

Temporary Insanity

The Social Networking IPO Bubble Will End in Tears



Dr Adrian Saville

Chief Investment Officer

Cannon Asset Managers

adrian@cannonassets.co.za · www.cannonassets.co.za

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"I never meant to be so bad to you
One thing I said that I would never do
A look from you and I would fall from grace
And that would wipe the smile right from my face"

Asia, Heat of the Moment

1. Heat of the Moment

The initial public offering (IPO) market has rebounded sharply in 2011. According to Dealogic, \$22bn in capital has been raised in the 64 deals which have come to the US equity market so far this year. This puts the US IPO market on track to match 2007's towering value of \$54bn, although at this juncture it seems unlikely that the number of deals done in that year, 254, will be matched in 2011.

Regardless, May 2011 represents the busiest month for technology IPOs since 2000, and the days of September 2008, when Lehman Brothers collapsed, seem a distant memory to many. Without question, LinkedIn (LNKD), the business-related social networking company has captured the most attention, with the price of LinkedIn shares rocketing from \$45 to as much as \$122 on their first day on the public market (19 May). Since then, the stock price has settled at about \$80 per share, giving the seven-year old LinkedIn a market capitalisation of \$7.7bn. More than 30mn shares of California-based LinkedIn changed hands on the first day of trading, 3.8 times the amount sold to the public. According to Inyoung Hwang and Nikolaj Gammeltoft (2011a), data show that this is the biggest difference between supply and demand in at least five years for an IPO of a US company.

2. Crowdsourcing Capital

A few days later, the Russian web search company Yandex (YNDX) listed on the Nasdaq market at \$25 a share, representing the biggest technology-company IPO worldwide this year. The price soared 55 percent to close the first day at more than \$38 per share. Since then, the stock price has settled at just over \$30 per share, giving the company a market capitalisation of \$10.8bn. In part, the keen interest in the Moscow-based Yandex stems from the fact that the company has almost triple Google's market share in Russia.

If one is looking for arguments to support the case for investing in Yandex, there is a wealth of abetting anecdotal evidence. Online advertising in Russia climbed 51 percent from 2008 to end- 2010, when it reached 26.6bn rubles, according to the Moscow-based Association of Communication Agencies. By contrast, spending on print advertising plunged 41 percent, while the radio and television segments fell 21 percent and 6 percent, respectively.

To boot, the Boston Consulting Group has noted that Russia's internet industry is the largest in Europe after Germany and that it is experiencing rapid growth. Based on this, Boston Consulting Group anticipates that the industry may account for 3.7 percent of Russia's gross domestic product by 2015, which is more than double the industry's contribution in 2009. The attractiveness of the industry, and Yandex, is boosted by the fact that the Russian President Dmitry Medvedev, who posts to online blogs, has made 'modernisation' a priority of his administration.

The flurry of May's IPO market activity included the listing of the Chinese social networking business, Renren (RENN), on the New York Stock Exchange at \$14 per share. This placing raised a little over \$700mn for the business and translates into a market capitalisation of \$5.0bn. As is the case with Yandex, strong arguments have been made for investing in Renren, which is comparable to Facebook (although important differences exist). The Renren Network, literally 'everyone network', is popular among college students in China, and the company reports that hundreds of universities and colleges, 56 000 high schools and

85 000 companies in China are connected in Renren's network. Alongside this, Renren reports that another 1 500 universities and colleges in 29 other countries are inside of its network. The company's massive growth potential is underlined by the fact that it has a total of (just) 31mn active monthly users, which compares to Facebook's eye-popping 500mn active monthly users. Moreover, only 38 percent of Chinese internet users visit social networking sites compared to 81 percent of US internet users. Taken together, these figures highlight the huge upside potential in the number of Renren's active users.

In each of the above cases, the arguments for the businesses are compelling. Kevin Shacknofsky, of US-based Alpine Mutual Funds, goes further to explain that the specific appetite for social-networking and related IPOs is a function of the strong demand for 'quality social-networking plays' that are in short supply. Further, although Nick Train, the manager of the Finsbury Growth and Income Trust considers the social networking companies to be richly priced, he argues further that we are 'years away ... from the mania phase of any bubble'. Moreover, his view is that there are still 'great money-making opportunities in technology and, particularly, the internet'. In making the case for social media and networking companies, Train emphasises that 'technology drives capitalism' and that whilst there have been 'successive booms and busts in the global technology sector since the advent of the railroads in the 19th century (themselves a transforming and disruptive technology), we are at only an early stage of another boom, as digital and online technology is applied in previously unimaginable ways to both corporate and personal affairs'.

