

We're All Venture Capitalists Now

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10 January 2000

Until a few years ago, there was a quaint custom that in order to issue publicly traded equity, firms had to make money. This no longer seems to be the case. A case in point is VA Linux Systems, which went public in early December 1999, selling an 11 percent stake for \$132 million. VA Linux's claim to fame is its Unix-based operating system, created by a Finnish graduate student, designed to run web and database computer servers, and given away for free! VA Linux's only revenue comes from the sale of the computers themselves. Nevertheless, on December 9, 1999 its first day of public trading, the stock opened at \$300 — 10 times the initial offer price — before settling down and closing at just over \$240. Needless to say, the founders of VA Linux Systems are now very wealthy (at least on paper).

The recent run up in the price of NASDAQ over-the-counter shares has been truly extraordinary. Overall, the NASDAQ composite index rose by over 80% in 1999. During this time, the price-earnings ratio (P/E) of the NASDAQ overall has gone from around 80 to over 130. By comparison, during the early 1990s, the NASDAQ P/E ratio was closer to 40. Since people who buy stock ultimately expect to be paid back, valuations have usually been based on companies' earnings, which are indicative of their ability to return money to their shareholders.

Price-earnings ratios rise and fall for various reasons. The two most important are changes in risk tolerance of investors and reassessments of a firm's future growth prospects. An increase in risk tolerance means a reduction in the risk premium investors require to hold a firm, resulting in an increase in stock prices and hence in the P/E of all stocks. An increase in estimates of future earnings growth has the same impact.

But it is hard to square the numbers we have seen with these traditional explanations, so what is going on here? While the world may have gone crazy, there is an explanation that makes some sense. The fact is that companies now issue publicly traded shares at a much earlier age. In the bad old days, the only funding such firms could get would come from venture capitalists. Such people only parted with their money if they were

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guaranteed very high rates of return. But given the risk inherent in these investments, the terms on which the venture capitalists provide funds seems reasonable. Investing in start up firms is a very difficult and risky business.

With the issuance of equity in start up firms — companies that have little or no revenue — we have seen venture capitalism become more democratic. Instead of going to the specialists, entrepreneurs starting new high-tech firms can go directly to the capital markets to raise funds. Selling a portion of the start up firm one share at a time is the securitization of venture capital.

My reaction to this is that I am very glad to avail myself of this new investment opportunity. Before this, I was stuck holding only the listed shares of firms with well-established profit records. Now, I can diversify further and hold shares that were previously unavailable to me.

There is a catch, however, and that is that anyone who holds shares in these new firms has to be ready to bear the risk inherent in owning a part of a very young company. The venture capitalists of old knew that a significant percentage of the firms they invested in would never return any of their investment — they would go broke. Small investors in companies with little or no earnings (or even revenue in some cases) must put their money in with the expectation that five years from now, many of these new firms will no longer exist.

I am reminded of the experience of the automobile industry at the beginning of the twentieth century. In 1910 there were over 200 auto manufacturers offering a total of over 1000 car models. This fell to less than 50 producers and 750 models in 1928, just before the Great Depression, and finally to around 20 firms and 400 models in 1940. A slow and steady consolidation that continues today on a grander scale with the creation of Daimler Chrysler last year has created a small number of spectacular winners, but a large number of losers.

We can find evidence for this viewpoint by looking at the differing valuations of young and mature firms. First, note that the S&P 500 Index, which is comprised entirely of well-established companies, rose nearly 20% in 1999; a substantial increase, but much less than the NASDAQ's rise. Furthermore, since 1999 has been a phenomenal year for earnings, the price-earnings ratio for the S&P 500 has been relatively stable at just over 30. Granted, this is a very high level, as the average over the past 100+ years is only 14, but, while valuations have risen significantly over the past few years, and are very high today, they did not skyrocket in 1999.

Turning back to the NASDAQ, we can compute the price-earnings ratio for those

NASDAQ stocks with positive earnings. These firms are more comparable to New York Stock Exchange listed companies, as the NYSE maintains a minimum earnings requirement. The results are quite striking: the bulk of the divergence between the NASDAQ and the S&P 500 is due to firms that make no money! Looking at the NASDAQ firms with only positive earnings we see the end of year 1999 P/E (based on 12 month trailing earnings) is just over 40. Granted this is higher than that of the S&P — and the divergence is actually at its historical high — but it is not nearly as outlandish as the initial estimate appears.

We are left with two conclusions. First, unless investors' currently demand significantly lower compensation for the risk they are bearing in the stock market — and risk measures in other market such as bonds suggest that they have not — things do look over valued as price-earnings ratios are at all-time highs. The money making firms on the NASDAQ have prices nearly fifty percent above those in the S&P 500, which themselves are at very high levels. But second, and more importantly, there has been an important change in the way firms finance themselves that makes old ways of looking at the numbers less relevant. In this new world, we all have the opportunity to be venture capitalists, and must expect that some of our investments will have spectacular payoffs, while the majority will turn out to be worthless.