

Between the Devil and the Deep Blue Sea

June 26, 2000

Making sense of technology stock valuations is a mind-roasting task particularly when there are no known and tested valuation techniques to ascertain quality.

The first quarter of the year 2000 saw the Kuala Lumpur Stock Exchange (KLSE) awash with news of IT and Internet related tie-ups, propelling share prices of many Second Board companies to dizzying heights. Like its start-up counterparts around the world, many of these Internet ventures are not yet revenue generating, let alone profitable.

Whilst many of these Internet start-ups may or may not succeed, they have captured the attention of investors with their potential. The share prices of these companies appreciated strongly at the mere mention of the "e" word. Even now, most companies are planning to or have already launched their own e-commerce/e-business outfits.

However, the past three months have seen a dramatic turnaround in the fortunes of the technology sector. A global correction in the technology segment resulted in the sector's benchmark - NASDAQ - moving southward.

It is against this backdrop of these events, that **zoomFinance** posed these questions. How are such stocks to be priced? Even with the sharp falls in recent weeks, many technology stocks remain at incredible valuations compared to 'old-economy' stocks. How do we make sense of this?

THE PANELISTS



Vincent Khoo [VK] (SG Research (M) Sdn Bhd)

Vincent Khoo has over 10 years of experience in investment research. He is currently Vice-President of Research at SG Research Malaysia, covering technology, automobile and F&B stocks. He began his career in the U.S. where he spent four years as an analyst assisting in managing a growth stock portfolio for a pension fund client, prior to moving back to Malaysia where he spent another six years as a buy side analyst in houses such as Phileo-Allied Securities and Kezan Securities. Khoo is a chartered financial analyst (CFA) and has an MBA from the University of Cincinnati.



Ralph Lim [RL] (Lycos Asia (M) Sdn Bhd)

A graduate of Australia's Royal Melbourne Institute of Technology (RMIT), Ralph Lim started his career as a field engineer with Dataprep Holdings Bhd before moving on to be the founding general manager of IPACS, a solutions provider affiliated with IBM and Oracle. He was recruited by Lycos as Country Director to start LycosAsia's Malaysian operations.



Kee Kin Onn [KKO] (CIMB Securities Sdn Bhd)
Kee Kin Onn is Vice-President of Research at CIMB Securities. A KPMG chartered accountant by training, he now specialises in infrastructure research as well as oversees the market analysis at CIMB. His advisory experience is wide ranging having advised companies on listings as well as mergers and acquisitions (M&As), investment allocation and selection and financial planning and communication. Kee is an avowed collector of qualifications especially in his field of finance, financial planning, management and accounting. He has professional awards from U.S., Britain and Australia.



Stanley Ng [SN] (Microsoft Knowledge Capital Center Sdn Bhd)
Stanley Ng is the director of Business Solutions Group for Microsoft Malaysia. He also manages Microsoft Knowledge Capital Center. Prior to this he was Microsoft Malaysia's Internet Business Development Manager responsible for working with the Internet community in Malaysia to adopt and develop content on Microsoft products. He holds a Bachelor of Business Administration in Management Information Systems from the University of Oklahoma.



Daniel Chan [DC] (Andersen Consulting Sdn Bhd)
Daniel Chan is a partner at Andersen Consulting in Kuala Lumpur. A consultant for the past 17 years, his experience has brought him to work with large local corporations as well as multinationals. He is presently the driving force behind the electronic commerce practice for Andersen Consulting in Asia and has spent his past year actively working with clients building various e-commerce applications. He is of the belief that companies should focus on Internet technologies to improve their own efficiencies, not just in logistics, but also in customer service. Chan graduated with first class honors in mechanical engineering from the Imperial College of London.



