



Worth Noting

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Worth Noting is the fortnightly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

Internet Giants

Three and a half years on from the implosion of the Internet bubble, it is time to take a look at how some of the giants that emerged from that remarkable period are faring. Despite the many failures of the Internet era, the sector has produced companies which are collectively worth hundreds of billions of dollars. Only biotechnology and the broader technology sector rival the Internet in terms of wealth creation in the last two decades.

That wealth creation has been narrowly focused, however. One of the ironic things about the growth of the Internet industry has been its tendency to produce a very small number of big winners and scores of failures. There are thousands of very profitable retailers around the world, for instance, but there is only one Amazon.com. There are many thousands of successful auctioneers, but there is only one eBay. And there are any number of wealthy media proprietors, but there is only one Yahoo!.

This concentration of success is ironic because the Internet was meant to “disaggregate” traditional industry structures, leading to a diverse, splintered economy. This simply has not occurred. Barriers to entry have proven to be much larger than anticipated, brands have taken on real power online, and technology execution has turned out to be a much more complex (and expensive) business than anyone predicted.

In our view, the Internet industry structure most closely resembles that of mining and resources. Both markets are characterised by a small number of highly profitable, global operations, with prohibitive barriers to entry. In this issue of *Worth Noting*, we take a look at three of the most successful Internet companies.

eBay

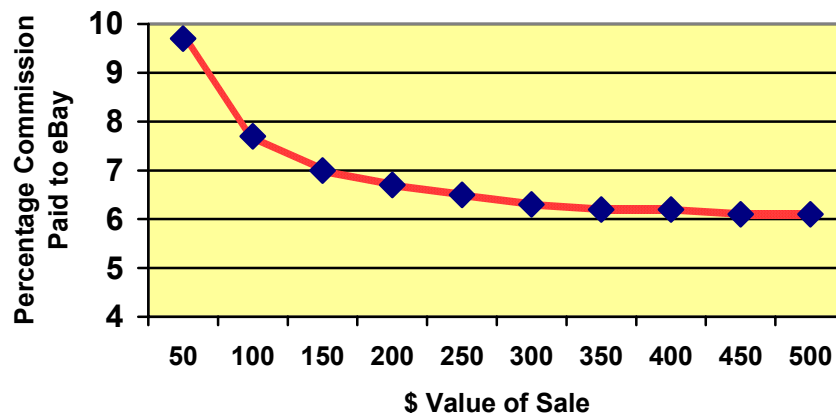
The online auctioneer eBay is one of the world's most exciting businesses, and its growth shows few signs of slowing. The company has an exquisite business model which is delivering massive profits to shareholders. The market is obviously a fan of the company – eBay trades on a price-earnings ratio of 96 and has a market capitalisation of \$US 37B.

eBay's business model is disarmingly simple. The company allows individuals and businesses to place items for sale on its web site, and then charges a commission on successful sales.

The company charges two main fees – an Insertion Fee and Final Value Fee. Effectively the Insertion Fee is the marketing spend required to place the advertisement while the Final Value Fee represents the transaction cost - a percentage of the selling price. eBay also operates a system called PayPal, which allows buyers to pay into an account upon which the seller can draw, using credit cards or other forms of deposit. For merchants who do not have credit card processing facilities, PayPal provides a secure method of ensuring that payment has been made without the administration required to develop a merchant facility.

Assuming that the PayPal service is used, merchants face a total commissions structure as follows, depending on the value of the item sold.

eBay Commission (US merchants) at Various Sale Prices, November 2003



Source: eBay, L21 analysis

In the quarter ended September 2003, eBay's revenue grew to \$US 531M, up from \$US 289M in the corresponding quarter in 2002. The company achieved an extraordinary gross margin of 79%, which fell a little from the previous year as the lower-margin PayPal business increased in size.

The great virtue of eBay's business model is its capacity to create value in all directions. For sellers, the proposition is simple: access a vast market of potential buyers at minimal cost. For buyers the proposition is even more compelling: browse through large collections of the most obscure items, obtain a competitive price and have the product delivered in the next few days. Simply put, why would a buyer look anywhere else? If eBay has 1,000 euphoniums for auction, why go to a site that has 10 or 15, let alone a shop that might have 5?

