Double bubble trouble: is history repeating itself again?

A regular column on the information industries

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With the Chinese stock market seemingly in headlong retreat, as its "bubble" is burst, it is not altogether surprising that bubble fears have also begun to find favour on Wall Street. There are some grounds for this: between 1 January and 31 July 2015, the Nasdaq Composite index rose in value by an astonishing $660 billion, yet more than half of this was accounted for by a mere six companies, of which five – Amazon, Apple, Facebook, Google and Netflix – are significant players in a broadly defined telecommunications sector. Much the same was true for the S&P 500 and this has led some commentators to wonder whether there is a "tech bubble" in progress that is distinct from what is happening in most other sectors where, typically, share prices have made no progress during 2015.

The classic "tech bubble" is better known as the "dot.com bubble" and took place between 1998 and 2002. This witnessed the market value of companies associated in any way with the Internet rising exponentially only to crash back within a short space of time. This was analysed in an article in this journal in 2002 (Curwen, 2002) and it is of interest to note the list of key companies involved in this bubble – Alcatel, AOL, Cisco Systems, Corning, Ericsson, Lucent Technologies, Motorola, Nokia, NTT, Qualcomm, Vodafone Group and Yahoo!.

It is notable that the list contained primarily long-established companies because, being publicly quoted, they could be valued at market prices, and that they were largely concerned with physical aspects of the Internet. This reflected the fact that improving the infrastructure for the Internet was a more urgent consideration than creating content for its increasingly fat pipes. But "multimedia" and "convergence" were increasingly coming to the fore, and the prime example was the takeover of Time Warner by America Online, which (subject to regulatory permissions) created AOL Time Warner (AOLTW) in January 2000 (Curwen, 2000). The key aspect that AOLTW shared with the other companies listed above, and indeed with start-ups that had yet to make any profit at all, was the total disconnection between performance and market value. In effect, the doctrine was that the Internet was the future, and hence bloated market values would be justified when the profits flowed in at some ill-defined future date.

Naturally, by late 2003, everyone of note had gone on record to say that they had learned their lesson and that a bubble of this kind would

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never be allowed to happen again. If one restricts oneself to the companies involved during 1998 to 2002, then these companies have indeed escaped any further association with bubbles. Nortel Networks, for one, did not even survive, although most operators and vendors struggled on, partly bolstered by strategic alliances and mergers. However, they became the dinosaurs of the Internet, producing low-margin commodities in a fiercely competitive environment. The traditional providers of content also struggled, as the public increasingly applied their ingenuity to obtaining content without needing to pay for it. But the point about bubbles is that they involve new ideas, which is precisely why notional value on paper cannot immediately be turned into hard cash.

The issue of bubbles returned to the fore in 2011 (Curwen, 2011), but involved a rather different set of companies – for example, Facebook, Groupon, Spotify, Twitter and Zynga. The core issue to be addressed at the time was whether this was "the future of the Internet" or merely a further bubble, and it was suggested that the following questions be asked:

Q1. Does the start-up have a plausible revenue/profit-generating business model?

Q2. Will its market(s) continue to grow rapidly?

Q3. Will competition sooner or later drive down growth and/or profitability?

It was argued that companies such as Facebook, Groupon and Zynga were set to grow rapidly and generate revenues in the billions of dollars, whereas Twitter's revenues fell well short of $1 billion, reflecting a less robust business model. However, in the medium term, the prognosis for most of them was debatable. On the Internet, the volume of customers is critical because prices are certain to be driven down by competitive behaviour unless brand recognition is rock solid and so many customers are signed up early on that there is too little room left for rivals. That seemed to be a positive feature for Facebook, but the Groupon model was easy to replicate and Spotify was in the music business, which is, at best, precarious.

Overall, two conclusions appeared to be in order. First, the bubble was far more limited in scope than its predecessor, which affected established as well as start-up companies connected with the Internet. Second, while some bubble companies such as Facebook would probably thrive, just as Google had done, because their business models were resilient, the bubble was going to burst for the majority.

One may ask whether this conclusion has been borne out in practice, and the answer is broadly as follows (as of August 2015):

- Facebook, after a patchy period during 2012, has gone from strength to strength and is currently worth $270 billion.
- Groupon floated at $26 a share in late 2011 but was worth only $2.8 a share one year later. Despite some improvement during 2013, it has once again fallen back, to $5 a share, and the company is currently worth only $3.3 billion.
- Spotify has yet to undergo an IPO, but its prospects are very limited now that Apple Music has seen the light of day.
- Twitter's share price peaked at $64 in December 2013. Since then it has had its ups and downs, but the company is currently worth $22 billion (and falling). The likes of City Index believe this should fall by a further 80 per cent.
- Zynga peaked at a market value of $10.7 billion but is currently worth only $2.5 billion.

It would appear therefore that the conclusion was indeed broadly correct with only Facebook still prospering, although the others are hanging on as best they can for the time being. But what about the current batch of allegedly bubble companies? These are mostly a far hardier breed because, in effect, they have a long trading history with many years spent slowly building up a head of steam:

- Amazon suffered badly during the 2000 to 2002 bubble but 2007 eventually saw its share price take off, roaring up from $37 to $95. Despite some ups and downs, it has overall progressed quite rapidly, with the share price reaching $400 by the end of 2013, and taking fire during the period commencing in October 2014, when it stood at $228 – it is currently $515 and the company overall is worth roughly $230 billion.
- Apple began quietly, taking four years to reach a share price of $5 at the end of 2004. The year of real progress was 2010 when it finally crossed the $30 mark and by September 2012, it had reached $100. However, this was almost halved during 2013, before the $100 mark was reached once again at the end of 2014. The current value is $113 a share, equivalent to an extraordinary market value of nearly $700 billion.
- Google was launched at $85 a share in August 2004. The share price peaked at $358 in December 2007, but collapsed to $131 in November 2008,

before re-crossing the $300 barrier at the end of 2011 and reaching $500 towards the end of 2013. It was still at this level in July 2015 prior to a sudden surge that saw it peak at $679, although it subsequently fell back towards $600. The company is currently worth roughly $400 billion.

- Netflix has a chequered history, with its share price collapsing from $42 in July 2011 to $7.7 in August 2012. However, it roared ahead during 2013 in response to changing patterns of access to content and currently sits at $116, valuing the company at $45 billion.

It is extremely difficult to apply the term "bubble" to the likes of Amazon, Apple and Google. These are companies with long, solid trading histories and a record of innovatory behaviour in their respective fields. Naturally, their share prices will be susceptible to socioeconomic forces over which they have no control, and hence they could potentially fall sharply in the short term, but that is hardly bubble behaviour which assumes a significant disparity between valuation and trading performance. The problem, such as it is, relates to their importance for maintaining the high levels of the Nasdaq and S&P 500 which would look very anaemic if these companies were stripped out.

References

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