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# *L21 Worth Noting*

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*Worth Noting is the journal of research and conferences company L21. It is focused on social, economic, political and international issues of relevance and interest to senior executives.*

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Way back in 2001 not long after the dot-com crash, we identified a few companies which we thought would make it through the tough times and eventually flourish. Almost five years later, we thought we would revisit those predictions and see what has happened.

Before we do so, what was the setting? We noted then that:

"It is well established that the vast majority of Internet ventures over the last five years have failed. For many and varied reasons, most Internet business ideas destroyed rather than created value."

*L21 Worth Noting, October 2001*

However, we also noted that:

"...while most internet businesses have failed, the Internet itself has not failed. Every month Internet usage increases. The more time passes, the more email and other forms of Internet communication take over from more traditional mediums. Most senior executives still believe that the Internet is the biggest thing to happen to business in a generation."

*L21 Worth Noting, October 2001*

As far as the rise of the Internet is concerned, there is little dispute. The Internet is the biggest thing to happen in a generation. Online marketing has gone from strength to strength, growing at about 30% and is due to overtake radio advertising over the next eighteen months.

Macro trends bode well for the medium but success stories are also rare by definition. Let's find out how our five year old predictions have gone.

## **The Predictions**

We said back then that there are four companies which, in our view, stood out as examples of Internet success stories. They were:

- Checkpoint Software
- eBay
- Travelocity
- Websense

We can deal quickly with eBay. eBay is one of *the* Internet success stories. This has been easily the most compelling prediction.

We said then that there were four main reasons for eBay's dominance:

**First Mover** - perhaps the most overused term of the Internet era, it has genuine resonance in the auctions industry. The proposition is all about range and choice . if eBay has 108 million items for sale, why would I look at a site with only 1 million? Because it was the first to recognize the opportunity (and execute it) eBay made it very tough for its competitors

**Brand** - again, an often overvalued commodity in the Internet industry. But eBay has successfully used low cost pay-for-performance online campaigns to drive traffic while at the same time build brand.

**Reliability** - eBay gets tough with merchants who don't show up with the product, or buyers who don't come through with a cheque. Its fair play policies have engendered confidence in users

**Vertical markets** - the company has gone deep on markets where it sees long term opportunities, such as collectibles and automobiles. eBay management has created a service which is a series of tightly knit user groups, rather than a random group of anonymous web surfers

When we were writing about eBay five years ago, there were about 35 million users. Now there are about 100 million. What we said then about eBay remains true today.

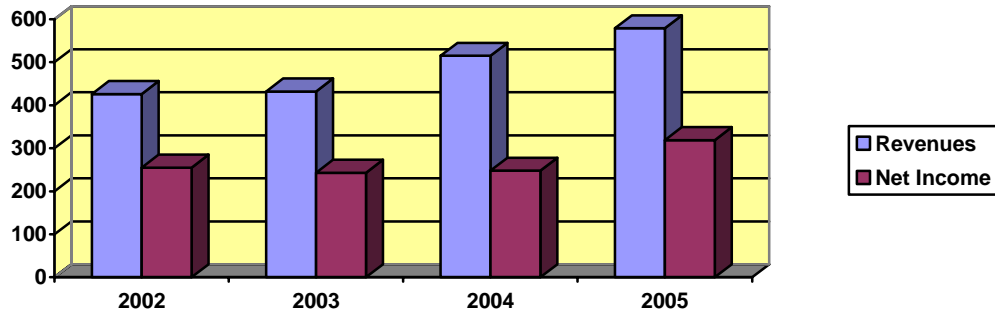
### **Checkpoint Software**

Checkpoint Software was the world leader in security software for the Internet when we first put forward the company as one for the long term. We argued in 2001 that Checkpoint Software was "The company with perhaps the most impressive numbers in the entire Internet industry" – quite a big claim indeed. Let's see what has happened since then.

