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SVB, tech firms and the folly of putting all eggs in one basket

Following the euphoria of recent times, it is good to revisit the question: What is a tech company, anyway?

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Silicon Valley Bank (SVB) failed last week largely because it had put all its eggs into one basket – the tech sector.

Once the darling of the global economy, the tech sector is now struggling under the weight of the same factors that sunk the bank – rising interest rates and the lack of diversification, which in SVB's case meant a concentrated customer base.

The tech label has been a badge of honour for the past several years, particularly after Covid-19 struck in 2020. Some fledgling companies, such as Zoom, provided a great service with almost everyone in lockdown. They had products that prevented our lives from coming to a grinding halt.

And so their revenue soared as did their stock prices, generally speaking. Skyrocketing demand coupled with the low interest rate environment – both of which were induced by the extraordinary circumstances of the pandemic – saw investors rushing to buy tech shares. Valuations of tech companies such as Adobe, DocuSign, Zoom and Sea reached dizzying heights.

AN AWKWARD QUESTION

Amid the euphoria, though, one question – posed by a respected publication in the sector even before the pandemic – was lost. Renowned UK publication Tech Nation had asked: "What is a tech company, anyway?"

Even if we leave aside thorny questions such as whether users, rather than creators, in e-commerce should be classified as tech companies, there are many examples where the link is more dubious.

WeWork is essentially a property company with a large valuation at one point. There is little doubt it uses technology, but this is neither central to its operation nor to its competitive advantage. WeWork is also not alone. In Singapore, similar examples include PropertyGuru, which calls itself a prop-tech company.

The fundamentals of this prop-tech business are the same with or without the technology. Technology is just a means to deliver the service (like physical paper did before the technology arrived). While technology might improve service standards with searchability, 24/7 access and user access to archives, its application does not change the underlying prospects of the business.

Home owners and buyers will not undertake more property transactions because of the availability of a website, so growth in the sector remains the same as before in some sense, with the prop-tech company simply seizing market share from traditional non-tech players such as property agents without the technology.

This conundrum matters most to two specific groups of stakeholders – investors and employees – who should, in hindsight, have paid more attention to the label. They have the most to lose – whether capital put up, having to bear the risk of being stuck in a not-so-fast growing company, or the possibility of losing their jobs when the tech company scales down and sheds jobs.

Other stakeholders have less skin in the game. Customers can switch to another provider; there may be some inconvenience but this is not significant. Meanwhile, suppliers to tech companies likely have low exposure since they service other businesses.

When it was trendy and booming, investors were drawn to the sector's high growth rate and the allure of high investment returns. Employees were attracted by high salaries, lavish perks and stock options so generous they turned some into millionaires at a young age.

Few investors, and probably even fewer employees, paid attention to the "minor" details that many of these high-growth companies were growing fast either because of the pandemic and the unusual macroeconomic environment, or that they were pricing their products and services at below cost.

Many of these companies also did not have a clear path to profitability.

BEWARE THE TECH LABEL

Now that the bubble has burst, does the tech label still have any cachet? Should potential investors and employees give any weight to the label? The answer is yes but with important caveats.

First, one should be aware that tech is a broad label, with a wide dispersion within the sector. Investors should look at growth rates for the long haul and not the variant emerging because tech companies loaded with venture capital can afford to stomach a price war aimed at weeding out competition.

The surge in demand for ride-sharing companies has not lasted. And passenger satisfaction with private-hire car and taxi services in 2022 has dropped in Singapore.

I would put my money on computer security firms, which can expect robust growth for the foreseeable future as hacker attacks or malware remain latent threats.

AVOID FOLLOWING THE HYPE

Faith in growth should not be driven by peculiar circumstances such as a pandemic. Zoom grew phenomenally during Covid-19, but this was unsustainable in the long run, largely because of moderation in the growth of the videoconferencing sub-sector in general and the arrival of more competitors.

Linear growth in sales has little value unless it is accompanied by growth in profits. E-commerce is a classic example of a sector where sales have grown exponentially, but profits have largely been elusive.

After more than a decade of dominating the landscape, Amazon's e-commerce arm lost US$2.7 billion (S$3.65 billion) in the last financial year. The ride-sharing business and key players, including Uber and Grab, have not posted a profit yet despite doing business for over a decade. They grew rapidly when their pricing was below cost but had growth curtailed after raising prices, and none including Lyft have turned a profit consistently.

Investors and potential employees seeking jobs would do well to cast aside notions of the tech labels, and focus more on factors undergirding true long-term growth and profit prospects of a company in the tech sector.

But what if you're simply looking for a quick buck? A word of caution: When looking for gains in the short term, one must be ready to stomach volatility that is part and parcel of any other sector. Volatility implies higher risk – employees may get laid off and investors might lose a chunk of capital during a downturn. Anyone lured to the tech sector might do well to remember that the promise of greater rewards will always be accompanied by greater risks.

It is dangerous to bet on short-term trends, which are sometimes amplified by stories linearly projecting the recent past into the distant future, like the idea that work-from-home will continue as the default mode of working. Like any investor burned by the crash of a stock or a laid-off employee, following the herd can be hazardous.

If you're following, you're not bound to emerge a leader in any sense of the word.

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