Why does Wall Street hate Silicon Valley?

By Chris O'Brien
Mercury News Columnist
06/16/2011

Apple's stock price has tripled in the past two years, making it the second most valuable company in the U.S. Profits and revenues at other tech companies are soaring. And investors can't wait to get their hands on the latest social networking IPO.

All of which makes it strange to ask: Why does Wall Street hate Silicon Valley?

And it's not just me saying this. "The public markets hate tech," said Marc Andreessen at the recent D: All Things Digital technology conference. He's as plugged-in as anyone in the valley, so he's worth listening to.

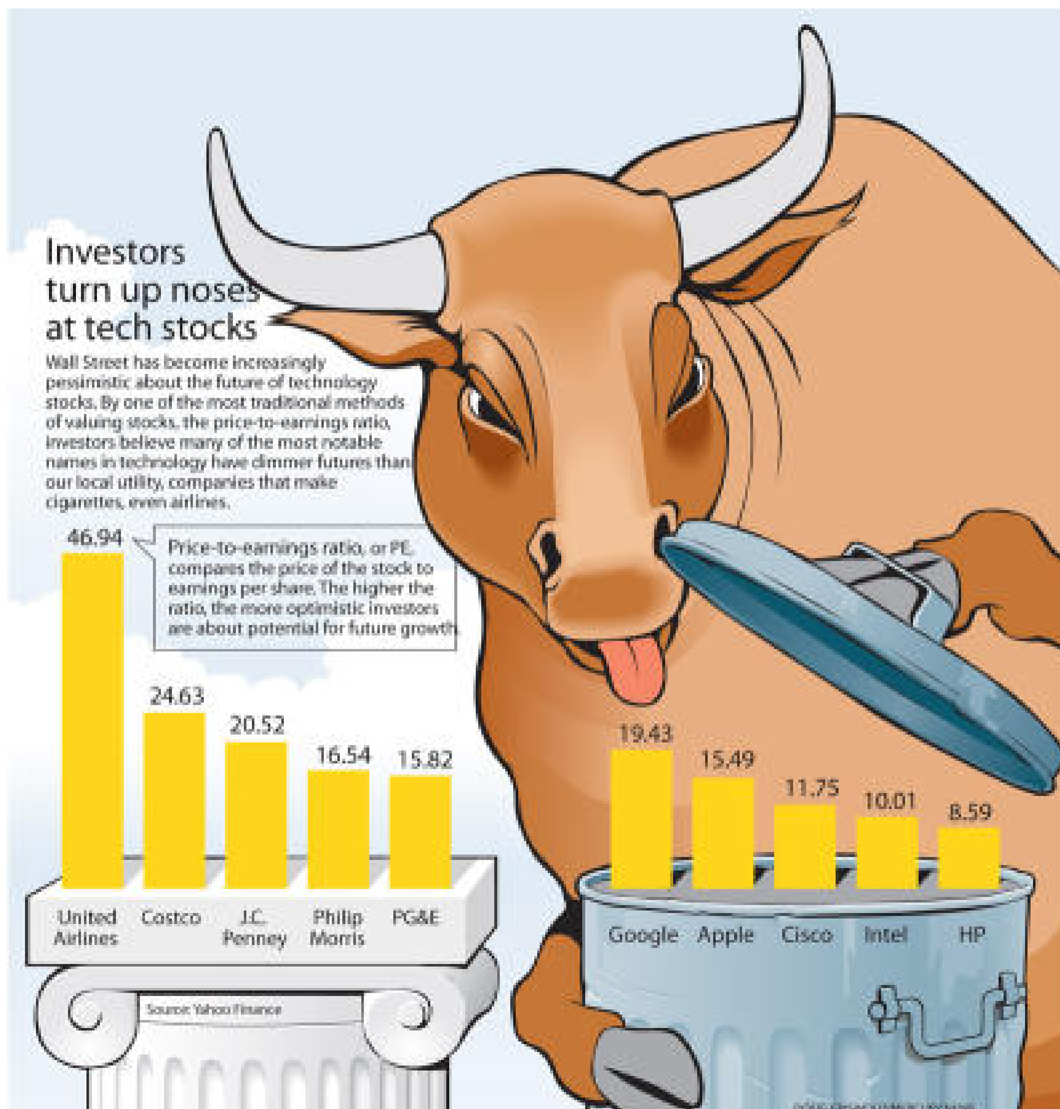
Sounds crazy, I know, but consider this: By one of the most fundamental methods investors use to value stocks, Wall Street thinks more highly of dowdy PG&E than it does of mighty Apple. And Apple's not the only big tech company that's lost Wall Street's love.