Ho Chin Beng [HCB] (The DotComBrokers Pte Ltd, Singapore)
Ho Chin Beng is the chairman of The Internet Call Centre Pte Ltd, the world's first multi-country direct customer care service provider for the Internet, and concurrently President & CEO of The DotComBrokers Pte Ltd, a venture capital corporation and six-star dot-com incubator operator in Singapore. Ho, a Harvard-trained MBA also sits on the boards of several other Internet companies. He is a life

member of the Economic Society of Singapore and an ex-committee member of the Harvard Club of Singapore. He was an international banker specialising in Southeast Asian syndicated loans and ran a Singapore "Big Four" Bank's Representative Office in Myanmar.



THE MODERATORS

Rajen Devadason [RD], (RD Book Projects)

Rajen Devadason is an award-winning journalist. As staff writer, of *Malaysian Business* magazine, he won the Malaysian Press Institute's award for best economic journalism in 1992 and the Citibank Pan-Asia business journalism award, which included a stint at New York's Columbia University and visits to the White House, World Bank and the US Federal Reserve. His first book "*Your A-Z Guide to the Stock Market*" was published in 1997 and since then he has seen a new book out each year. Devadason holds a Bachelor of Science (Hons) degree in Physics and Computing from King's College, University of London, and is a member of MENSA UK. He currently writes two distinct financial planning columns - a print column for *Malaysian Business* magazine and an online one for *zoomFinance* - and is overworked as a financial planning trainer-cum-consultant.

Steven K C Poh [SP], (i2Media Sdn Bhd)

Ex-journalist Steven Poh is the CEO of i2Media Sdn Bhd, an integrated marketing communications specialist. He was formerly business correspondent for *Asiaweek* magazine and General Manager/Senior Consultant of a KLSE-listed software development house. He won the 1992 Malaysian Press Institute prize for best magazine writing while still at *Malaysian Business*. Also a former Press Fellow of Wolfson College at the University of Cambridge, Poh graduated with a Bachelor of Science degree in Communications (Journalism) from Southeast Missouri State University. He completed his Master of Science degree in Speech Communication from Southern Illinois University at Carbondale.

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RD: From about March, we have seen a general drop in global tech valuations. The NASDAQ went from 5,000 points to 3,000. It has since climbed back up to the 3,800 level. Nobody really knows what's going to happen. The main issue: Has the way the investment community viewed equity stocks changed because of the shift towards technology? All of you are well aware of the fact that there are many dotcom companies with incredible valuations but no earnings. Because of that, the old method of valuing stocks has become passé. Let's begin by trying to define precisely what it is we are talking about. So perhaps we could hear from our panelists what their own definition of a technology stock is.

HCB: In Singapore, we have seen movements in the stock market affected just as in Kuala Lumpur by the stock valuations of dotcoms that have dampened sentiment as in NASDAQ. My notion of technology stocks encompasses more than just dotcoms; more so in Singapore where the emphasis is beyond dotcoms. We have dotcoms, biotechnology and semiconductor companies. Loosely speaking, they are all lumped as technology stocks. But presently, the sector is being spearheaded by dotcom companies.

KKO: Personally, I don't have a precise definition for technology stocks. The common definition we use are those companies that are involved in the information and communication industries. These industries are leveraging a lot on the changes in technology to improve their performances.

SN: My definition of dotcom companies is that they are Internet companies. Technology companies are predominantly the producers of technology required in any industry. For example, if you take Microsoft as a whole, MSN (or Microsoft Network) is an Internet company. But Microsoft is a software technology company. So, of course, the grey area lies in the larger organisations that are involved in both. As a whole, I would define technology companies as producers of technology, and dotcoms as companies who use the Internet to create new business models and new ways of doing things.

RL: I tend to agree that technology firms are not just electronics, but firms that innovate, be it biotechnology or electronics. Basically, they are firms that harness new technologies to find new and better ways of doing business.

VK: Just to clarify a few things here. The common denominator is that these companies have intellectual properties that use computing technologies. Most dotcoms, especially the business-to-consumer (B2C) companies are not technology companies. They are technology-driven companies, who are in essence retail companies.

DC: Just to give you another perspective, anything that revolves around the digital economy relates to the technology stocks that we are aware of today. So you could be a creator or a carrier or a user of the digital technology. This encompasses a wide

range of companies.

