



Worth Noting

The Fortnightly Journal of L21 Management Consultants

Issue 5, October 22, 2001

Worth Noting is the fortnightly journal of L21 Management Consultants. The aim of the publication is to provide our clients and associates with insights of relevance to their business. It will be distributed every second Monday.

Worth Noting will focus on the three key practice areas of L21, namely:

- Strategy
- Growth
- Business Development

Practice Area: Growth

Internet Success Stories

The title of our analysis this fortnight may seem to be something of a misnomer. 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.

But while most Internet *businesses* have failed, the Internet *itself* has not failed. Every month Internet usage increases. The more time that 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. Nobody would argue that a serious corporation can ignore the Internet in the hope that it might go away.

So why all the failures? Or, more importantly, what did the success stories understand about the Internet that eluded the rest of the market? And finally, what lessons can all businesses learn from the Internet winners?

Putting Success into Context

It is important to point out that the success stories we will profile are very much the exception to the rule. In our view, there are less than fifteen public Internet companies in the US market which are likely to generate significant profits over the medium term. Given the hundreds of companies to go public – and thousands to attract VC funding – this is a tiny number. The industry has reached a point where some fairly strong observations can be made:

- Very few online retail businesses focused on physical products (eg books, CDs) has reached profitability. Amazon.com is narrowing losses but is in our view highly unlikely to ever generate significant profits
- Almost all businesses pursuing the “portal” business model have either been wound up or merged into other entities. Yahoo! was highly profitable for a brief period but broke even in the last quarter as online advertising slumped. Only Overture (formerly know as Goto.com) is expected to be profitable in the September quarter
- No B2B marketplace company has reached profitability. The prognosis for this sector is grim as expected competitive advantage from proprietary software strategies has not eventuated
- Few ISPs have reached profitability, as providers struggle to cover the high fixed costs of technology. The industry structure is emerging as “leaders-take-all” with one or two companies dominating in each market
- Online brokers are generally breaking even as thin margins and a cooler market for equities make conditions difficult

In this decidedly negative environment, there are a small number of companies which we believe provide useful insights into how the Internet will develop over the coming years.

Highlighted Companies

There are four companies which, in our view, stand out as examples of Internet success stories. They are:

- Checkpoint Software
- eBay
- Travelocity
- Websense

Some of these companies are well known, others are relatively obscure. However they all demonstrate the commercial opportunities of the Internet – and consequently the way the technology is likely to develop. They are not the only four success stories, but provide a useful mix of characteristics of Internet winners.

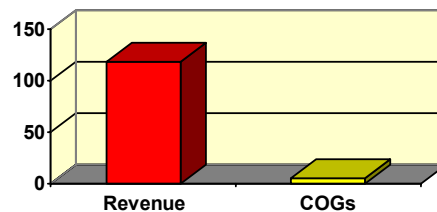
Checkpoint Software

The company with perhaps the most impressive numbers in the entire Internet industry is Checkpoint Software. Checkpoint is the world leader in security software for the Internet. Its two key products are corporate firewalls – which limit network access – and Virtual Private Networks – which provide secure network connections across the public Internet. The company was founded in 1993 in Israel and has grown to a point where its 2001 revenues are set to exceed \$US 500 million.

Readers of Issue 3 of *Worth Noting* will recall our discussion of the cost structure of the software industry. As we emphasized there, once a software product has been developed, the incremental costs of sales are very low. Low COGs means a high gross margin, and a high gross margin should lead to a high operating margin.

Checkpoint is an outstanding example of the robust economics of the software industry. Its third quarter report, released last week, shows its COGs at less than 5% of revenues.

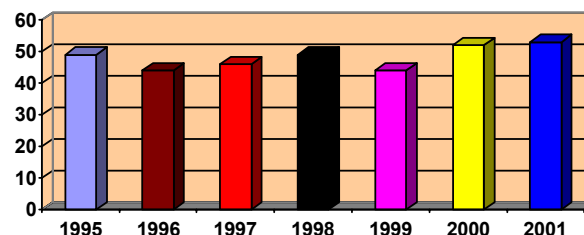
Checkpoint Software Revenue and COGs (\$US), Q3 2001



Source: Company Report

The company's economics are even more exceptional in relation to operating performance. Since 1995, Checkpoint has recorded a net operating margin of over 40% in each year. Despite the market downturn, the company has managed to expand margins again in 2001, with the September quarter recording a stunning 63% net operating margin. Year over year, Checkpoint has maintained an exceptionally high net operating margin.

Checkpoint Software Net Operating Margins (%)



Source: Company Reports

The company will generate positive cash flow of close to \$US300 million in 2001 on revenues of only slightly over \$US500 million. It is difficult to find better numbers in any industry, let alone amongst Internet companies.

