

Toxic Tech: 5 Tech “Darlings” to Dump Right Now

By Jeff Brown, Editor, *The Near Future Report*

I’m an optimist by nature.

As longtime readers know, I believe we are on the verge of an age of abundance. And this new age will be driven by the companies and technologies we invest in here at *The Near Future Report*.

I’m referring to technologies like 5G wireless networks, precision medicine, artificial intelligence, cloud computing, quantum computing, and the next generation of clean energy production – nuclear fusion.

But we have to be realistic. Not all technology companies are great investments. In fact, even great technology companies can be bad investments. And I’ve predicted we’re on the verge of a “splintering” in the market.

This splintering will send a small segment of the tech world – one that was largely ignored until the pandemic – much higher.

The pandemic pulled forward some tech trends by 5–10 years. For example, we’ve been talking about teleworking for the last 20 years. But what happened?

Organizations and their management teams became even more centralized, and urban centers grew. Companies and managers were reluctant to have their workforce go remote. After all, managers felt they couldn’t control and

manage their employees if they couldn’t “see” what they were doing all day long.

But now they’ve been forced to. As recently as March, it was estimated that almost 6 out of every 10 Americans were working from home. And this trend will persist even after the pandemic passes.

Or consider e-commerce. In the first half of 2020, many online retail categories showed a 74% increase in online orders immediately following the economic lockdowns. And now that consumers understand how convenient these services are, there will be no turning back.

Let’s consider one more example. Last year, Nokia released data saying that most wireless networks around the world see 30–45% growth in traffic over a year. But peak usage jumped 20–40% over a period of just four weeks during the lockdowns.

These numbers are beyond crazy. And it’s all because people have been working and entertaining themselves from home. Videoconferencing traffic – for both work and socializing – spiked 300%. Gaming traffic exploded 400%... because the kids were staying home from school.

To put this growth in context, network data traffic would more than double every 12 months if this persists. We are talking about exponential

growth. And it is overwhelming networks all over the world.

We stand to profit from all of these trends with our model portfolio – specifically, our 5G and cloud computing holdings. Readers can always view our model portfolio [right here](#).

But not all technology investments will be winners in the years ahead.

In fact, investing in some companies right now could actually be dangerous. Some tech stocks have reached absurd valuations. And these are going to crash hard.

This report is about those stocks. I see two different kinds of companies heading lower... as much as 87% lower from here.

Stodgy Old Darlings

To be successful in the tech sector, companies must be innovative. Their product strategy and product road map are critical. And they must be improving people's lives. At one point, every successful tech company was an innovator. But some companies have simply lost the touch. They got buried in their past success and fell prey to unnecessary processes and groupthink.

Some Silicon Valley “old guards” are trying to profit off their reputations from 20 or even 40 years ago... But they will be a black hole for investments.

These companies may even look like good “value” plays right now. But they are dangerous investments. Or put another way, there are far better places for investors to put their money.

Here are two former tech darlings well past their prime and headed lower.

Toxic Tech No. 1: Intel (INTC)

I could write a book about how terribly run Intel is.

Intel was one of the first Silicon Valley

companies. Founded in 1968 by Robert Noyce and Gordon Moore – of “Moore’s Law” fame – Intel was known for decades for its central processing units (CPUs). Specifically, Intel is most often remembered for creating the x86 semiconductor architecture found in most personal computers. Perhaps we even remember its famous slogan: Intel Inside.

But the company hasn’t innovated anything meaningful in over a decade. And it can’t even produce the products it does develop in a timely manner.

Look no further than its Q2 2020 earnings announcement to witness how far behind Intel is. The company announced *nearly another year in production delays* on its 7 nanometer (nm) processors.

7 nm processors were on the bleeding edge for semiconductor technology in 2019. And Intel won’t produce its 7 nm processors until late 2022 or 2023.

For comparison, AMD is manufacturing 7 nm processors right now. The Apple 5G iPhone is built on next-generation 5 nm technology... And one company has already started working on 3 nm tech.

It’s inconceivable that Intel, the former leader in CPUs for decades, could be three years behind its competitors. Intel will be launching 7 nm products at a time when others will be launching 3 nm semiconductors. That means that Intel will be two generations behind the competition.

But production delays appear to be in Intel’s DNA now. Something is systemically wrong at Intel. The company has even gone so far to suggest that it may have to outsource its own semiconductor production.

In fact, the company indicated that it may tap Taiwan Semiconductor Manufacturing Company (a current recommendation in our *Near Future Report* portfolio) or Samsung to produce its next

generation of chips.