3. But Wait ... There's More

It is this type of enthusiasm that is likely to fuel robust demand and support high valuations for other IPOs of social-networking businesses, including the social games maker, Zynga; Twitter, the social networking and microblogging service; Facebook, the biggest social network; and Groupon, the voucher site, which at the time of writing has revealed plans for an IPO that could raise \$750mn (Dembosky, Waters and Menn, 2011).

The valuation multiples implied by Groupon's capital raising suggest that the business could be worth more than \$20bn at the time of its IPO, placing the business on a price-revenue multiple of 30 times. Whilst the business is loss making (\$453mn in the most recent financial year), investors explain the lofty valuation multiple by pointing out that the company is growing extremely quickly and that it has extraordinary prospects. To this end, Groupon reported revenues of \$645mn in the first three months of 2011, almost as much as the \$713mn it generated in the whole of 2010. Further, its subscriber base has grown from 152,000 in mid-2009 to 83mn as of March 2011. In turn, this exceptional growth in its subscriber base helped Groupon sell 28.1mn vouchers in the first quarter of this year, compared with 30.3mn in all of 2010 (Dembosky *et al.*, 2011).

In considering the financial worth of companies such as Groupon, some investors argue that traditional measures of a company's value may not necessarily apply to social networking and other high-profile internet companies. PriceWaterhouseCoopers (PWC, a global professional services firm) argues that the conventional valuation methods, such as the use of price-earnings multiples, are flawed when used for social media firms (Economist Intelligence Unit, 2011). Instead, PWC points to a 'value per user' approach, which compares valuations with telecoms operators and broadcasters on the assumption that a customer base can be monetised, as a more appropriate measure. Because many social media

companies prioritise growth over earnings, the argument is that a lack of earnings means an earnings ratio may be a misleading gauge of value (Economist Intelligence Unit, 2011).

More problematic than alternative valuation measures are alternative accounting metrics. On this score, Groupon is a prime candidate for the lineup, by having smartened up its financial figures in devising its own measure of profitability called 'adjusted consolidated segment operating income' or 'adjusted CSOI'. How exactly does it 'adjust' its operating income, you may ask? As John Gapper (2011) reports, Groupon does this by ignoring the cost of stock-based compensation and – notwithstanding the fact that this is an online business – by writing back the huge amount it spends on online marketing. Marketing expenses are by far the larger of the two figures, and by adding these back, Groupon gains \$241mn in 2010 and \$179mn in the first quarter of 2011, vaulting itself into the black. By manipulating its financial reports in this way, the business is able to report adjusted CSOI of \$60.5mn in 2010 and \$81mn in the first quarter of 2011.¹

Groupon is not the first company to choose a financial metric that suits it better than plain old Generally Accepted Accounting Principles. But ignoring marketing expenses is laughable. As John Gapper (2011) observes, 'it is like counting the revenues from subscriber growth while ignoring the costs'.

Returning to the argument, despite the great stories behind these businesses and their bright prospects, the arguments seem to overlook a key principle of investing, namely, the best way to turn a great business into a bad investment is to overpay for it, or to allow yourself to be fooled into overpaying for it. On this front, to borrow from Robert Shiller, the valuations that have been applied to the recent technology IPOs are 'irrationally exuberant' and are almost impossible to explain or support.

4. Nothing to See Here

By way of example, China's Renren, with a \$5.0bn market capitalisation, is valued at the equivalent of 65 times revenue, versus the industry average of 3.5 times. Enterprise value (EV) is equal to 357 times earnings before tax, depreciation and amortisation (EBITDA), or about ten times the already lofty industry EV/EBITDA multiple of 40 times. Other valuation aspects to consider include that, whilst revenue is growing extremely quickly, the company is making a loss, pays no dividend and has no book value to underpin the business.

In the case of Yandex, the market capitalisation value is a less demanding 21 times sales, and the EV/EBITDA multiple is a more industry-like 40 times. Further, whilst the company is profitable, and grew earnings by 60 percent quarter-on-quarter, the earnings base is wafer thin compared to the company valuation, and this translates into a price-earnings multiple of 70 times the last years' earnings. For any value investor, the fallback position is book value per share. To label this modest might be considered an understatement: book value per share is just \$1.22, which translates into a price-book multiple of 27 times. By contrast, Google (GOOG) trades at 5.5 times sales, 20 times earnings and 3.5 times book value per share. Whilst this is not necessarily a screaming bargain, relative to Yandex and Renren, Google looks drop-dead gorgeous.

¹ The term 'manipulating' is chosen as carefully as Groupon's accounting adjustment.

