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The current technology boom might be different from the previous one, but valuations are still stretched. **BY CHUA ZONG YOU**

THE first quarter of 2016 turned out to be disastrous for high-profile unicorns, or startup companies valued at over US$1 billion.

According to a quarterly global report on venture capital (VC) trends published last year by KPMG International, only five venture-backed companies in the US managed to join the exclusive billion-dollar club. Most companies faced layoffs, down rounds, and mutual fund markdown valuations.

Even the biggest was not spared. LinkedIn's share price plummeted 40 per cent after its earnings call in February, wiping out nearly US$11 billion of market value. Fund manager T Rowe Price marked down its Dropbox valuation by 51 per cent, reflecting declining investors' confidence in cloud file-sharing solutions.

Being public might be glamorous but it is not safe. Nowadays, the slightest shortfall in results can lead to an unrelenting selloff. Private companies do not need to publicly disclose their financial statements. They do not have to hold earning calls or explain why their stock is falling, because they have no stock trading on the stock exchange.

LinkedIn's share price plummeted 40 per cent after its earnings call in February, wiping out nearly US$11 billion of market value. PHOTO: REUTERS

It is thus not surprising that despite the astounding valuation of over US$60 billion by private market investors, Uber's CEO Travis Kalanick is in no hurry to list the company anytime soon.

Tech companies can easily gain or lose value. Startups that raised private capital from fund houses such as Fidelity or BlackRock might face scrutiny by Wall Street investors as though the startups were public.

Values of both Twilio, which makes tools for app developers, and CloudFare, which enhances Web performance and cybersecurity software for businesses, were considerably slashed by Fidelity when they second-guessed the worth and progress of the companies in the short run. At the same time, startups such as Shazam, Zynga, Weibo, Pandora, and Instagram are worth billions despite being unprofitable.

What can explain the irrational exuberance of startup valuations? Are we really in a tech bubble?

This bubble is different

Let us first compare the dotcom technology boom from 1997-2000, which ended with a burst bubble, to the current 2009-2016 startup boom.

A typical bubble results from unsustainable price rises from increased speculation. The perceived values of companies exceed their true values. The dotcom bubble was a result of inflated market expectations of Internet companies. A lot of investors jumped in, expecting big returns. Many unproven tech companies went public. When the hyped-up expectations failed to materialise, the bubble popped.

For the technology boom we are seeing today, is this time different?

We highlight three main differences – size, source of capital, and customer maturity – before going through the arguments for and against.

Early stage startups start small. The best thing a young startup can do is bootstrapping. Self-funded startups rely on free or almost free services. It enables them to quickly prototype, try out business models, iterate, and discard ideas that are not sustainable.

On the other hand, in the dotcom days, the founder had to invest between US$500,000 to over US$1 million upfront, before he or she could even produce a proof-of-concept.

Today, modern startups fail faster with minimal loss of capital and jobs. An average of three rounds of investments allows the business to prove that its model is both profitable and scalable.

As for the sources of capital, we know that modern startups are typically privately funded. Dotcom companies with less capital had to go public to raise funds, unless it had capitalisation before going public.

Startups need very little capital to get the business off the ground. Having proved the sustainability of their business models, they can raise additional funds through private rounds of investment.

The risk is then split between founders who contribute their time and effort ("sweat equity"), and private investors such as angels, seed investors, and venture capital firms (VCs) who contribute cash. The risks are contained within a small investor circle.

According to Ernst & Young, during the peak of 1999, 480 companies, out of which 280 were dotcom businesses, managed to go public. However, the number was much smaller in 2014, as only 55 tech companies out of a total of 275 went public, according to Renaissance Capital, a firm that manages IPO-related investment products.

Therefore, public capital might have been important for dotcom businesses 10 years ago. But for modern startups it is definitely not as important, and dotcom startups prefer to remain private.

In terms of customer maturity, today's tech savvy customers are open to new products and services. Upscale millennials will not think twice when it comes to getting a smart and cool gadget or trying out a new utility app. In contrast, the dotcom society was much less ready for futuristic products.

Real customers, real revenues

There is no agreement whether the tech bubble exists. Unlike dotcom companies, most startups today have real customers and real revenues.

Even though VCs are still cautious, they spent some US$12 billion on startups in the first quarter of this year. The expansion stage investment saw a growth of 25 per cent, and late stage deals were up by 10 per cent, according to the National Venture Capital Association in the US.

On the other hand, we should expect a market correction when too many startups grow above a certain size. Some private companies are set to disappear if they do not control the rate at which they spend their capital before the market turns.

Investors with deep pockets gave rise to over 160 unicorns in total worldwide. Many unicorns still have to experience and survive a price war with their competitors, yet 152 of them are collectively valued at US$532 billion, according to VC research company CB insights. This raises the question of rigour and uniformity in the way these valuations were calculated. Private tech startups tend to get better valuations than public companies. For example, investors are valuing Uber as if it is bigger than the whole taxi market.

Many unicorn CEOs are confident that they can survive the recession. Some of them are hoping that it will wipe out second-rung companies that exist solely because VCs want to diversify portfolios across many tech sectors.

The greater fool theory states that it is possible to make money by buying securities, whether overvalued or not, and sell them later at a profit because there will always be a greater fool willing to pay a higher price.

When acting in accordance with the greater fool theory, an investor buys questionable securities with the hope of quickly selling them off to the greater fool. Unfortunately, this is how bubbles are formed, and we know that speculative bubbles tend to burst eventually.

All things considered, we could be fast approaching a tech bubble implosion despite modern startups being self-funded, smaller in employee numbers and having a more mature, tech-savvy customer. Millennials are always looking for the next best thing and apps that are not regularly updated and progressive can get left behind.

However, if this bubble bursts, the effects should be more limited than that of the dotcom bubble. Modern startups carry less debt and have a lighter asset capital structure than dotcoms.

Startups with slashed valuations will face layoffs and possible closures. VCs will limit funding rounds, handing out lower sums of money than before. The companies unable to establish sustainable business models and curb their spending will cease to exist. Startups will have to make sure that they can survive even if major investors back out. This means less lavish offices, fewer perks, and lower salaries.

A bursting of the tech bubble can create opportunities for many companies, provided that they can turn a profit and survive.

▮ The writer is a student at Singapore Management University's Lee Kong Chian School of Business and a student trainer in the Citi-SMU Financial Literacy Programme for Young Adults. Jointly launched by Citi Singapore and SMU in April 2012, the programme is Singapore's first structured financial literacy programme for young adults. It aims to equip those aged 17 to 30 with essential personal finance knowledge and skills to give them a firm foundation in managing their money, and a financial headstart early in their working lives.

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