What is fueling the Internet stocks' bubble?

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12 January 1999

The 1999 opening week on Wall Street saw skyrocketing share prices for a number of Internet-related companies. While to a certain extent this jump continued the late-1998 trend and mirrored the rise in the market as a whole following the autumn interest rate cuts, it has taken on a phenomenal character.

Last week share prices rose 10, 20, even up to 50 percent in a single day for a number of companies. It is not unusual to find Internet firms--Yahoo, the popular search Web site; and Amazon, the bookseller, for example--whose stock prices have quadrupled since September. The overall market capitalization figures have correspondingly gone through the roof. America Online, the popular online service, for example, has seen its price more than triple during this time, giving it a larger capitalization than General Motors.

Why are the prices of the Internet stocks soaring? To find out, I examined one of last week's heavily traded companies, broadcast.com, which bills itself as the "leading aggregator and broadcaster of streaming media programming on the Web." Broadcast.com held its initial public offering on the NASDAQ exchange last July. In September its stock fell from the mid-60s to the low-30s, only to skyrocket to 100 at the end of the year. Last Friday it rose from 132 to 197, a jump of 50 percent. Panicked NASDAQ officials stopped trading and tried to get an explanation from the company, which could offer none. On Monday, after the company announced a two-for-one stock split, its price climbed to 278, a 40 percent gain.

Broadcast.com is little more than a name, a company in search of a business. Its web site is limited, almost amateurish. It produces nothing itself (it relies on "content providers" in Internet lingo). It simply plays ("streams" to use the jargon again) low-quality audio and video generated by other companies (radio stations, CSPAN, etc). The most recent of its "Current Events" is a speech given by Sandy Berger, the US National Security Advisor, on December 23, i.e., more than two and a half weeks ago. Even with a high-speed modem the picture is choppy, hardly a surprise given the still limited technology of Internet video.

The company's most recent filing with the Securities and Exchange Commission is a revealing document. "The Company has incurred significant losses since its inception and, as of September 30, 1998, had an accumulated deficit of approximately $20.2 million." In the first nine months of 1998 it had revenues of $11.4 million, a figure that, within the framework of US capitalism, puts it in the category of small- to medium-size businesses, a group encompassing tens of thousands of generally struggling firms. The company spent $23.1 million in the same period, a figure twice the size of its revenues. Nevertheless, Monday's closing price gives the company a market capitalization ($4.873 billion) larger than Wendy's ($2.831 billion), which has annual earnings of $100 million and 47,000 employees, and more than half that of Delta Airlines ($8.282 billion) which has annual earnings of nearly $1 billion and 70,000 employees.

Broadcast.com's losses, even the company admits, will continue. It's SEC filing states: "The Company expects to incur substantial operating losses for the foreseeable future." Are there plans to cut back? "The Company expanded from fewer than 10 employees on September 20, 1995, to 225 employees on October 31, 1998, and the Company expects to increase its personnel significantly in the near future." It goes on: "The Company currently intends to increase substantially its operating expenses in order to, among other things, (i) expand its distribution network capacity, (ii) fund increased sales and marketing activities, (iii) acquire additional content, (iv) develop and upgrade technology and (v) purchase equipment for its operations."

The long-term outlook is also highly questionable.

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"There can be no assurance that the company will ever achieve profitability or, if profitability is achieved, that it can be sustained." The SEC filing adds that the company's agreements with its program providers are nonexclusive, i.e., broadcast.com can be underbid. Most of the company's revenue is from short-term advertising on its web site and radio and TV. There is no guarantee that their site will ever be widely used. "It is not known whether businesses and other organizations will utilize the Internet to any significant degree as a means of broadcasting business and other events."

And finally there are the internal problems, including: that nearly all the senior management just joined the company, that nearly all of its equipment is in a single location with no backups maintained, that it may not be able to handle a large increase in user traffic, that it has no guarantee against being hit by the year 2000 problem, and that it carries no insurance to protect it from copyright lawsuits or the loss of key employees.

In other words, the company is a young, small startup facing immense risks and uncertainties. Its underlying fundamentals are shaky. It has few ideas and no real product. Not only its future earnings, but even the company's future existence, are dubious. The skyrocketing share price is entirely speculative.

Broadcast.com has become a magnet for drawing together vast aggregates of capital, which it does not employ for any real constructive purpose. It exemplifies the growing detachment of capital from the social productive process. Money is poured into the market, driving prices up, increasingly without regard to the underlying productive capabilities. The company's dividend from earnings plays an increasingly negligible role in the return on investment in light of the inflated prices. Prior to the 1990s bull market a price-to-earnings ratio (PE ratio) of 20:1 was considered to be at the upper end of a safe investment. In 1999, however, PE ratios of 100 to 200 are increasingly common and ratios of 400 are not unheard of. For some stocks, like broadcast.com, the PE ratio cannot even be calculated as the company has never earned money.

The snapshot of broadcast.com gives some idea of the feeding frenzy that is presently under way in the US stock market. The Dow Jones Industrial Average, and other indices, have become quasi-religious national obsessions, displayed and cited ubiquitously. The spirit of the lottery and the unhealthy ambition for easy money have swept over a substantial layer of US society. This has coincided with the entry of wider sections of the middle class, and even a strata of the working class, into the stock market. Their mesmerization by share prices will continue until the inevitable puncturing of the present bubble.

If history teaches anything, the runaway valuations will end in a flood of tears. The rupture of the bubble--the fall in prices--will leave substantial numbers of people hard-hit. Many have allowed themselves to accumulate personal debt that they view as offset by the increasing paper values of their portfolios. The resulting decline in consumer spending will also have a dramatic international impact since the US has absorbed a large fraction of the exports from the Asian countries still reeling from the 1997 meltdown.

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