The Internet Bubble Goes Pop!

Internet stocks have finally begun the long awaited correction many have predicted. Dozens of Internet stocks are hitting new lows as this is written. Many of these stocks are down by more than 30% from their highs. And the big names such as America Online, Yahoo! and Amazon.com have not been spared from this drumming. The overall sector went down 30% between July 9 and August 4 and is down about 43% from it's all time high in April as measured by the Goldman Sachs Internet Index.

A number of factors have contributed to this sharp and sudden decline. Several companies have had disappointing revenues or greater than expected losses. Many companies that are turning a profit have been cutting prices on their online products to keep volume up. Others are moving into aggressive marketing campaigns to attract more users. This could cut into existing profitability or postpone profitability for those companies that have yet to reach a profit. There also appears to be a slowing growth rate for some of the big names like Amazon.com. In an effort to combat this slowing growth rate Amazon has announced it will be spending a lot more to attract customers. This has indicated to some investors and analysts that business on the net is about to get much more competitive and costly.

A final blow was struck to the Internet bubble on August 3 when a Credit Suisse First Boston analyst predicted that online-trading volume would decline this quarter. This put a virtual dagger into the price of online trading companies like E*Trade.

IPO'S have suddenly taken on a different perspective. Last year there were about 40 Internet related IPO'S. This year there have been about 125 with another 100 or so scheduled. Institutional and retail investors suddenly seem no longer willing to buy any IPO that ends with .com.

What should we expect to see from here? Well, it depends on which camp you are in. On one side of the fence we have the analyst and institutional investors who are significant believers and supporters of the "New Economy" way of thinking. These are the traditional growth oriented analyst and investors. This camp believes that we are in the midst of a fundamental and profound change in our society and culture. They believe the Internet will revolutionize the way you and I shop and communicate. These believers point to the dramatic and significant increase in the amount of e-commerce now happening. Estimates are that online advertising budgets will grow from $2 billion to $32 billion. Some $1.5 billion was exchanged on auction sites last year, according to Gomez Advisors, who expects that number to grow to something like $15.5 billion by the year 2001. So far, that growth has been largely on Internet-only sites like eBay, which currently controls 70 percent of the market. But conventional retailers are beginning to move into the space in a big way.

On the other side of the fence we have the traditional value oriented investors and analyst who find it almost impossible to buy any Internet stock at any price. Value investors are leery of rosy forecasts for earnings and revenue growth in the Internet sector. They'll buy only into companies with real assets and solid earnings and at bargain prices. Benjamin Graham and David L. Dodd developed the principles of value investing in the 1930's. They frowned on earnings forecasts because they were too speculative. Value investors have always looked at the balance sheet--but traditionally as a snapshot in time rather than as a moving picture. Value investors attempt to identify the tangible assets--and a value stock was/is one that was/is cheap relative to those assets. As a result, value investors have ended up in tangible-asset businesses, mainly manufacturing and natural resource companies. Most old-line value investors would rather fold their tents than welcome Microsoft into their camp. Some however, recognize that their models need tinkering.

This time honored debate between the two camps has led to a whole new way of evaluating companies. In response to the "New Economy" way of thinking, a new method of value investing is emerging. "New Value" investing as it has come to be called, uses forecasting, which has traditionally been taboo for value investors. "New Value" investing has begun to rely upon the theories of another economist of the same era as Graham and Dodd, John Burr Williams. Williams's theory was that a company's value could be computed by the present value of its future cash flows.

For "New Economy" companies the business model is entirely different from what value investors are used to. Compared to traditional manufacturing companies, a company such as Amazon makes minuscule capital expenditures. Amazon collects it's revenues immediately when customers buy. But they don't have to pay suppliers for 50 days. It is the suppliers who end up funding the company's growth. Cash flow comes from the working capital accounts not the income statement.

To use these new methods to evaluate a company's worth; some analysts estimate future cash flow and then discount them back to the present. For rapidly growing net companies a much greater discount rate is used. This helps provide a margin of safety when buying net stocks.

An additional technique involves examining the quality of the earnings of these companies. Approximately 67% of Microsoft's profits come from sales booked in the same quarter. This compares to about 38.9% for the average company in the S&P. This is the equivalent of two-thirds of the profits coming in cold cash. This is a significant advantage over companies who have greater risk as a result of a higher ratio of receivables. There is always the potential for non-payment on at least some portion of the receivables.

To put the average S&P Company on the same level playing field as Microsoft would require an adjustment to the total earnings for this cash factor. This would lower the forecasted S&P earnings from $54 to around $31. Thus taking the S&P's price to earnings to almost 42 instead of 24. This helps explain why people are willing to pay for stocks with p-e's of 40 to 50.

The other significant factor that goes into "New Value" investing is the growth rate of earnings. Microsoft grew its profits at about 40% a year over the last 5 years. Future growth expectations have been paired back to a 24% rate. This can be contrasted with an S&P 500 earnings rate that was 10% during the same 5-year period. 15% growth is the current prediction for the S&P. Therefore, Microsoft's p-e is 2.2 times its estimated earnings growth rate vs. 2.8% for the S&P 500. So, for a "New Value" investor this makes Microsoft cheaper than the average company and can be considered a "value" stock.

How does a successful tech fund manager pick his stocks? Chip Morris, runs T. Rowe Price Science & Technology Fund. Prior to the most recent pull back, his fund was up about 80% this year. How does Morris calculate value for the profitless Internet stocks? He calculates what he calls a "practical price-to-earnings ratio" (table).

First you assume a company will net as much on a dollar of revenue today as it hopes to in its best-case forecast of future profitability. For companies unwilling to say what its optimal profit margin may be, Morris looks at similar companies in the same field to see what kind of margins they enjoy. "What you're doing, is converting companies that are promising profits and saying 'I'm going to compute your future promises into current profitability.' That takes a lot of the mystery out of it."

Doing this calculation for Amazon.com, yields a result of 230 times* earnings and it hardly seems a bargain, even if it is dramatically lower than it was a few weeks ago. Morris said "if they pull back 30% or 40%, they might be worth buying," at a practical p-e of, say, 80 to 100.

In conclusion, it is clear the Internet and e-commerce are here to stay. We are probably only in the beginning stages of an incredible revolution in our lives we can only begin to recognize. Traditional methods may have little value in trying to determine the worth of these companies. Some will survive and go on to become tremendously profitable while others will quickly take their place in history as companies with a great concept but the inability to survive the changes and competitive pressures they face.

Buy selectively. Buy wisely, avoid the hype.

THE STEPS	THE MATH
1. Find the company's current market value-- the number of shares outstanding times the price per share.	161 million x $118 3/4* = $19.1 billion
2. Multiply the most recent quarter's sales by four to find a current annual "run rate."	$294 million x 4 = $1.2 billion
3. Divide the market value by the annual run rate to get a price-to-sales multiple.	$19.1 billion ÷ $1.2 billion = 16
4. Divide this by your estimate of the biggest net profit margin the company may enjoy, say, 7%.	16 ÷ 0.07 = 230

5. Were Amazon.com profitable now, its "practical p-e" would be 230.

*May 28th 1999 price. Computed at today's price Amazon's "practical p-e" would still be 172.