There are two sides to these results: the cost structure which underpins the margin, and the quality of the product which drives the revenues.

As we noted above, the cost structure is underpinned by the very low COGs. G&A expense is also extremely low, at less than 5% of revenues, while marketing expenses absorb approximately 20% of revenues.

The company is able to keep its non-COGs costs low for a number of reasons. Firstly, its distribution and marketing activities are focused purely on corporate IT managers. As a consequence, Checkpoint has never needed to engage in the large scale marketing campaigns characteristic of so many Internet companies. Its marketing activities have tended to focus on trade shows, industry magazines and so on – there is a limited audience for its products and it is not difficult to reach.

Secondly, average sale sizes tend to be high. The company's Virtual Private Network software is sold on a "seats" basis – that is, a fixed charge per user with access to the system. As most of the company's customers are large scale corporations, one sale to a corporate IT manager is effectively a sale of hundreds or thousands of seats. Given the relatively small number of sales and their large size, G&A costs are a small percentage of total revenue. The office infrastructure required is small compared to the revenue earned.

For these reasons the company maintains a highly desirable cost structure. Its leadership in customer popularity is earned by the quality of its products and the high switching costs associated with moving to another company once Checkpoint is installed.

Checkpoint specializes in products such as corporate firewalls and Virtual Private Networks. The aim of these products is very simple: keep unauthorized users out of reach of sensitive corporate material. Security products have become ubiquitous in recent years as corporate IT managers fear raids on company material. Checkpoint is a leader in this industry – controlling over 60% of the Virtual Private Network market alone.

Buyers of security products are generally interested in two things: the level of security provided, and the operating efficiency of the product. Some security software provides an exceptional level of security but involves a "clunky" network architecture, slowing the speed of the network and making it more difficult to use. Checkpoint is well known for its focus on speed and ease of use – these are qualities which have seen it reach its strong position in the market.

In addition, Checkpoint operates in an industry where switching costs are relatively high. If a company has 1000 users who access a Virtual Private Network (VPN) remotely, each of those users will require network software and authentication information in order to access data behind the corporate firewall. And if the company was to change the provider of its VPN, the software and authentication settings need to be changed for each user. As a pioneer in the industry, Checkpoint enjoys the advantages of incumbency.

Finally, Checkpoint operates in an industry which is not particularly price sensitive. Our research in the Australian market has emphasized that decision makers for the purchase of IT security products do not rate price highly on their list of priorities. The attitude is very much "we have got to get this right, and we will pay to get it right". The perceived cost of a breach of corporate security is much higher than the cost of installing security software. Consequently prices and margins for the industry remain strong.

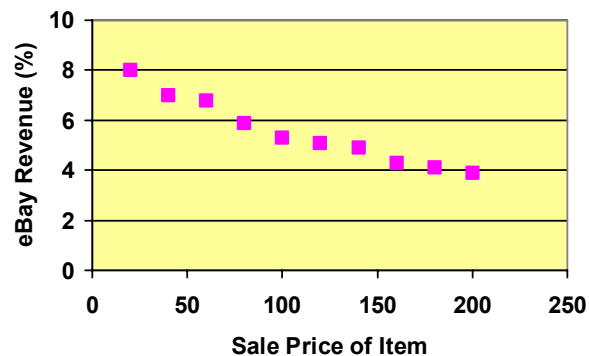
In identifying a large and immature market early, executing with great products, and building an outstanding cost structure, Checkpoint Software is a standout among Internet companies.

eBay

eBay is one of the best known consumer brands on the Internet. Unlike other well known Internet consumer brands however, it is highly profitable. The company reached profitability in 1998 and has been profitable every quarter since.

eBay is a trading platform which allows its 35 million users to initiate or participate as a buyer in auctions over the Internet. Its model is simple: facilitate transactions and clip the ticket on the way through.

eBay Revenue at Various Sale Prices (\$US)



Source: eBay, L21 Analysis

The chart above shows eBay revenue as a percentage of the sale price of items. eBay uses two main mechanisms for charging fees – a listing fee, which is paid regardless of whether or not the item is sold, and a sale fee, which varies depending on the final price for the item. As seen above, the highest percentage of the sale price that an owner will pay is 8%. This is an extremely compelling proposition – a potential market of 35 million people, no infrastructure costs, simply a small commission.

For buyers the proposition is even more compelling: no charge whatsoever. And what's more, in the three months just completed the company listed over 108 million items for sale. Infinite choice and no costs other than the price of the good is a hard combination to resist.

