

Stock Market Review



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Another internet bubble?

The recent surge in the share price of LinkedIn on its stock-market debut has led to suggestions that a new internet bubble is forming. On May 19, LinkedIn's equity rallied by 173 per cent to a high of \$122.69 on the first day of trading in New York. A few days earlier it had been offered on the primary market at \$45 per share!

LinkedIn is a business-focused social networking site. It was set up in 2003 by Reid Hoffman, a founding member of PayPal. Basically, it can be defined as Facebook for business. Just as people use Facebook to update their friends on their personal lives and share links to websites they might be interested in, LinkedIn is used to connect with people you might want to do business with, for job hunting, recruitment, etc. The strong demand for LinkedIn's shares is due to the attention being given to such companies benefiting from the online social networking revolution.

The hype is also due to the scarcity of other similar public companies in this sector since its larger rival Facebook, the retail services company Groupon and social games service Zynga have not yet taken the public route. Some commentators claimed that the response to the LinkedIn IPO shows that investors are desperate to get into social media.

Moreover, the strong gains on LinkedIn's market debut accompanied by high volumes was also due to the relatively small free float as only 10 per cent of the company's shares were sold during the IPO. During the first two days of trading almost 40 million shares were exchanged, about four times the number of shares in public hands.

Despite touching a high of \$122.69, LinkedIn's shares closed the first day of trading at \$94.25, repre-

senting a gain of 109 per cent over the IPO price. At the closing price, LinkedIn was valued at \$8.9 billion, making it the biggest IPO of a technology company since Google's offering in 2004. LinkedIn has 100 million users on its site and although its revenues doubled in 2010 to \$243 million, its profitability was only \$15 million. An overall market value of \$8.9 billion compared to profits of \$15 million, produces a price/earnings multiple of almost 600 times. Using other indicators such as price to sales or price to EBITDA also presents stratospheric multiples. The high valuation is one of the major reasons for many overseas analysts to draw comparisons to the dotcom bubble in the late 1990s.

To put this into perspective, blue chip companies in the UK such as oil giant Royal Dutch Shell and the mining company BHP Billiton trade on multiples of eight or nine times. In Malta, Bank of Valletta plc trades on a p/e ratio of 10 times last year's earnings with HSBC Bank Malta plc at a multiple of 16.

On the other hand, however, some analysts who have defended the LinkedIn valuation draw a parallel to the Google IPO in 2004. Many critics had failed to take an exposure to Google due to the very high valuation at the time. High multiples are afforded to companies with exciting growth prospects and Google's financial performance and upturn in the share price over the years (+383 per cent) vindicates the claim that such companies are bound to produce exceptional profitability growth in future years.

A few days after the LinkedIn IPO, Microsoft acquired Skype for \$8.5 billion - a valuation also claimed by many to be comparable to the internet euphoria of the previous decade. It is interesting that while many have criticised Microsoft for the amount paid for Skype, the valuation attrib-

uted to the internet calling site by the tech giant is equivalent to \$13 per user compared to almost \$100 per member for LinkedIn.

The euphoria surrounding LinkedIn may not be surprising for those who followed other tech IPOs in recent months. Earlier on this year, Renren (the biggest Chinese social networking site) and other Chinese internet IPOs also attracted sky-high valuations on expectations of strong growth prospects of the internet market in China. However, Renren's share price has fallen by close to 20 per cent since the IPO amid increased talks of a new internet bubble.

The international business media has contrasting views on whether the LinkedIn IPO could be the culmination of another tech bubble or whether the situation is really different this time. Those voicing their views that this is not "history repeating itself" use two major arguments to support their ideology: (i) many of the internet companies becoming publicly listed already have substantial revenues and profits in contrast to the profitless dotcoms of the late 1990s; and (ii) the landscape has changed dramatically over the years with almost two billion now connected to the internet compared to much lower numbers in the 1990s. Moreover, the speed of broadband connections is another important differentiating factor.

While the debate has so far focused on whether the internet bubble is related to those companies performing IPOs in the public market, other commentators have argued that the actual bubble is gathering stronger momentum among private investors. Before the May IPO, shares of LinkedIn reportedly changed hands between institutions at an estimated \$17.74 per share in June 2010 rising to \$23.27 in March 2011. These valuations are

established as these growth companies regularly seek fresh capital from private equity firms and very high net worth investors to fund their growth.

Another example of the private market for Internet companies comes from Facebook. In 2007, Microsoft had purchased a 1.6 per cent share of the company for \$240 million giving an implied value of \$15 billion. Meanwhile in January 2011, Goldman Sachs raised \$1.5 billion in fresh capital on behalf of Facebook from various wealthy individuals.

The world's largest social networking site was attributed an overall valuation of \$50 billion at the time. However, in the latest round of financing from private sources the value of Facebook seems to have risen by a further 50 per cent to \$76 billion. The various fund raising activities over the years diluted the stake of the company's 26-year old founder Mark Zuckerberg to circa 24 per cent. However, such equity injections helped Facebook's founder to finance its extraordinary growth to over 500 million users.

Is this a sign of "irrational exuberance" or will more tech IPOs follow in similar spectacular fashion? What is driving this renewed appetite? Various international analysts are of the view that the strong appetite for such growth companies in part reflects the loose monetary policy adopted by central banks since the financial crisis in 2008. With the real return on deposits close to negative due to rising inflation, investors normally turn to equity in the hope of a positive return. Companies operating in the social networking universe may produce spectacular returns for investors as the phenomenal growth rates being registered may lead to even stronger demand once the larger companies debut on the stock market in the near future.

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