Warning: Tech Stocks Could Be Overvalued

Description

For the first time in years, the largest company in Canada is a technology company. **Shopify** (TSX:SHOP)(NYSE:SHOP) stock has eclipsed every single bank and energy giant on the **TSX Index** to become the country's most valuable enterprise.

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However, the e-commerce juggernaut isn't the only one riding a wave of investor enthusiasm. Investors seem to have moved capital out of traditional sectors and capital-intensive industries to fast-growing, high-margin technology companies. Ever since the outbreak, digital tools and software platforms have become absolutely indispensable.

However, it now seems like investors have pushed valuations past reality. Tech stocks across the board could be overvalued. Mitigating exposure at this stage could be the ultimate contrarian bet of 2020. Here's why.

Tech stocks are vulnerable

Tech firms may have seen a surge in activity during the lockdown. Online shopping, food delivery, and enterprise software saw double-digit gains in the first quarter of this year. Adoption has been boosted by the fact that everyone is confined to their homes. However, when the lockdown measures are gradually eased, tech firms could be as vulnerable as the rest of the economy.

A sudden drop in consumer confidence and a set back in household income could be reflected on tech balance sheets. Shoppers could be less inclined to spend money with Shopify's merchants. Failed restaurants could drag **Lightspeed POS's** top-line numbers lower. A slowdown in global trade will impact **Kinaxis** or **Descartes**.

In other words, the technology sector is tethered to the rest of the economy. This means tech stocks can't sustain their spectacular growth numbers forever. However, their stock prices seem to be reflecting a different outcome.

Tech stocks are overvalued

Tech stocks seem to be priced to perfection at the moment. Shopify, for example, expects between $2.13 billion and $2.16 billion in sales over the course of 2020. Meanwhile its market capitalization is $124.8 billion. In other words, it trades at a ludicrous *58 times forward sales*.

Similarly, Lightspeed is trading at 17.7 times forward sales. But analysts seem to have overlooked the fact that the company's sales are overexposed to restaurants and the hospitality sector. These sectors have been particularly hard-hit due to COVID-19.

Smaller companies like **Facedrive** have also seen tremendous appreciation in just a few weeks. The stock is now worth 727 times revenue. That's too much by anyone's standards.

It's important to note that this over-excitement doesn't seem to apply to larger, more profitable tech stocks. **Constellation Software**, **CGI**, and **Open Text** haven't seen a rapid acceleration in market value and could represent opportunities for long-term investors.

Foolish takeaway

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Over the past few weeks, we've seen decades of technology adoption pulled forward. Everyone is shopping, working, and interacting online like never before. This has pushed top tech stocks to record-high valuations. However, now the market values seem overdone.

Tech stock investors must reconsider then long-term implications and jaw-dropping valuations of some of their holdings. Ditching "exciting" tech stocks in favour of more well-established names in mundane businesses could be the perfect way to create value in the years ahead.

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