RD: Roughly 300 hundred years ago, there a tulip mania in Holland. For a 20-year period, interest around these flowers spread across Europe, and it hit a peak in Holland. When the bubble burst, the price of tulip bulbs fell to a tenth of its peak. What's interesting is that when the NASDAQ collapsed, many stocks have actually dropped to a tenth of their previous highs as well. Is the tech party over? Do regional tech stocks need to correct some more?



VK: Yes, the bubble has burst. The high valuations in technology stocks were basically a reflection of the high liquidity in the global markets. This is highlighted by low interest rates in the U.S. and even here for example. This has created a situation where investors have a lot of cash to spare, particularly towards the end of the run where people with too much money chasing too few ideas. When people have too much money to invest, then they are always looking for the next sexy idea, and what can be more sexy than technology stocks? But the situation has reversed. Liquidity is drying up, as evidenced by rising U.S. interest rates, and will continue to happen in the future, albeit at a slower rate.

SN: My view is that there is definitely room to go down and I agree that the bubble has burst. The rationale of high liquidity is a valid point. But a key thing, based on my interaction [in the industry] in the last two years, is that venture capitalists at one time were going with the flow that if someone has a reverse auction online, the next guy down the street needs one as well. So everyone was looking at their portfolio because they were saying we have got to have one as well because if it hits, we will hit as well. This creates a snowball effect. The investment community was, at one time, looking at say three reverse auctions companies all at once. If you go back today, the mentality is the same. You may say, "I'm not interested in reverse auctions, let's look at something else. Too many people had invested in the same thing." So firstly, there will be consolidation. If your business model was flawed, you would already be at 10 percent. If your business model was good, you would have room to grow to reflect your progress.

SP: Are you referring specifically to the U.S. or Malaysia?

SN: Generally, it's applicable worldwide, except that the measurements are different. Recently you have heard that one dotcom in Singapore wasn't well-received. The reason is that financial markets in Asia remain very regulated. In a regulated market, there is very little room for margins to move and the business model does not give a lot of margins. Therefore, reverse auctions would not work. Hence the question: is it the right business model? Yes but is it the right environment to execute it? It's not. So maybe in five years, when the markets deregulate, it will become the right business model.

RD: The educational level of the average Malaysian investor is quite low, when it comes to technology stocks. Very few people are really looking at the figures to come up with a sensible valuation model. The views so far are that there is a little bit more downward movement, but not too much. What is the situation like in Singapore?



HCB: As far as stock movements are concerned, the 10 percent indicator is a good bet that this is the bottom of many of the

technology stocks. In Singapore, the irony of things is that when the market is so jittery about technology stocks, there is more money than ever chasing the next good idea. So what we are seeing is not money rushing for initial public offer (IPO) stocks, but instead into the start-ups, with companies scrambling to set up incubation centres to nurture a portfolio of companies. So there is still a lot of room for excitement in the dotcom world. In Singapore, the venture capital community has really grown, with money continuing to flow in from overseas. This could partly be due to the fact that investors from the U.S. still consider investments in Asia to be cheap.

RD: Is this downturn in technology stocks signifying the beginning of a bear market or the end of a correction?

DC: The Internet phenomenon makes it very difficult to predict anything based on historical data. While some companies are trading at 10 percent of their highs, the Internet is nevertheless about creating new ideas. Big ideas will continue to come up, and there will be success stories, regardless of the overall condition of the market.

VK: As I see it, this is just a temporary correction. We now have more sensible valuations, which is very healthy, and investors and venture capitalists alike will be more discriminatory in looking for new business opportunities in the technology sector. This is a positive development.

RL: This correction may not be the last one, although it has jolted many people. Nevertheless, it has forced investors to be more careful in allocating their investment decision towards more viable businesses.

SN: It is not the beginning of a bear market. The correction was a necessary one. Investors should continue to look at the growth of the individual companies. If there is a strong basis of growth, all things considered, then investors will go back to invest. When this happens, money will go back to these stocks.

