ILLUSTRATION 1.5

Do Profits Matter in the Information Age?

In 1999 many economists and most financial analysts were confounded by skyrocketing values of firms in the high-technology sector of the U.S. economy. The year-long run-up in market valuations of Internet companies, the so-called dot-coms, as well as some new software firms resulted in a stock market "bubble" in which many of these high-technology firms traded at values far exceeding the present values of their expected future profits. Amazingly, some of these highly valued dot-coms had never earned any revenues at all. The "bubble" seemed to undermine fundamental economic principles governing the market values of firms. Practically every day in the news, a financial guru offered another explanation for the "new economics" of the Information Age.

During this dot-com frenzy on Wall Street, investment bankers and venture capitalists frequently clamored, "Profits don't matter anymore." Pursuit of market share was hailed as the replacement for old-fashioned, outdated pursuit of profit. Greg Bohlen of investment house J. C. Bradford & Co. summed up the "new thinking" about surviving on the Web in a *Wall Street Journal* article: "When you're in a fast-paced world (and) the barriers to entry are very low, profits don't matter—it becomes market share." For some analysts, the idea that profits matter to owners of firms seemed destined to become one more case of road kill on the Information Superhighway.

For nearly a year, instructors of economics and finance faced inquisitive students who asked, "Why don't profits matter anymore?" Students were told that Internet firms and other high-tech firms were no different from other firms: Either economic profit would become a more certain part of these firms' futures or their market valuations would fall. If the dot-coms continued making losses without any realistic prospects for future profits, investors would eventually revise downward their expectations about future economic profits, and the firms' values would fall.

By the end of 1999, prospects for economic profits failed to materialize for many, if not most, of the Internet firms that experienced huge increases in their market values. In mid-April 2000 the "bubble" finally burst. *The Wall Street Journal* described the jolting experience of Red Hat Software, Inc., a distributor of Linux operating-system software: "Like many high-flying tech (firms), Red Hat has been crushed . . . Its Friday 4 P.M. price of $25.0625 was 84 percent off its high. Among the reasons cited by Wall Street analysts: Losses widened to $19.2 million . . . "

Rather than view the sharp declines in firms' values as a natural adjustment process for correcting situations in which the present value of expected future profits does not justify current market valuations, many financial analysts instead interpreted the collapse in high-technology stock prices as something new and seemingly different. William Glynn, director of Southeast Interactive Technology Funds, said in *The Wall Street Journal:* "The world has changed. Your concept company? Forget it. Your company with no revenue that had a valuation of $30 million? Today it's worth half that." The author of *The Wall Street Journal* article also seemed to view the April crash as a fundamental change in the economic order of markets: "Remember that world (in which profits don't matter)? It has vanished now. Profits suddenly matter a lot, especially to the dot-coms and software companies whose shares were crushed in the great April sell-off. Sadly, many of the companies . . . are still profitless . . . "

We want to emphasize that the decisive April 2000 sell-off of technology firms was not a change in the way the world works. It was no surprise that sharp stock price declines punished firms that remained profitless or that earned less profit than expected. The only surprise was the rather long period of time that investors tolerated economic losses before they adjusted downward their expectations of future profits. As we told you at the beginning of this chapter, economic principles and analytical methods do not quickly become outdated. Expected future profits continue to matter, even in this Information Age.

Source: Bernard Wysocki Jr., "The Outlook," *The Wall Street Journal*, May 1, 2000, p. 1.