat competitors (such as Google in the WhatsApp case). Betting that this may occur, investors looking for capital gains may acquire equity at inflated prices in the first instance, resulting in relatively high valuations even before the acquisition by firms aiming to exploit perceived synergies or prevent an erosion of their own markets.

The problem is that there are innumerable start-ups with potential for success in the internet and social media space. “Success” in even the limited sense in which the word is used in this space depends on what catches the imagination of the mobile device and Internet using public. So deciding on which start-up to back is often little more than a bet on a few horses amongst a multitude. This implies that even the so-called success stories are a fractional subset of the available universe of start-up targets. For every Whatsapp or Snapchat (let alone a Facebook or Google) there are many start-ups that attract venture funding and then disappear. Then there are those that are successful in attracting users and investors but fail to generate revenues and gradually sink into oblivion. This is common since most firms are looking to advertising for revenue, and Internet advertising though growing is not adequate for all. And finally there are those that are not even socially successful.

Even among the instances of success in attracting investment, performance in terms of the conventional measures of success varies hugely. Consider, for example, IPO value, or the amount garnered when the firm first choses to go public. In 2012, Facebook set a mouth-watering record (even if below some market expectations) garnering $16 billion. Compared to that the $1.8 billion that Twitter mobilised last year or the $1.7 billion that Google got (though as far back as 2004) seem small. As elsewhere under modern day capitalism, the winner seems to take all. But even Twitter’s $1.7 billion should not be scoffed at, given the fact that it had no revenues to show.

A better index of the social appetite for these companies is, of course, their market capitalisation. In that league Google does very well with a market cap of $381 billion as compared with revenues of $60 billion in 2013. The market cap figure for Facebook is a disappointment at $160 billion, but its revenues are a low $8 billion. On the other hand, the older Internet retail success Amazon boasted revenues of $74 billion but showed a market cap of just $160 billion.

These outcomes have been the result of longer-term trends. But recently, investor passion for the Internet has surged resulting in a spike in stock values. Around late November last year, the year-to-date rise in the price of publicly listed stocks of Yelp was 220 per cent, of Netflix 266 per cent, and of LinkedIn 96 per cent, with price-earnings (P/E) ratios of these three companies placed at 332, 84 and 100 respectively. If equity prices are to reflect potential returns (in terms of revenues not profits), investors were implicitly betting on huge revenue increases. Another word for that is speculation.

This speculative boom is not restricted to listed stocks. Venture capital firms seeking out promising start-ups for successive rounds of funding in the private placement markets have also contributed to a spike in the valuations of unlisted firms. According to a January 2014 study by The Wall Street Journal and Dow Jones Venture Source, there are more than 30 companies in the US, Europe and China valued at more than $1 billion by venture capital firms. Leading the pack are firms like Dropbox and Xiaomi set up in 2007 and 2010 respectively, which in the course of 5 and 4 rounds of funding respectively are today valued at $10 billion. At least these firms had products and/or services they sold. Others did not.

One reason for the dramatic financial performance of the latter is a combination of hugely enhanced liquidity and a passion for financial as opposed to real assets on the part of investors. While the crisis was a minor setback, the willingness of governments and central banks to pump liquidity into the system as an antidote to the crisis has only enhanced the availability of capital in search of quick and high returns.

In the 1990s the old economy was not offering opportunities for such returns and investors turned to the relative young Internet. The dotcom boom followed, with investors rushing in to invest in any firm that claimed to have an idea. The bust followed, and most firms, excepting for the very best, disappeared.

In this round too the success of firms like Google and Facebook is being used to suggest that the "next big thing" if not the "new new thing" is still around the corner. Awash with liquidity and leveraged to the hilt, the system is seizing on every sign that makes a firm a potential strike. There are not enough in the publicly listed space. So younger firms, with just an idea and some user support, but no roadmap to revenues let alone profits are also attracting venture support and notching high valuations. This is without doubt a bubble. Whether it would burst or gradually shrink only time will tell.

One feature of the bubble is that it is built on a foundation of excess liquidity. If for one reason or the other that foundation gives, so would the speculative surge. The bust could occur even before the economic irrationality that led to the boom is fully revealed.

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