KKO: Most bear markets are caused by an economy going into recession. At this moment, I don't see many of these economies going into recession. Nevertheless, there can still be corrections to the index. The NASDAQ still has an overall PE (price earning ratio) of 100 times. In this case, investors have become more willing to take more risks for a lower return. With this in mind, higher PEs have become more acceptable. So I do think it is still on the high side and that there will still be corrections, but definitely not a bear market.

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HCB: I would like to look beyond the gyrations of the index and look at the phenomenon of the revolution that has taken place. A few years ago, people who came to look for me were young. Lately, lots of 40 year-olds are now coming to see me with ideas and who have tremendous business experience. Also, we are seeing big companies coming in as well. So the fluctuations in NASDAQ is in part a reflection of whether these companies will successfully make the transition. It is not the end of the world, and there is a new dawn for traditional companies.

RD: The consensus here is that no one really sees the bottom falling out, and that there is a degree of optimism here, that some sense is returning to the market. A lot has been said about the new and old economy. The old brick and mortar companies have more staying power while the new economy companies are seen to be more susceptible. Is there any way of identifying which old economy companies are likely to succeed in making the transition? What attributes will help them?

KKO: My definition of old economy stocks are those not in the dotcom arena. A lot of companies that will do well are those providing services to the new economy, for example, software, networks, media, transportation and telecommunication companies.

VK: I would tend to agree that these would be the clear winners. There is also another type of company that could benefit from the business-to-business (B2B) portals. One example would be **Metrojaya** (a major operator of departmental stores) that is implementing a B2B portal with its suppliers. This portal will create a lot of efficiencies for its business.

RD: Everyone here has heard of the new paradigm, where earnings are not important. I myself find it unlikely that investors will move away very long from the risk reward relationship. People are willing to bet that one of their investments will take off. In general terms, is there a real shift in paradigm in stock valuations? If so, is it justified?



DC: Predictions on business models have proven to be not exactly true. At the end of the day, it has to boil down to revenue. And in many cases, not just revenue potential, but the capacity to collect money. You should stare hard at the business model and its assumptions and answer the question whether the business can stand on its own feet. It is quite easy to tell you that I have a market potential of 200 million subscribers. But you forget that you have 50 other dotcoms who have the same 200 million subscribers. What this means is that your potential earnings is divided by 50 times. So as you can see most valuations are inflated. What we are seeing today is an emphasis towards a sustainable business model.

SN: When you look at valuations of companies, the business model is very important. As an individual investor, I would select stocks very differently from a venture capitalist. A venture capitalist looks for size - is the idea big? The investor looks for returns. This will definitely impact the perspective which you are coming from. How do you value the opportunity the company is capable of exploiting? If we use traditional valuations, everybody will get the same answers. The question is if you want superior returns, how do you value this company one step ahead of everyone else? So we look at other factors, for instance, does management have the necessary experience to execute? What are the success factors and the milestones? On that basis, we should see how to value this as a business.

RD: We have got the Internet businesses of local companies that are pretty much sky high. Some of the figures I have here are **Dai-Ichi Industries'** Internet business being valued at RM150 million, and **TH Group's** being valued at RM400 million. Do these companies have some differentiating products and do they have genuine management skills?

VK: I do not come across many companies that are pure dotcoms. It's difficult to ascertain whether dotcoms have good management or products because a lot of them are still in their infancy, and they are still struggling to build their models. Hence, valuations are fluid because they are still growing and looking for a way to strengthen their revenues. However, it is clear that many of these dotcom companies are very expensive. For example, **Delloyd Ventures'** Internet business valuation, at RM18 million is high because while it is enhancing its existing business, present profits, derived from its traditional business is not much more than that. So on that basis, it is difficult to justify that figure.