Companies like AMD and NVIDIA are eating Intel's lunch. I would avoid this company at all costs. Intel's best days are behind it.

Toxic Tech No. 2: International Business Machines (IBM)

IBM also hasn't had a great innovation in decades.

Like Intel, IBM is a legacy technology incumbent. Originally founded in 1911, IBM is remembered by retail investors for its numerous inventions. The company helped create the modern ATM, the floppy disk, the hard disk drive, and the magnetic strip used on credit cards.

For decades, this was a great stock to own. But also like Intel, IBM has failed to innovate in recent years.

Even where IBM is most advanced – its quantum computing system – others have surpassed it. IBM's quantum computing platform, the IBM Q Network, is available to its corporate clients. But it's common knowledge that IBM's quantum computing platform is behind those launched by small, early stage companies like Rigetti Computing, D-Wave, and IonQ. This is particularly embarrassing because IBM has spent years and more than \$1 billion on research and development. But small early stage companies that have only invested tens of millions have developed better technology.

And the product lines where IBM is growing sales the most are the result of incremental improvements to other companies' achievements.

Since IBM hasn't been able to innovate in-house, it has already begun sliding down the slippery slope of overspending on acquisitions that help it "buy" innovation. A perfect example is IBM's \$34 billion acquisition of Red Hat. Red Hat is most

known for making an easy-to-use enterprise version of the free operating system Linux. And Red Hat also develops and sells products built on top of other open-source software.

And more recently, IBM acquired consultancy firm 7Summits as part of a wider strategy for growing its Salesforce services.

The problem with an acquisition strategy like this is simple. Once these companies are integrated, IBM makes every effort to assert its process and the "IBM way" onto the executives and employees of the acquired company.

And guess what? They don't like it. There is a reason that these people worked for an innovative, leading-edge company and not IBM in the first place. Key executives and employees tend to stick around long enough to earn any incentives that were part of the acquisition and then they move on.

Innovation has fled the corporate culture of IBM, which now focuses more on cutting costs.

IBM's legacy consulting and server business lines are struggling. And that is forcing revenue and free cash flow lower. From 2011, revenue declined 31% and free cash flow fell more than 24%. These are not the numbers of a healthy business... and definitely not the numbers I look for in a potential investment.

Investors in IBM will be hard-pressed to make any money, let alone beat the market over any period of time. In fact, investors who have held on to IBM in hopes of reliving the good old days have seen the value of IBM's share price drop more than 20% since 2017. How's that for moving backward?

This is a company rotting away at the core and one we should avoid at all costs. No matter the valuation.

Overhyped Tech Stocks

Right now, I see a lot of tech stocks trading at insanely high valuations... Valuations so high that even if these companies meet the aggressive growth assumptions, the stocks won't rise much over the next five years. This future growth is already priced in. And if these companies see even one misstep or market downturn, the stocks will plummet.

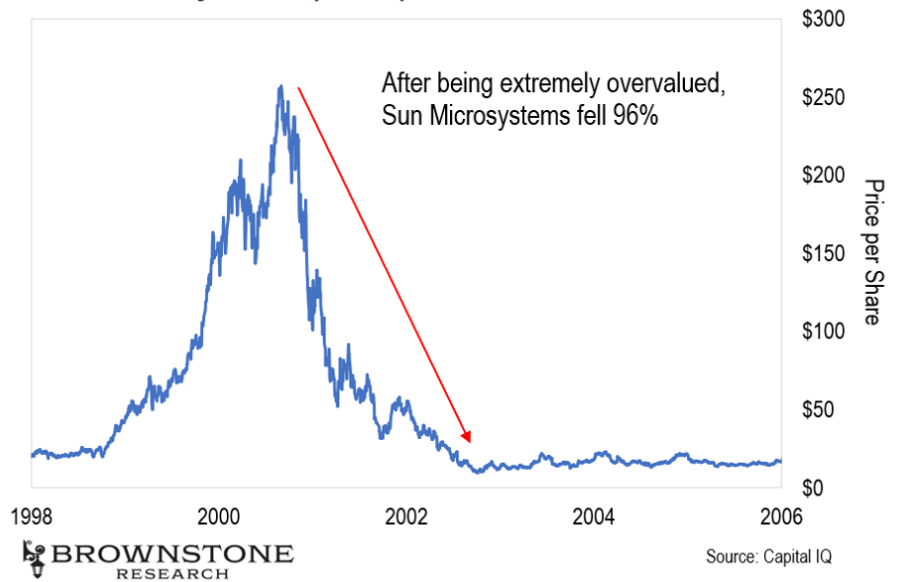
Understanding a company's valuation is the most important part of any investment. Even the best companies with technology that none of their competitors have are not good investments if they are trading at too high of a valuation. Investing at an irrationally high valuation in a fantastic company will still lead to investment losses.