Perhaps the most interesting question related to eBay is one we ask about all businesses: how big can this be? At the company's current run rate, around \$US 20B worth of merchandise is sold through its sites each year. When one considers the company's geographic reach and the size of the markets in which it operates, its current sales represent a small fraction of the potential. eBay is not limited to listing second hand merchandise – thousands of merchants sell new products through its sites, acquiring customers at a lower price than the traditional retail model allows.

eBay is forecasting EPS for 2004 of up to \$US 0.91, up from an estimated \$US 0.65 in 2003. If it can maintain its current growth rates, eBay has the potential to be the most significant of all Internet companies. Its model has captured the potential of the Internet, developing a business which taps into large existing markets without the cumbersome administration required in the physical world. With no stock to hold, eBay cannot be caught out like retailers. Its model is sufficiently flexible to apply to any type of merchandise. And it is important to point out that the business is unlikely to suffer significantly in economic downturns – both buyers and sellers should find its low cost, value-driven model particularly useful in lean times.

Yahoo!

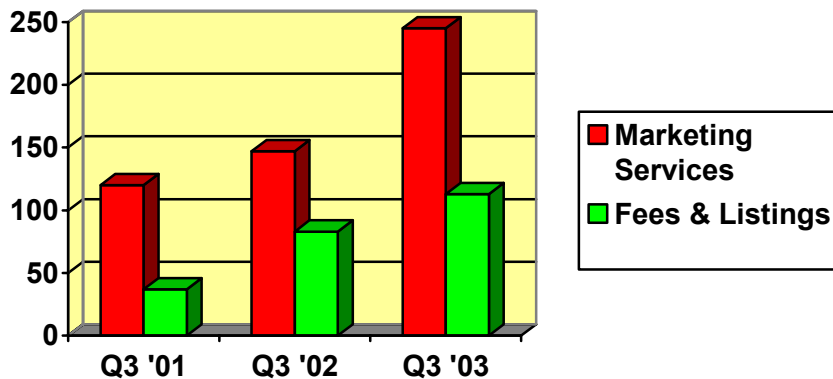
One of the best known Internet names, Yahoo! has had a checkered history. Initially the Internet's most popular search engine, the company was one of the darlings of the NASDAQ market in the late 1990s. After the demise of the Internet boom, the company ran into trouble, with faltering revenues and a departing management team. In the past two years it has executed a remarkable transformation and regained much of its early lustre.

The market likes Yahoo! even more than eBay, with its current share price translating to a price-earnings ratio of 129 and a market capitalisation of \$ 28B. Analysts of the stock have been impressed by its increasing diversification in

revenue streams – away from its early focus on Internet banner advertising and towards fee income, and innovations such as sponsored search listings.

The market for “traditional” Internet advertising has fallen substantially in the past two years, and Yahoo! has been called upon to find other revenue drivers. The company has proven itself to be up to the task.

Yahoo! Revenues By Segment (\$M US)



Source: Company Reports

Earlier this year Yahoo! acquired the pioneering Internet marketing company Overture. Overture developed a highly profitable search results auction model which Yahoo! now operates. The model involves companies bidding against one another to improve their rank in search results. The company that bids the most to appear first after the desired word – say “travel” – receives the highest ranking, and the increased traffic which results. Online marketers have found this to be a more effective method of driving traffic to their sites than banner advertisements and other forms of Internet advertising. The addition of the Overture business model to the Yahoo! user base promises to deliver highly profitable growth to the company.

The economics of Yahoo!’s business are very sound. Its model is effectively that of a publisher, without the physical infrastructure that large media businesses require. The company has an operating margin at present of around 23%, broadly in line with leading media companies. With no portal competitor in sight after the demise of so many other names, Yahoo! dominates the sector. It is well placed to tack on to its offering any high margin service of use to its massive bases of consumers and marketers.

Amazon

We are happy to admit it when we get it wrong - in October 2001, in Volume I of *Worth Noting*, we wrote:

“Very few online retail businesses based on physical products (eg books, CDs) have reached profitability. Amazon.com is narrowing losses but in our view is unlikely to ever generate significant profits.”

Since then Amazon’s stock price has risen from \$8 to \$57. But as you will see below, we still don’t quite share the market’s enthusiasm for the company.

The promise of Amazon has always been immense: retail is one of the world’s biggest markets, and the infrastructure barriers to entry for other online players are very high. Couple that with the unique difficulties of picking and packing individual products for literally millions of users, and you have an extremely strong competitive position for any player that can make it work. The market clearly accepts that Amazon is about to deliver on that promise.