We were attracted to this company not only because revenue growth looked at worse solid and at best spectacular, but also because the company's cash flow was extremely sound (unlike other Internet competitors), and net operating margins were spectacular (over 40% on 2001 and increasing.) We saw Checkpoint as a perfect example of a software company

that had developed robust scale: once the basic software was built, beyond technological improvements and redesigns, the incremental cost of sales were very low.

**Checkpoint Software Revenue & Net Income (millions)**  
**2002-2005**



Source: Company Report

The company remains probably the only real Internet success story emerging from Israel in the last ten years. However, although still a very solid company, some might argue that Checkpoint has not fully delivered on the earlier promise. Margins have remained strong oscillating between 45-60% during the period but revenue growth has not been spectacular at about 10%.

Checkpoint is a good illustration of insufficient emphasis on market presence. Although numbers are still solid, bear in mind that Checkpoint once dominated the firewall market when there were 4 or 5 vendors in that space. While the company continued to see product leadership as the foundation for success (R&D almost doubled in this 2002-2005 period), spending on sales and marketing was more reactive than proactive – occasionally investing in improving existing distribution channels as the need arose rather than spending significantly on developing and entrenching a greater market and brand presence as new competitors sprung up. During the period from 2002-2005, spend on sales and marketing only rose from about \$105m to about \$140m.

The below chart showing the company's stock price clearly shows that the earlier optimism about Checkpoint has been tempered by modest growth during the past 3-4 years.

### Checkpoint Software Stock Price, 2000-2006



Source: Nasdaq

### Travelocity

Even though margins were tiny, we identified Travelocity as a success story because the company was a notable example of using the Internet as a large scale channel for an existing business model (i.e., a travel agency business.) In other words, successful Internet business did not have to reinvent the wheel – they just had to exploit a new channel.

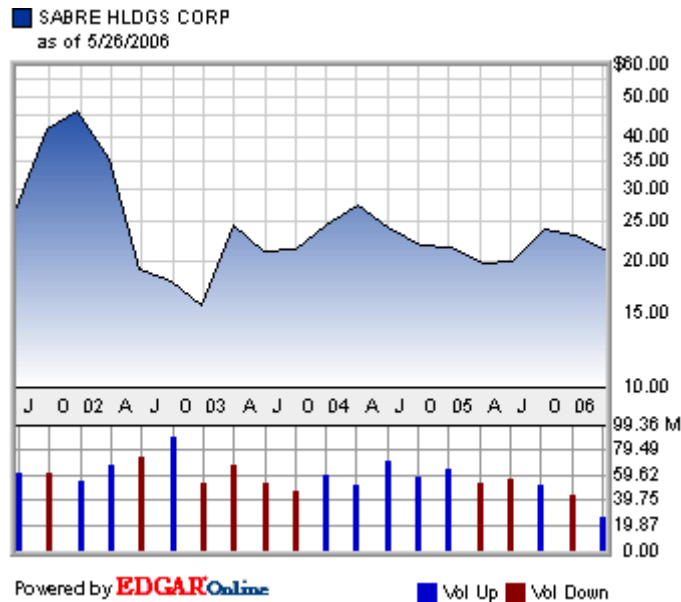
We argued then that online travel services would work for several reasons:

- Online travel bookings are extremely useful for consumers. Prices are often more competitive than offline, and the technology can match a consumer's precise needs with literally thousands of providers in an instant. Consequently demand has been particularly strong, allowing the travel sites to recover their substantial technology establishment costs.
- No inventory costs and therefore low COGs. Once the travel provider is paid, the agency's direct costs associated with the sale are minimal
- Significant advertising revenues, as the sites are all about transacting. An advertiser knows a Travelocity user is a potential buyer of their travel product. Few other online businesses have such a focused clientele. Advertising revenues add high margin cream to the cake.

First, what has happened to Travelocity?

Briefly, Travelocity (within the Sabre Holdings Group) remains a leading online travel services company and has expanded operations to Europe and the Asia Pacific. In this space, the company is one of the lasting success stories.

