**Is This Rational?**

Although many of you don't spend much time reviewing the financial statements of public companies, we do, and we think that some of the current valuations in the stock market deserve serious scrutiny. Although the internet is a real and growing force in many areas of our professional and personal lives, the valuations of many companies related to the internet defy explanation. The following illustrates one such example.

The Internet Capital Group (ICGE) is a company that has only been public since early August of 1999. A description of the company's business found in the prospectus for their Initial Public Offering (IPO) in August is as follows;

***Internet Capital Group is an Internet holding company actively engaged in business to business e-commerce through a network of partner companies. We provide operational assistance, capital support, industry expertise and a strategic network of business relationships intended to maximize the long term market potential of more than 30 business to business e-commerce partner companies. We focus on two types of business to business e-commerce companies: market makers and infrastructure service providers.***

| Company | Market Value | Annualized Revenues | Annualized Net Income (Loss) |
|---|---|---|---|
| **Internet Capital Group** | **$34,275,000,000** | **$17,919,000** | **$(44,841,806)** |
| **Adobe Systems** | $7,320,000,000 | $1,043,504,000 | $228,620,000 |
| **Alliance Capital** | $5,250,000,000 | $1,780,648,000 | $406,616,000 |
| **Elan Pharmaceuticals** | $6,600,000,000 | $1,013,600,000 | $361,600,000 |
| **Knight-Ridder** | $4,840,000,000 | $3,138,956,000 | $304,836,000 |
| **Staples** | $10,100,000,000 | $7,360,440,000 | $210,976,000 |
| | **$34,110,000,000** | **$14,337,148,000** | **$1,512,648,000** |

Although the price for the IPO in August was $12/share on December 13 the stock was trading near $270/share, a gain of more than 2,100%. At that price ICGE has a market value of approximately $34 billion. As the table above details, the company's revenues for the most recent quarter would annualize to just $18 million and losses would annualize to almost $45 million. The five companies in the table below ICGE have a combined market value of about $34 billion, nearly identical to the market value of ICGE. However, those five companies have annualized revenue of more than $14 billion and net income or profits of $1.5 billion. Adobe Systems is the premier provider of graphic design and illustration software. Alliance Capital is one of the largest institutional money managers in the U.S. Elan Pharmaceuticals is a rapidly growing developer of medicines and drugs. Knight-Ridder is the second largest U.S. newspaper publisher. Staples is a leading office products and stationery supplier in the U.S. If you had $34 billion to spend you could buy all of ICGE ***or*** you could buy all of Adobe Systems, Alliance Capital, Elan Pharmaceuticals, Knight-Ridder and Staples.

Looking at the table on page 1 you might wonder why a brand new company with a new and untested business model, tiny revenues and presently losing money can have a market value equal to the five other companies with robust and rapidly growing revenues and profits. The table raises some serious questions about the rationality of the collective mind of the multitude of market participants and yet offers few answers.

**The Truth About Investing**

A wise and highly successful investor from Omaha recently said, " investing is simply the proposition of exchanging a present sum of money in expectation of receiving a future sum of money." One can only hope to do enough research to accurately estimate the size of the future cash flow and assign a probability to the future cash flow high enough to justify giving up a certain sum of money in the present. In fact, many investors consider the value of an investment to be the present value of all future cash flows one can expect to receive from owning the investment. For a bond that statement is clearly true. A bond's current price is the present value of all future coupons and principal. For a stock it is also true, although the future cash flows are subject to a wide variety of uncertainties.

Prudent equity investing usually involves an assessment of a company's business, business model, competitive advantages and threats, management, and a host of other company and industry issues. One can then develop some rough probabilities regarding the likelihood of the company growing, remaining profitable and so on. The more an investor can properly estimate and discount future cash flows and the probability of those cash flows, the more likely he or she is to be a successful investor.

Of the many thousands of public companies in America there are only about 65 companies with market capitalizations greater than $35 billion. Most of them took years if not decades to achieve that size and their market capitalization is closely correlated to the growth of their revenues and profits. Virtually all of them are highly recognizable companies; General Electric, Johnson & Johnson, Microsoft, Merck, Procter and Gamble, Cisco Systems, Intel, Fannie Mae, Citigroup, Wal-Mart, Home Depot and so on. How is it possible for a company that has only been public for 5 months to have a market value of nearly $35 billion? How is it possible for a company with annualized revenues of less than $18 million and annualized losses of $45 million to have a market value of nearly $35 billion?

With the broad market as measured by the S&P 500 trading at a multiple of about 25 times year 2000 earnings estimates, ICGE would have to have a net income right now of about $1.4 billion to justify a normal market P/E multiple. If you assumed ICGE would eventually have an above average profit margin of 30% that implies they would need to have annual revenues of about $4.6 billion to have net income of $1.4 billion to justify their current market value.

If you chose to own our basket of five companies you would own a collection of businesses with revenues of $14 billion and profits of $1.5 billion in the present. If you owned all of ICGE you would essentially own a business that may eventually have revenues and profits in the future, but right now, it is just a business with some (assign your own probability) potential to have revenues and profits. Does it make any sense that the market considers ICGE to be equal in value to the basket of five?

Now there are plenty of people out there who will tell you that we are in a new world of stock valuation, where earnings don't matter and multiples are meaningless because of how big and profitable this whole internet thing is going to be. Yet the investing proposition remains unchanged; cash out now for cash in later. And believe it or not, risk is directly related to price. Paying too much for a stock now means two things are true. The first is that you immediately have more money at risk than someone who paid less (or did not buy it at all). The second is that your eventual return will be smaller (or loss larger) than someone who paid less than you did, assuming you sell at the same time. It is that simple.

Returning to our Internet Capital Group example, an investor who bought all of ICGE today who expected a return of 20% annually for 5 years would need the market value of the company to grow to $75 billion at the end of those five years. Is that a high probability undertaking? Remember that the revenues and profits in a normal world that would be required to justify a market value of $75 billion (with our assumptions) would be $10 billion in revenues and $3 billion in profits. Starting with their current annual revenue rate, Internet Capital Group would have to grow revenues at the astonishing rate of 11% per month or 250% annually. Meanwhile, our collection of "normal" companies—Adobe, Alliance, Elan, Knight-Ridder and Staples—who already have combined revenues of $14.3 billion and combined profits of $1.5 billion could chug along at 20% annual revenue and profit growth and wind up in 5 years with revenues of $28 billion and profits of $3 billion. At the current valuation of ICGE and many companies just like it, the market seems to be saying... "a bird in the bush is worth two in the hand."

From where we view the investing world it is clear that for most of the internet companies the "market" is awarding enormous valuations to companies that are little more than an idea and a web page. Some of them may eventually become real companies with revenues and profits and some will not. However, most of them are being valued as if they had significant revenues and profits right now. How likely is it that the Internet Capital Group will ever achieve a revenue and profitability level high enough to justify their current multiple? Your answer may lead you to your own conclusions about the proper valuation for this company or for any company. Without stating unequivocally what our opinion is, we do believe that "a bird in the hand is worth two in the bush."

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