We can see the dangers of investing in overvalued technology companies by looking back at the dot-com bust. Back then, companies were going public at absurd valuations with little more than a vague business plan and a "dot-com" in their name.

The founder and former CEO of Sun Microsystems, Scott McNealy, put it best. In an interview in 2000, he said:

We were selling at 10 times revenues [...] At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends,

Sun Microsystems (JAVA)



which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?

As you can see in the chart above, Sun Microsystems peaked at \$257 and plummeted 96% to \$9.68.

The company's fall didn't happen because Sun Microsystems had bad technology. In fact, its Java programming language is still in use today. It fell because the valuation was way too high to support its future growth expectations.

I want to be very clear about one thing. I am not suggesting that the technology market is poised for a broad collapse like we saw in the dot-com era. Broadly speaking, many technology companies are much healthier than they were in the late '90s. And our portfolio companies are some of the best companies to own.

I retell this story to simply point out the dangers of investing in a company with an absurdly high

valuation.

McNealy said an enterprise value (EV) to sales of 10 was crazy high. I disagree with him on that. Some companies can justify an EV/sales ratio of 10 as long as they have the gross margins and growth rate to support it.

But now we see some large companies trading at an EV/sales ratio of 90! That's an absurd valuation... and investors could lose 92% of their money if they hold on to these companies.

Toxic Tech No. 3: Zoom Video Communications (ZM)

Zoom is the poster child for an overhyped, overvalued tech stock. Now, Zoom has some great technology for videoconferencing applications. And when the pandemic lockdowns began, millions of people began using Zoom. Businesses use it to conduct meetings and interviews. Schools use it to deliver remote lectures. Even my team and I use Zoom's product.

And people connect with friends and loved ones with Zoom. The "Zoom happy hour," where people grab a drink and chat, has become a cultural event. And people of all ages use Zoom.

Zoom arguably has the best videoconferencing platform. It has higher customer satisfaction ratings than its competitors. And its number of daily meeting participants rose from 10 million in December to over 300 million today.

But user growth alone doesn't mean it will grow into its valuation.

Right now, Zoom has an enterprise value of nearly \$108 billion. That puts Zoom's valuation at an EV/sales around 55. Consider Scott McNealy's quote with a 55 in place of the 10, and we can begin to understand how absurd Zoom's valuation is right now.

And Zoom has a lot of competition. Microsoft

Teams, which comes preinstalled with Microsoft's Office Suite, has a video chat feature. Corporate America won't have to pay more to use that... And Teams' offering is comparable to Zoom's.

Facebook and Google also have video chat options as well... Zoom has major competition. I'm not confident it will be able to meet its growth expectations. And with an EV/sales ratio around 55, the first time Zoom misses those growth targets, Wall Street will unmercifully sell off the stock.

No large-cap tech stock should ever trade at a valuation that high.

I wouldn't touch this stock until its EV/sales ratio falls below 7. At 7, Zoom would trade more in line with companies that have a similar growth and profit profile.

To get there, Zoom would need to fall 87%. And that makes Zoom potentially the most toxic tech stock anyone can own.

Toxic Tech No. 4: Coupa Software (COUP)

Coupa has the most "boring" business on the list. It offers procurement and expense management software for organizations – in other words, accounting software.

This is a product that will always be an expense for a company. And it's not a revenue generator like the platforms of *Near Future Report* holding Salesforce. Coupa's clients will always try to negotiate a better rate or find a cheaper replacement. Competition will be fierce, and the low-cost provider is likely to win.

Coupa is a software-as-a-service (SaaS) company. This means its products are sold on a subscription basis, which means recurring revenue. This is one of my favorite business

models. But even a solid business model can prove unprofitable for investors if the valuations get too high.

And Coupa is valued way too high. Its EV/sales ratio is 50. This company isn't growing nearly fast enough to justify that kind of valuation.

In Q1 fiscal year 2021 results, Coupa Software beat its revenue guidance by \$3.6 million. So one would think it might raise its full-year guidance by at least that much. But Coupa only raised full-year guidance by \$1 million. To me, that signifies that management sees something that will cause growth to slow.