However, the move towards online travel services has been good for consumers but challenging for investors in the industry. While it is extremely convenient for consumers to peruse travel offerings from different providers on the one site, this has led to enormous downward price pressure. Consumers armed with a list of flights or hotel rooms on their screen choose overwhelmingly based on price. Travelocity with a dominant position does better than most competitors in terms of financials (with net profit margins at about 5%.) However, since travel services companies are now almost always competing on price, where margins were already small at around 5% several years ago it is now around 1-2% for most travel agencies.



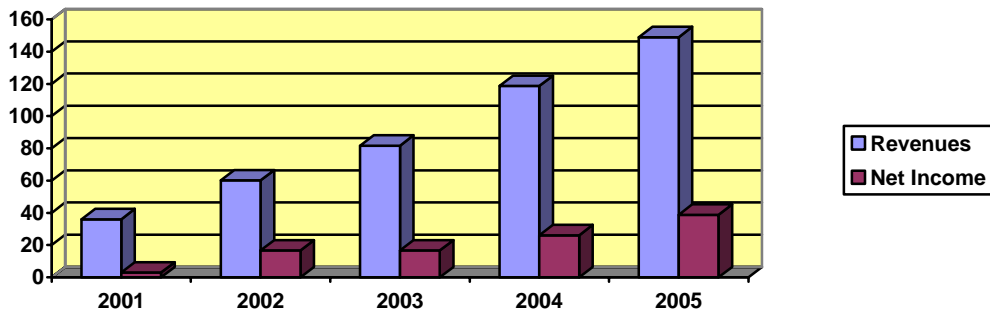
Moreover, advertising take-up by companies on travel services sites eager to gain exposure to a specific and captive market of travel-interested consumers have not generally covered the loss in pricing power that travel agencies enjoyed before the Internet. Australian based examples like travel.com continue to struggle despite good market penetration while companies like Flight Centre having moved into the online space now find margins challenging and are targeting higher margin areas such as packaged tours.

## Websense

Websense was the Big Brother of the Internet. The company makes software which is designed to increase the productivity of employees by monitoring their Internet usage and limiting access to non-business sites. In 2001, Websense had over 14,000 customers, including half of the Fortune 500.

We were attracted to Websense because of a demonstrated demand for that kind of product as well as the strong financial structure of the company. We will look at what has happened since then.

### Websense Revenues & Net Income 2001-2005



Source: Company Reports

Margins have remained between 20-30%. However, revenue growth has been the driver behind the continued success. Significantly, unlike Checkpoint, spend on marketing, advertising & sales have been growing exponentially since 2002 from about \$26m in 2002 to over \$55m in 2005.

Websense has not stood still largely because a strong drive to improve their presence in the market has helped to maintain brand and industry leadership in their space. They have deliberately and skillfully worked on their brand and positioning as the market moved, as well as invest in continual product development, rather than only focus on securing the next contract renewal with clients.

### Websense stock price, 2001-2006



Source: Nasdaq

### Conclusion

How did we do? All four companies have survived, all are still among the leaders in their industry, but Ebay and Websense have been the financial success stories.

Although we have given only a brief analysis of what has happened, there tends to be a clear pattern. The early survivors after the crash were those with products that created value and were useful, had sound financial and cost structures, kept cash flows under control, and understood the power and limitations of what the Internet could offer as a new medium.

The Internet created opportunities for companies with vision to sell new products (Websense, Checkpoint etc.) and also opportunities to offer existing types of products and services but using a new medium (eBay, Travelocity etc.) Both opportunities offered first mover advantage for the earlier companies in that space that seized the opportunity. Their stories are the stories of any business in any period. Those that continued to grow were the ones that continued to enjoy product, price and brand leadership to compete successfully when online and non-online competitors moved into their territory. They were the ones that grew revenues without eroding price or margin.