KKO: Just to update those valuations, which have come down a bit. The company with the highest Internet valuation is **Dijaya Enterprise**, which is at RM540 million. I believe that everyone would say that they have products. The issue is whether they can actually make money from them. In terms of the Internet economy, there are very few things where you can maintain a competitive edge. You can have many competitors coming in who will drive your margins down. In this case, assuming you have a product, then it comes down to management and execution.

Malaysia does not have a vibrant venture capital community to



determine a dotcom's success. Working backwards, what kind of growth would this company need to justify this valuation. A lot of these companies may really grow at 50 percent for the next 10 years. But can 10 companies in this industry grow at this rate? Maybe not. So we would then suggest to investors that they diversify their portfolios, instead of betting just on one.

RD: How do you justify an over RM500 million valuation for Dijaya Enterprise?

KKO: Going back to the assumptions, we use a discounted cash flow scenario analysis to find out what the possibilities are. Dijaya Enterprise has to grow very strongly, something like 30 percent growth for the next 10 years. We have not done too many analyses, but right now it depends largely on management and execution. The question to ask is: are you comfortable with the justification? If you are, then you should invest.

RD: Looking at growth figures over the next 10 years, what growth are you talking about?

KKO: We are working on the assumption that revenue and profit growths will both be growing at that rate (30 percent). This together with the future sustainable margin is the larger factor that will impact the value; the calculated value is relatively insensitive to the assumed path from loss to profitability.

RD: Are there any new developments on the Internet that could be the flavour of the month such as WAP (Wireless Application Protocol)?

HCB: WAP is attractive as a futuristic solution to enlarging the Internet market. It's good, but the technology is not there yet. There are some frustrations and some of the WAP technology in Singapore is not working as well as it should. If WAP is here and comes about the way it should be, then with the geo-positioning function, a lot of new features could open up.

RD: You run an incubator centre. What other things can we look forward to?

HCB: A lot of it is not pure technology, but the commercialization of it. In Indonesia, there are all kinds of discoveries, for example super rice strains that have enormous potential.

RD: Beyond WAP, what else can we look out for?

VK: We are currently looking at embedding technologies that embed operating systems into microprocessors, which allows the convergence of mobile phones and hand held computers allowing broadband internet access.



SN: There are two areas you look at. Firstly, infrastructure and secondly, the technology related to content. Obviously, WAP is a channel to access. The billion-dollar question is: how do you make money? So what if WAP gives you another 10 million customers? What are the technologies that are coming up that will enable you to build better ways of performing transactions and selling online that today's transactions are not able to offer. On Microsoft's side, we have a product called *Site Server*. A company called BroadVision has a product called one-to-one marketing. All these solutions have one disadvantage: they ask too much information from you. So potential customers get turned off before they can transact.

The technology that will change this is the technology that will get you to transact without asking too much information. In other words, it allows you to maintain your privacy. The market will be really big for this product.



SP: Daniel, from your experience in consulting with companies on electronic commerce and what the Internet can do for them, how do you convince your clients of the various approaches to take to make sense of this whole thing, and what are the recommendations that will add value to these companies?

DC: A few clients have told me that many analysts are no longer excited about just their brick and mortar businesses. They want to know what Internet strategies these companies have come up with. I think that at the end of the day, there are different kinds of companies. I have always told my clients that if you want to do a pure play, we can brainstorm on what kind of global game you can play. My focus has always been that the Malaysian market is too small. With a pure Internet play idea, you almost always have to think about the world. If you cannot and you can only think about the Klang Valley, then you should stick to your core business. Having said that, it is really difficult to compete globally. Dominating Asia is a gargantuan task. Having worked in the Asian environment for quite a while now, we understand that our own people in different countries in Asia exhibit far too much patriotic behaviors. So dominating Asia is not as easy as we think. Even for the companies not going into pure plays, they have not utilized the Internet to improve their businesses. The Internet play, at this moment, is secondary. We will see a more dominant force in about two years, when we reach the inflection point - when more people are logging on to the Internet than those who read the newspapers. Until that day comes, the Internet will remain a by-product. Companies should focus on using Internet technologies to improve their own efficiencies, not just in logistics, but also in customer service, which we do very badly in. But companies in pure plays should be prepared for the fact that the Internet will not be a major revenue generator now. However, it is a necessary channel for service-oriented companies.