On the subject of book value, it is worth remembering the vulnerability of intangible assets to material write down by remembering the AOL Inc. (AOL) and Bebo saga. In that case, in March 2008, AOL, the internet company spun off from Time Warner Inc., paid \$850mn for the social networking service, Bebo. Two years later, AOL sold its investment in Bebo to Criterion Capital Partners LLC for \$10mn, or less than two percent of what it paid for the site two years before. Ahead of the sale, the New York-based internet company had advised shareholders that it was weighing a sale or shutdown of Bebo because AOL was not in a position to fund a turnaround at Bebo after losing ground to bigger social-networking rivals, including Facebook and MySpace. Interestingly, the price AOL paid for Bebo included \$766mn of goodwill which, in a fire-sale, is worthless. In some cases, intangible assets are incredibly valuable: Coca Cola Bottling Company (COKE) is perhaps the best example of this point. But when a business stumbles heavily or fails, it is often the case that intangible assets become invisible assets worth nothing.

Related to this last point, it has to be emphasised that new-fangled valuation multiples, such as the 'eye-balls-per-screen' multiple that was widely applied during the dotcom bubble of the late 1990s, are quickly shown to be baseless when it comes to the crunch. The behaviour of investors shows again and again that whilst price can run a long way ahead of value during exuberant periods, in the end it is the asset base and profitability of a company that are valued. To put the point simply, intangible assets are extremely vulnerable to debasement and 'special case' valuation methods are prone to embarrassment.

Returning to the argument of overvaluation, the case of LinkedIn is intriguing. At a market capitalisation of \$7.7bn, the company is trading at 26 times its past twelve months' sales of \$292mn and more than 1 200 times last year's profits. As with the other social networking businesses, LinkedIn has no balance sheet to speak of, and this is evidenced, in part, by the price-book multiple of more than 115 times. Of course, investing is never about taking a photograph, but rather watching the movie, and so it is essential that we factor in the prospects for growth in the company, which certainly are extremely good. On this score, if LinkedIn enjoys robust growth to become a well-run, mature business, it can probably look forward to commanding a price-earnings multiple at maturity of about ten times, which is what Microsoft (MSFT) commands today. Coincidentally, Microsoft trades at about 3.5 times its book value, which is about identical to Google. That aside, reversing a price-earnings' multiple of ten out of LinkedIn's market value of \$7.7bn implies bottom-line profit of \$770mn - and that is at today's price of \$80 per share. To put this figure in context, profit of \$770mn is 1 000 times current profit.

5. Could This Time Be Different?

It would be naïve to suggest that the spectacular growth implied by current valuation multiples cannot happen. It can, and there are many examples of staggering company growth where valuation multiples that, at some point appeared outrageous, were later justified by history-making business successes. The more important question, though, is not 'is it possible' that LinkedIn, Yandex and Renren achieve the staggering success implied by the current valuation multiples, but rather 'is it likely'? To this question, the answer has to be a resounding no, which means that the valuation multiples being applied do not belong to the world of intelligent or common-sense investing, but rather to a world of outrageous speculation and absurd optimism.

Investment history is not on the side of those who have paid the current high multiples for these social networking companies. These may well be the world-class businesses of tomorrow, but they are not world-class investments. For that, we need to look elsewhere – but not necessarily too far away from the technology cluster. Intel (INTC) is one such example.

6. It's Not on Top ... It's Inside

Whilst Intel's history is filled with colour, today the business is the world's largest semiconductor chip maker with a timeline that reaches all the way back to 1968 when the company was established as Integrated Electronics Corporation. Despite its size and unexciting, middle-aged stature, Intel is an exceptionally well run business that boasts a strong balance sheet, is highly profitable, has good prospects and is valued on compelling multiples. To evidence this, in its most recent quarterly report, the company's financials show a profit margin of 35 percent and a return on equity of 27 percent, with year-on-year earnings' growth of 29 percent. Through the cycle, Intel's return on equity is about 25 percent and return on assets is about 15 percent. Put simply, this is a good business. Equally important in an investment decision is the market valuation of the company.

With a market capitalisation of \$120bn, Intel trades at 2.6 times its revenue of \$46bn and ten times its bottom line profit of \$12bn. These are undemanding multiples for a high quality business. Moreover, the company has \$12bn cash on its balance sheet, having just applied cash of about \$2bn to buying back its own shares. On top of being a great business, the company is compellingly priced, making it a great investment.

7. Not Just an Advanced Bubble, But an Emerging One Too

Opportunities aside, a further aspect of the 'IPO-bubble' argument that is worth noting is that whilst the dotcom bubble of the late 1990s was mainly a US phenomenon, as the cases of Renren and Yandex illustrate, internet companies from emerging markets are causing just as much of a stir among investors, who are keen to capitalise on the huge opportunities offered by high-growth countries like China (which has the largest and fastest-growing internet population in the world) and Russia (Economist Intelligence Unit, 2011). If anything, this means that the extreme pricing of these companies should be of greater concern to global investors because of the elevated threats of contagion and spillover risk.

