# Pre-bubble hype for second dot-com bubble?

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What's a dot-com worth? Investors got it badly wrong when they pushed Internet stocks to nose-bleed levels in 2000, only to lose billions when the companies mostly went bust.

It's 2011, and here we go again. There may not be sock puppets and Super Bowl commercials, as in the last Internet boom, but signs throughout Silicon Valley are starting to show eerie similarities to the dot-com bust. Now, some are wondering if a bubble is forming around a new breed of Internet companies even before they reach the stock market.

Although not at the 2000 fever pitch, things are moving in that direction as small sets of investors are seemingly willing to pay any price for promising Web start-ups. Consider the:

Online coupon site Groupon spurned a $6 billion buyout offer from Google, according to published reports.

The public's current infatuation with tech has been a long time coming. Tech and Internet stocks turned into bad words after the dot-com bust in 2000. But the get-rich-quick feelings toward tech are back.

Those 48 tech IPOs represented 28 percent of the total number of deals.

It's hard to blame tech CEOs for rushing the IPO window. Investors can't seem to get enough. The stock prices of those tech IPOs, on average, jumped 19 percent on their first day of trading-the strongest reception for any industry, Renaissance Capital says.

Given the near-hysteria about promising but largely unproven companies, investment professionals warn that things could start getting out of hand.

Much of the excitement and the astounding price tags on companies are products of a relatively new corner of the markets in which most investors can't participate.

Private marketplaces, including SecondMarket and SharesPost, allow owners of shares of private companies such as Digg, Facebook, Zynga and Twitter to sell to high-net-worth individuals and institutions. Typically, the sellers are employees at these companies looking to cash in on shares they've received. And the buyers are sophisticated investors who understand they could lose their entire investment.

These online services provide a way for employees to sell their shares now rather than waiting for an IPO that may never occur.

However, with the great power that such marketplaces offer comes confusion. Many of the valuations put on companies are overinflated based on limited sales of shares occurring on the relatively small markets.

For instance, if one employee sells a few shares of a company at a seemingly high price, some observers might infer that all the company's shares would sell at that same price. Multiplying the price fetched in one sale by the company's total number of shares can produce a high market value for the company. However, the fact is these private marketplaces conduct such a small sliver of the trading volume on the exchanges that prices for transactions can be extremely volatile. A good one-day sale of stock could greatly inflate the market value of a company temporarily. "It's like the baseball player who goes 2-for-3 in a game, and an announcer jokingly says the player is on pace to hit .667 for the season," says Phil Sanderson, managing partner at IDG Ventures.

Before long, estimates for the value of popular Internet companies can soar. Consider Twitter. In December, The New York Times reported the company was valued at $3.7 billion after a funding round. Now, it's pegged at about $7.2 billion, according to SharesPost. Further fueling the speculation are largely unsubstantiated rumors that big Internet companies are on the prowl for acquisitions. Last month, Twitter CEO Dick Costolo scoffed at Twitter acquisition rumors, the driver behind the $10 billion value estimate, during a speech at the Mobile World Congress in Barcelona. Twitter co-founder Biz Stone is more blunt. In an interview last month, he said the $10 billion figure was "made up" in a published report by The Wall Street Journal.

"Twitter is not for sale," Stone says. "I have no idea where it came from. We have never specifically mentioned numbers." Private marketplaces, in part, have influenced the sky-high valuations, Stone says. "Someone buys 100 shares, and then someone comes up with head-spinning, outrageous figures," Stone says. "We're very, very interested in building an independent company."

Until companies finally go public and the stocks actively trade on major exchanges, the small and relatively thin trading on private markets sets the price.

The problem for these companies and their investors, especially in the trendy Internet industry, is that valuations can quickly go up in smoke if anything doesn't go just right. Some Internet companies appear to be stranded as private companies, dashing some investors' hopes of cashing in on a splashy IPO.

Just because a company files plans for an IPO doesn't mean it will actually happen. Widely watched video game rental service GameFly, a sort of Netflix for video games, filed for a $50 million IPO on Feb. 10, 2010. However, more than a year later, the deal is still stuck in the pipeline.

Given such huge risks, the level of the public's infatuation with shares of privately held Internet companies is again taking on a feel of a mania, says Gary Freedman, securities lawyer with Ervin Cohen & Jessup.

Several ingredients that inflate bubbles are all present, including a broad acceptance of the companies' products. Also intensifying the distortion is the fact that there's very little financial information on these private companies, he says.

"It's the same mania," Freedman says. "Markets are cyclical. It's really no different than looking at the Internet bust and the housing market."

The marketplaces are designed to prevent running afoul of securities laws by only attracting investors who are deemed to be "accredited," Freedman says. To be accredited, investors must meet a number of criteria presented in securities law, including a net worth of $1 million or more or an annual income of $200,000 in each of the past two years.

Even so, industry observers expect regulators to take a closer look at the marketplaces, to determine if old rules are still appropriate, as they play a greater role in capital markets.

But proponents of the next breed of Internet companies say the valuations aren't absurd this time because the companies have fundamentals behind them.

"We're talking about real companies with real revenue and real profit," says Jeremy Smith of SecondMarket.

"It's a boom, not a bubble, when you hear the sound of dynamite profits," says Bing Gordon, a partner at venture-capital giant Kleiner Perkins Caufield & Byers. and board member of social-gaming company Zynga, valued at $9 billion.

"There is effervescence, but no bubble," says Geoff Yang, a founding partner of Redpoint Ventures.

A major shift in technology is bound to create companies with massive market values, the proponents say. The emergence of social media (more than 500 million accounts on Facebook alone), combined with mobile phone use (4.5 billion), is disrupting all of technology, so giant winners are to be expected, say venture-capitalists such as Cohler and Yang.

"Back (in the late 1990s), we built the best company we could with 75 million users and limited technology," says Marc Andreessen, a Facebook board member and early investor in Zynga whose company, Netscape Communications, saw its stock price soar to $75 a share in its first day of trading in August 1995. "Now, the social-mobile Internet is so much bigger."

"I think this boom is going to last awhile," says Ted Schlein, a managing partner at KPCB. "The trend lines are unlike anything we've seen in history."

He says the enormous size of the social and mobile Internet market-tens of billions of people-dwarfs the markets for the fledgling Internet (billions) and personal computers (hundreds of millions), putting companies such as Facebook, Twitter and Zynga in prime position to strike it rich in IPOs.

Facebook has about $2 billion in annual revenue. Groupon topped $760 million in sales last year. Pandora's revenue of $90 million for first nine months of 2010 has helped make it profitable.

"This is just the beginning of a big market run," says Tim Draper, founder of venture-capital firm Draper Fisher Jurvetson.