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The Façade of Financialized Demand

Dear fellow investors,

The capital markets are a highly complex system, where perturbations can cause a tidal change. Every business around the world has been affected by Covid-19. For a profitable business anywhere, this is a calamity. For a business that was losing money before this, it's a tombstone. The funding markets lately have been pretty fickle. American businesses were binging on debt like you'll rarely see prior to this. Now, raising debt isn't easy. This is the nature of friends on Wall Street. The current era has prodded institutional investors to alternative investments in a way never seen before. The cash that has gone to venture capital funds has never been larger. It's so large that companies can stay private for a decade. Eventually, they land in the public market at a mega-cap size, while still running losses. A large byproduct of these changes is that a highly complex system can confuse the façade of financialized demand for real economics.

In a recent article entitled "Google's Real Estate Pause Shows Cracks in Tech Office Demand," Bloomberg's Noah Buhayar looked at Google's recent decision to forgo commercial real estate locations in Seattle, Silicon Valley and San Francisco. Below is a chart of the percentage of new office leases that tech companies held in 2019. The numbers are stark across all categories, as tech greatly outpunches its weight. In my hometown of Seattle, tech jobs are 15% of the total jobs, but are 56% of new office leases. The stock market has remained confident in the tech behemoths to remain strong into the future. Why would Google be pulling back on real estate?

These tech companies are capital-light and produce billions in free cash flow. Why would a few real estate deals marginally matter for their income statements?

Large Slice
Technology companies accounted for a big share of new office leases in 2019

Market	Tech Share
Silicon Valley	69%
Seattle	56
San Francisco	50
Austin	43
Boston	33
Minneapolis	28
Atlanta	23
Los Angeles	23
Manhattan	22
Phoenix	22

Source: CBRE — Bloomberg

Hosting > Commercial Real Estate

In yet another Bloomberg article[1], published a week ago, we can find areas of spending that have even more leverage to a problem in tech: the hosting business. The Bloomberg reporters interviewed John Lyotier, the owner of Left Technologies Inc. The article explained that landlords had abated rent to help out with Lyotier's business. His hosting vendor did not.

The reporters talked about a particular problem for Left Technologies. "His $19,000 monthly AWS bill now exceeds his rent, while his coffers are shrinking. 'The reality is, we're a startup again' Mr. Lyotier said." Lyotier

[1] "Amazon, Microsoft Offer Little Relief to Small Cloud Clients" by Mark Bergen and Matt Day

is showing us all that technology businesses, particularly younger ones, have both commercial lease space and a hosting bill bigger than that. To some, this may seem intuitive. However, commercial real estate is by nature a low margin business. Hosting is a big margin business. As you can see from the stock market, they have different weights, due to their marginal profitability.

Many of these businesses are not on the financial footing people may have thought they were pre-Covid. It sounds like Lyotier's business had made it past the infantile stage until Covid-19 struck. The writers went on to quote Mr. Lyotier further: "'When you're a startup, your plane isn't too far off the ground,' he said. 'So, when it's going to crash, it's going to crash fast.'"

Digital Ads ≥ Hosting?

Another high margin business in the technology world is Alphabet and its monopoly in search and digital advertising. Advertising has always been a cyclical business. Go ask the newspaper, radio and television networks. However, in 2007-2009, digital ads were still a nascent business relative to today. The smart phone and the power of 4G networks weren't as familiar to us as they are now. The deep recession didn't affect digital ads because it was stealing large market share from the traditional media formats.

Some tech businesses have pushed to traditional formats for advertising today. Think Booking.com, Doordash, etc. However, the lion's share of customer acquisition costs goes to the likes of Alphabet and Facebook.

The companies that were looking for customers online, whether businesses or consumers, had never produced the largesse of profitability that it had to the end of 2019. The big advantage of the commercial lease market or the hosting business is that you have a contract you can be held to. In digital ads, you just shut your advertising down whenever you'd like. It's like the ease you started out with — a click of a button.

The Cisco Problem

In 1999, Cisco dealt with a scenario that has touches of the office building market of select cities and, more particularly, the hosting and digital ads business. Cisco was selling hardware to tech IPOs that were being minted left and right out of Silicon Valley. These companies were not making money, but the cash raised from their friends on Wall Street provided an abundant resource to expense and capex items to build their company. It was obvious to all that the internet was going to change our lives.

Cisco was also being blessed by telecom companies who were borrowing large amounts of money from their friends on Wall Street to build the networks that were going to power the internet and the PC revolution. Cisco was making money coming and going. They had a dominant position in that business. Since the demand was high to take us into the future, they commanded great margins for selling all they could.

To quote Buffett from the 2000 Berkshire Hathaway shareholder letter:

> *The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money.*

When the bubble broke, the financialized demand that Cisco had from the tech IPOs evaporated as those tech companies ran out of cash on their balance sheet. The telecom companies couldn't fund debt purchases any

longer to build their networks like they once did, so their demand cratered, too. Cisco was a $500 billion market cap company by then. It was one of the true darlings of that era. The value of their products declined 85%, I repeat 85%![2] Where did all their clients go? Did the value of its network components change that quickly?

Remember, their demand was coming from tech and telecom companies. In actuality, it was coming from those wonderful friends on Wall Street in the form of equity and debt funding. As Buffett said, it was "large doses of effortless money." Cisco produced some of the best equipment in their industry and still does now, but that didn't help the demand for their products when the façade of financialized demand disappeared.

The Façade of Financialized Demand Now

The nature of tech companies in general has stayed constant for 20 years, with some rare exceptions. You create a startup, prove a concept, run losses for years and hope that it one day turns profitable enough to sell part of the company publicly or have another tech behemoth buy you out. The difference today is that some of the largest mega-cap stocks in the U.S. stock market make great margins on these fragile customers.

The reason for giving readers the context for what has gone on in these tech companies' funding is because it is a circular argument and the pie is shrinking, due to an economic shutdown. Tech can't just easily steal market share now. It's too big to grow at a larger rate like the past. Alphabet's digitals ads business and Amazon's hosting business aren't dependent on the economy and the consumer. They are far more dependent on the large pools of venture money ("large doses of effortless money") thrown to new business ideas that most commonly need people, space, hosting and (depending on the business) digital ads. If venture capital funding and IPOs dry up, so will the façade of financialized demand. We believe this is more transitory than investors are anticipating. There's a reason Cisco has never gotten anywhere close to its $500 billion market cap it had once before.

Warm regards,

Cole Smead, CFA

[2] "What Went Wrong at Cisco in 2001" by Scott Berinato

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