Richly valued companies like this plummet when earnings slow.

In a healthy market, I would say this company should trade similar to Zoom at an EV/sales of 7. Maybe it could be a bit higher because it is slightly more profitable, so let's say it should be an EV/sales ratio of 8. But right now, it trades at 50. To get there, the stock would fall about 84% to be reasonably valued.

I never want to see anyone go through an 80%+ drawdown on their investment. Long-term investors will be in for a very bumpy ride.

Toxic Tech No. 5: Zscaler (ZS)

Zscaler is a cybersecurity company providing web and mobile security products from the cloud. Zscaler focuses on large corporations, helping 400 of the Fortune 2000 companies secure their corporate networks.

It has two main offerings: Zscaler Internet Access (ZIA), which ensures employees don't unwittingly download any viruses, and Zscaler Private Access (ZPA), which connects users to applications securely.

I like Zscaler's technology. It is a completely new way of securing company communications. The

old model of securing the corporate network isn't as efficient today because employees are working from home, airports, and coffee shops.

If an employee is on an unsecured network, it can give hackers an easy way to attack a corporate network... essentially allowing them to evade most security measures put in place.

But Zscaler focused on securing the user and applications directly. The company does this through its Zscaler cloud. Users login to this cloud instead of the corporate network directly. And each user only has access to files and applications they should. So if a bad actor gets into an individual user's account, they will still have very limited access to the rest of the company network.

This seems like such a simple idea, but Zscaler was the first company to master this approach. And IT administrators like it because it reduces the number of security programs they need to use. And it allows them to enforce best practice security measures more easily.

Having the easiest and one of the most secure products to enable a distributed workforce has made Zscaler a popular investment. Business is booming because of the pandemic... And investors are flocking to this stock.

It now trades at an insane valuation with an EV/sales around 58. The company is great. Revenue is growing 48-56% a year with impressive gross margins of almost 78%. But there is no way the company is worth 58 times annual sales.

A far more reasonable valuation would be an EV/sales ratio of 10 for Zscaler. But to get there, the stock needs to fall roughly 83%.

Even good companies can become toxic investments if the valuation is high enough. Zscaler is one of those companies.

And now, as a bonus, here's even one more

company none of my readers should touch...

Bonus – Toxic Tech No. 6: Fastly (FSLY)

Fastly provides the infrastructure software to allow websites and applications to work more efficiently. The company does this through its edge cloud platform... It allows businesses to scale edge applications (like websites, smartphone apps, Internet of Things, etc.) without having to worry about infrastructure problems like server bandwidth and costs.

This service is invaluable to development teams. It allows them to focus on their mission of developing websites and applications. And these developers are quickly adopting Fastly's technology.

But we should let Fastly be a warning sign for what can happen to all these other companies. On October 29, 2020, Fastly reported \$70.6 million in revenue, representing a jump of 41.9% year over year. That might seem like a solid performance for the quarter. But it shed some of its share price over that time frame and saw its revenue outlook for the year drop by \$10 million.

Why did Fastly see such a precipitous drop over 2020? Though it managed to increase its customer base, Fastly suffered from lower traffic from its existing customers. And Fastly revealed that traffic from its largest customer, TikTok - which consists of about 10.3% of revenue - dropped for the quarter.

The short-form video app has recently come under fire from the U.S. government for violations of data privacy laws and sending troves of user data back to Beijing. After unsuccessful attempts to ban the app outright, TikTok is still facing the prospect of being banned from the U.S. market entirely if the ownership structure doesn't change.

This is a good demonstration of what can happen

to overvalued companies when the first inkling of bad news is released.

Here at *The Near Future Report*, we look for stocks trading at reasonable valuations with great growth potential. This allows us to be comfortable owning these shares and allows us to sleep well at night.

But even after this 30% drop, Fastly still trades at unreasonably high valuations. This company has an EV/sales of 37. And while it's growing faster than Zscaler right now, Fastly's growth is projected to slow much quicker. And gross margins are only around 59%.

Fastly should trade around an EV/sales multiple of 7. That implies another 81% drop in prices.

Let's not make the mistake of chasing these overvalued stocks. It is a quick way to lose a fortune.

While recent market momentum and speculative buying have pushed these companies higher, eventually these stocks will come back down to earth. And investors who bought at these levels will be the biggest losers, while fast money traders like hedge funds will have pocketed the gains at the expense of normal investors.

Regards,

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