Amazon sold \$US 1.1B worth of merchandise in the quarter ended 30 September, and is giving guidance of around \$6B in revenue for 2004 and operating income in the range of \$400M. Amazon’s operating income figure excludes its (hefty) interest repayments and does not make an allowance for tax, given its massive accumulated losses.

In the current quarter, the company reported operating income of \$52M, or 4.6% of sales. After accounting for its interest expense and some other items, Amazon booked net income of \$16M (1.4% of sales). At the high point of its 2004 estimates, Amazon’s net operating income would represent 7.6% of revenues.

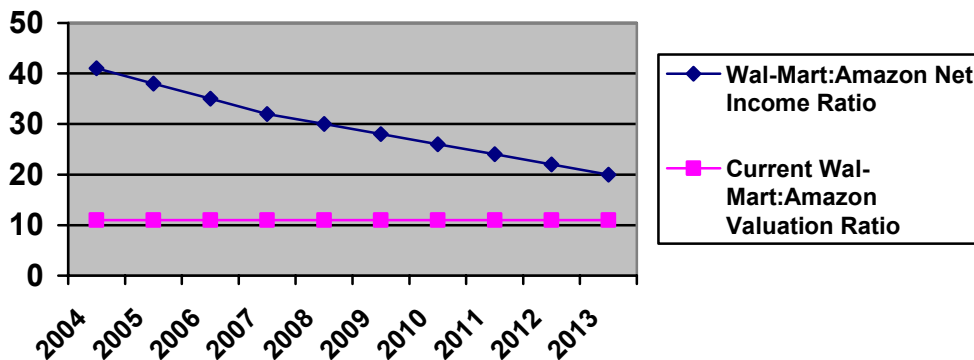
Let’s look at Amazon’s figures against the giant it would like to be – Wal-Mart. For the quarter ended July 2003, Wal-Mart recorded revenues of \$62.6B – about 57 times Amazon’s. Using Amazon’s pre-tax and interest formula, Wal-Mart’s net income of \$3.6B translates to 5.7% of revenue. Wal-Mart’s net income in one quarter is around nine times Amazon’s estimated income for the entire 2004 year.

One of the key facts that Amazon’s many fans point to is its gross margins – it is impressive that the company had a lower cost of sales in the last quarter than Wal-Mart – 74.8% to 76.4%.

Wal-Mart’s market capitalisation is \$256B, while Amazon’s is \$23B. Let’s take a look at the relativity of these valuations might play out, after making certain assumptions.

Let's assume that Amazon earns \$400M in net income in 2004, and using this same measure Wal-Mart earns \$16.4B based on analyst consensus revenues of \$287B. We will also assume that Wal-Mart's revenues grow by an average of 11% for the next 10 years, while Amazon's grow by an average of 20%, again based broadly on analyst estimates. Operating margins remain the same in our model – 7.6% for Amazon and 5.7% for Wal-Mart.

Projected Wal-Mart:Amazon Net Income Ratio over Time



Source: Company Reports, Analyst Estimates, L21 analysis

The pink line above assumes that Amazon's valuation ratio to Wal-Mart stays at current levels. What this analysis shows is that, even if Amazon maintains substantially superior margins to Wal-Mart, and grows at almost twice Wal-Mart's rate every year for the next ten years, its net income will still be only 1/20th that of Wal-Mart. The current valuation suggests that Amazon is 1/11th as valuable as Wal-Mart – extremely aggressive in our view.

That said, Amazon has certainly established one fact that was not clear until recently: it won't be going out of business any time soon. With its large bond issues and resulting debt payments, many analysts questioned the company's ability to remain solvent around 2001. Reduced marketing expenditure, growing revenues and improving margins have all worked together to make Amazon's position very sound today.

Unlike companies such as eBay and Yahoo!, however, Amazon operates in the physical world. It physically picks, packs and distributes goods – just like traditional retailers. While it has some cost advantages because of its lack of a store network, its COGs will inevitably be similar to its physical world competitors. The issue for Amazon, like eBay, is market size. But unlike eBay, Amazon is not creating an entirely new form of transaction – it is taking a piece of an existing market (albeit growing the entire market a little too). The world's appetite for eBay's service is not yet known, whereas the markets in which Amazon operates are mature. The company is obviously destined for a tremendous future, but has

natural limitations on its growth which are more apparent than for companies such as Yahoo! and eBay.

It should be pointed out that there are several very valuable Internet companies which we do not have the space to consider in this edition – Cisco, AOL (which has suffered problems but remains a giant), Google, and a small number of others. Immense wealth has been created by small pockets of the Internet industry.