If that surprises you, wait until you hear why: Wall Street thinks we're getting old. Yes, after years of parading sexy Silicon Valley around on its arm, the stock market has dumped us.

Some of the companies Wall Street has scorned won't surprise you: Cisco Systems, Hewlett-Packard and Intel. But it's not just them; besides Apple, there's also high-flying Google, for instance. No matter how big or profitable some of these companies have been, and no matter how much they are still expected to grow, Wall Street simply believes their best years are behind them, their futures too uncertain.

"A lot of these big tech names are question marks when it comes to sustainable, long-term growth," said Scott Kessler, head of technology sector equity research at Standard & Poor's.

To illustrate this rejection, take a look at the price-to-earnings, or PE, ratio of some of the valley's biggest names. The PE ratio, a gauge investors use when judging stocks, is simply a company's current stock price divided by its earnings per share.



So if a stock is trading at $50 a share, and its earnings over the last 12 months were $2 a share, its PE ratio would be 25. The higher the ratio, the more optimistic investors are about the company's prospects for growth.

That makes it sobering to learn that the PE ratio for tech stocks is 17.32, below the 17.7 ratio for the entire S&P 500 -- the first time that's happened in 20 years. By that measure, Wall Street's outlook for tech is even worse now than it was during the dot-com bust.

Negative factors

There are a few issues that cut across the entire technology industry. Many of these companies grew up in the PC era, which analysts believe is coming to an end. Uncertainty about what happens next worries investors. Tech companies also get lots of revenue overseas, where many economies are in worse shape than the U.S. And there is still nervousness over weak consumer spending on technology.

But things get even stranger when you look at individual companies. It's no surprise to see low

PE ratios for companies like Cisco (11.75) and Hewlett-Packard (8.59).

It's baffling to see a company like Apple stuck with a PE ratio of 15.49. By that measure, investors are a bit more optimistic about the future growth of PG&E (15.82) and Philip Morris (16.54).

How can a crusty old utility and a cigarette maker be getting more love from investors than the company that is leading the mobile computing revolution and has so much money on its balance sheet that it's building an alien landing pad in Cupertino?

And yet, investors are worried about the competition from Android and the health of Steve Jobs. And in their hearts, Apple has been so successful and has grown so much, investors simply refuse to believe it can continue.

Not everyone agrees with Wall Street's bearish assessment, of course. "That stock should be trading much higher," said Kevin Landis, chief investment officer for Firsthand Funds of San Jose. "I think people are just not running the numbers on Apple's market share. It's still tiny. What they're not doing is taking a look at how much potential market share gains are in front of this company."

If you're like Landis and think Wall Street is wrong, then Apple and other big tech stocks could be a bargain.

Investing strategies

But Silicon Valley is not used to being stuck in the bargain bin. And beyond the blow to the region's ego, these low valuations have real implications for the region's future.

Tech stocks typically attract "growth" investors, who are focused on a company's prospects for selling more widgets or gaining market share, and less about quarterly profits. But it's quite likely that these types of investors are being replaced by "value" investors, who expect companies to cut costs and spend more of their cash buying back stock and paying dividends rather than investing in new products.

Now, to be fair, there are still companies that Wall Street loves. There's Netflix, with a PE ratio of 71.60, and Salesforce.com at 401.40. And then there's LinkedIn with a ratio of 1,018.96 that's, well, just plain nuts.

But there is no escaping the larger verdict here. While Wall Street still has a crush on our shiny young things, it's worried that our biggest names are developing deepening wrinkles and spots of gray hair around the temples.

Contact Chris O'Brien at 415-298-0207 or cobrien@mercurynews.com. Follow him at Twitter.com/sjcobrien and read his blog posts at www.siliconbeat.com.