VK: Going back to what was discussed previously about valuations, I have to say that at the end of the day, it is about management. As an analyst, one important issue is the quality of corporate governance. A value has to be put on it, because it does affect the direction of the company and its profits.



SN: You have to understand the business. For example, is Cisco going to continue to growing its business for the next 10 years? Or is there a small company called Extreme which is currently building broadband switches with the capability of competing with routers that will become successful? The question is: what is its differentiating factor?

DC: If you have read the latest *Fortune* magazine, it said just last year, people were talking about B2C. Early this year, the rage was all about B2B. Now it is P2P path to profitability. I will leave you to ponder that.

RD: Jeff Bezos, the founder of Amazon.com once wrote about the Cambrian Age, where there was an explosion of life, and very quickly many of the life forms died out. It seems to me that only the very best will survive in the new digital marketplace. So which stocks do we look out for?

KKO: Just like the gold rush days in San Francisco, the strategy is not to be the gold digger, but to supply the gold digger with the required tools. So some of the companies that are able to leverage of the new economy best are companies that are able to supply the "gold diggers" with the required infrastructure. In Malaysia, there really isn't much of a choice. The most obvious are the semi-conductor stocks. It is a very cyclical industry, but there is still very strong growth, especially in wireless gadgets. So while there may be a risk of over-capacity somewhere down the road, this will be temporary and the recovery will be quick. **Malaysian Pacific Industries (MPI)** and **Unisem** are recommended and a possible range it would reach would be RM60 and RM45 respectively. They are long-term investments and are part of a wave that is still growing.

VK: I like to look at click and mortar companies that are benefiting from the technology trends, companies that have good core earnings, companies that are climbing up the value chain, and companies that have very good global and local prospects. Bearing this in mind, there is one company which I am very keen on - **Computer Systems Advisers (CSA)**. The key thing about CSA is that it is benefiting from its traditional role of providing systems integration which is growing at 20 percent a year, but more than that, it is a company that has gone through a management transformation, who have thought hard on to improve their value chain. There was a takeover a year ago, where it was sold to CSA (U.S.), a huge Fortune500 company, which has an array of businesses which CSA can leverage on for its skill sets, for example, outsourcing, a growing trend in Asia. This means providing all the IT needs of a company. So it is a big business. Contracts could run in the hundreds of millions over a five-year span. The second big opportunity for CSA is, of course, riding on the Internet bandwagon, where they provide the shovels for the gold mine.

SP: In your recommendations, I do not see you include companies like Renong, TRI or YTL who have big Internet plans. What are your reasons for not including them in your recommendations?

KKO: Renong is affiliated to us, so we don't cover it. We actually maintain a recommendation on **Technology Resources Industries (TRI)**, because it is an infrastructure player, and judging by the value it is trading compared to what its peers are trading at, both locally and overseas, it could rise to RM6 to RM7 from its current levels. We don't have much of a recommendation on YTL. It is probably safe to say that it is an incubator model. So far we have not seen any company being introduced to the market from its incubator. So we will reserve our recommendations until we see their plans.

VK: The key thing is that you need a good core business. So we would not consider Renong. YTL has excellent core businesses and their Internet play will have some linkages to their core businesses. All said, you still have to depend on good management. Investors, particularly foreign investors, are really looking for good corporate governance. And you have to focus on your core businesses.

RD: What are your global picks?

KKO: My picks would probably be in Taiwan, **Taiwan Semiconductor Manufacturing Company (TSMC)** and **United Microelectronics Corporation (UMC)**.



VK: One Malaysian company with global potential is **MPI**. What is interesting is that it has gone up the value chain, where it has experienced a breakthrough in technology. In the past, it was thought of as a low value-added company that was behind the technological curve.

For the first time, they have been able to climb the curve and provide a product called MLP (micro-leaded package).