To this end, it is worth noting that the inefficient pricing evident in the global technology cluster is also evident in the South African technology cluster. This argument can be made by comparing the ratings investors have applied to the media and technology business Naspers Limited (NPN) to less glamorous technology companies, such as Pinnacle Technology Holdings (PNC or Pinnacle).

There can be no mistaking the fact that Naspers is a superb business with an enviable track record, strong management and a desirable portfolio of underlying businesses which includes Tencent Holdings' QQ platform, the most popular free instant messaging computer programme in mainland China, with more than 600mn active users; Mail.ru, the largest free e-mail service in Russia, which also owns 32.5 percent of vkontakte – Russia's most popular

social network; 2.4 percent of Facebook; 1.5 percent of Zynga; and just over five percent of Groupon.

Echoing the global theme, Naspers and its underlying investments are richly priced. Tencent Holdings (HKSE:0700.HK), for instance, is on a price-earnings multiple of 42 times and a price-book multiple of 15.4 times. In this vein, Mail.ru is priced at 35 times earnings. Naspers itself is valued by the market at 35 times last year's earnings and, whilst the price-book ratio appears reasonably sober at 4.5 times, it must be kept in mind that the book value of the business essentially is represented by intangible assets. That aside, Naspers' top-line revenue has grown at a simple average annual rate of 43 percent *per annum* over the past decade, translating into a market capitalisation-to-sales ratio of 5.4 times. The average annual return on equity over the past decade of 14.3 percent supports an EV/EBITDA multiple is 34 times. Given these metrics, whilst Naspers is a great business with exceptional prospects, it is priced that way.

Compared to Naspers, Pinnacle is a modest business, with a market capitalisation of R1.4bn, or just one-hundredth of Naspers' R162bn. The principal activities of the group are the manufacture, distribution and support of technology hardware and software or, in modern parlance, 'boring stuff'. Whilst the absence of glamour means that the company is somewhat ignored, this belies the quality of the company. To evidence this argument, Pinnacle generated a return on equity of 28 percent in the last twelve months and an average return on equity of 24 percent over the past five years. Moreover, the company has produced a headline profit in each of the past ten financial years. Over this same period the company has grown its top-line revenue at a simple average annual rate of 94 percent. Despite this stout record, the lack of glamour manifests itself in the form of modest valuation multiples, with Pinnacle's EV equal to 5.9 times EBITDA; and the company's market capitalisation is equal to 0.5 times revenue, 8.5 times bottom-line earnings and 2.4 times its book value. These multiples translate into a compellingly-priced investment of quality. This stance is supported by the fact that the company is in the process of buying back 20 percent of its own shares.

Other examples of great value in the information technology and electronics arenas include Datacentrix (DCT), with a market capitalization of R1.0bn, and Reunert (RLO), with a market capitalisation of R12.0bn, to name two cases in the South African listed-company environment. Similarly, it must be noted that stripping the internet businesses away from Naspers leaves a pay television and print media 'rump' that is priced on compelling multiples compared to the aggregate business.

Such mispricing in the domestic and global environment presents investors with the opportunity to buy exposure to good companies at great prices. On the back of this argument and other evidence, the Cannon Equity Fund and institutional portfolios have no exposure to Naspers and between a 3.0 percent and 4.5 percent exposure to Pinnacle. By the same convention, Cannon's Global Equity Fund has no exposure to any social networking businesses, but has been invested in Intel since November 2010. Also, Intel is a core holding in our global 'ten best ideas' portfolio.

8. The Bottom Line ... In A Little Over 140 Characters

There can be no mistaking the argument: the potential in social networking businesses is huge, especially if Yandex and others get traction. But as things stand, the recently-listed technology IPOs appear priced for infinity and beyond, just as was the case during the 1990s dotcom bubble when the now-dull Intel achieved a peak price-earnings multiple of 100 times. In the same way, the valuation multiples that have been applied to the social networking IPOs are outlandish. Seen in this light, the question is not whether there is a social networking IPO bubble or not, but rather will the bubble burst sooner rather than later? In the meantime, for those willing to invest against the herd and the hype, exceptional opportunities exist amongst a number of overlooked, but high quality information technology companies.

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Cannon Asset Managers (Pty) Ltd
Unit 6 Rydall Vale Crescent
Rydall Vale Park La Lucia Ridge 4019
PO Box 5200 Rydall Vale Park
La Lucia Ridge 4019
South Africa

+27-31-566-6633
info@cannonassets.co.za

Cannon Asset Managers (Pty) Ltd
First Floor, Building B
Bryanston Corner
Ealing Crescent, Bryanston, 2194
South Africa

+27-11-463-3140
adrian@cannonassets.co.za

Directors: A Desai*†, SS Gilmour*, GG Blount, AD Saville, CB Simpkins
* Non-Executive † British