It is worth noting that eBay earns revenue from advertising and premium services used by professional merchants. But the bulk of its revenue comes from the very simple and compelling propositions detailed above.

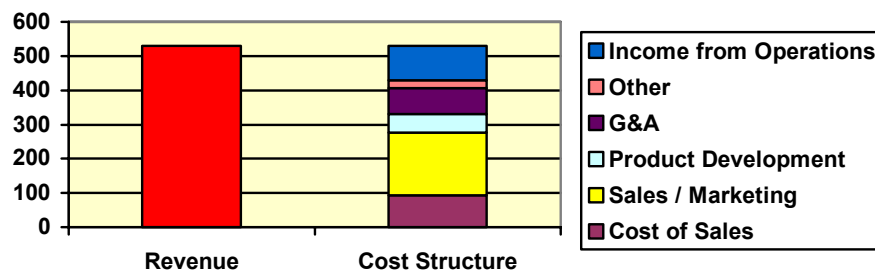
The auction model appears to be such a compelling proposition that it is interesting that only eBay has made significant profits online. Numerous competitors have risen up over the last four years, only to find that their revenues never reach a level to support the required technology infrastructure. We think there are 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

For these and other reasons eBay has done extremely well in building consumer demand. But as we saw above, its revenues are a relatively modest proportion of the total sales of merchandise on its site. How does eBay maintain profitability?

An examination of the company's cost structure over the past nine months is useful.

eBay Revenue and Cost Structure (\$US), 2001



Source: Company Reports

In the above chart, revenue and costs are equal, as income from operations is included so as to emphasise the percentage of revenue retained as earnings.

Perhaps the most striking feature of the chart is the high proportion of the budget devoted to sales and marketing – more than 35% at \$182M. This is not surprising, given the company's consumer focus, and is consistent with analogous industries such as fast moving consumer goods. At \$99M for the year to date, income from operations (ie pre interest and tax) is a healthy 19%.

While eBay's cost structure is solid, it is not outstanding. Its costs allow for a reasonable operating margin. However the problem the company has is that it is difficult to see how it can significantly reduce costs and consequently increase margins. Marketing is very much the lifeblood of the company, and a significant reduction in spending would see a significant reduction in revenue – 35 million users means a lot of relationship building. Product development costs – at 10% of revenue – are light for a technology company of its size. It is unlikely that there is much room to move downwards in this respect. The vast amounts of traffic which eBay enjoys come at a price: technology vigilance. eBay has not been faultless in this area and needs to keep its users happy. The company's costs of sales – largely credit card fees and other processing costs – have been on a downward trend for some time. Further reduction is possible but it is difficult to see the company picking up more than two or three points in this area.

In our view the eBay success story has been more about the success of the customer proposition than the development of a breakthrough business model. The company's economics are strong but there are better in the industry. The combination of a sound cost structure and rampant consumer demand makes eBay a major Internet success story.

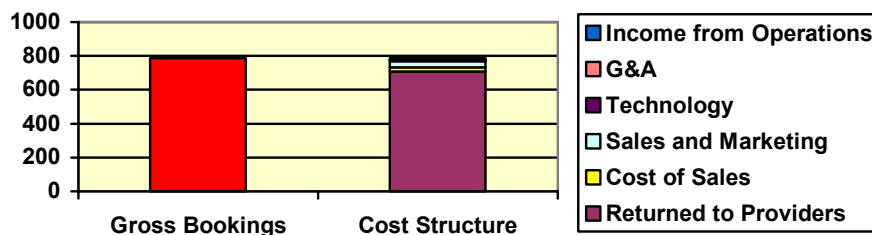
Travelocity

Online travel bookings has been one of the few Internet segments to produce a number of profitable companies. In addition to Travelocity, Expedia and Priceline.com have also proved the viability of the online travel market. It should be noted that this observation is specific to the US market - the large number of suppliers of travel products mean that Internet sites can play a valuable role in sifting information and finding the best deal for the customer. In Australia, our increasingly centralized aviation market means that Internet companies can add little value to the search process.

The traditional travel agency business is under genuine threat from the online providers in the US – a rare example of the Internet start-ups taking significant market share from established providers. More than \$US14 Billion in travel reservations were completed online in 2000.

The economics of the online travel business are not so different from traditional travel agencies. A tiny proportion of gross bookings make it to the bottom line as profit, as the following chart shows. The massive volume of bookings online, however, means that even a very small percentage profit is a significant sum.

**Travelocity Gross Bookings and Cost Structure (\$US),
September Quarter 2001**



Source: Company Reports

The chart makes the business look very unattractive – the blue “Income from Operations” section is such a small proportion of the total cost structure that it is indistinguishable. In fact, income from operations is \$US 4M, on gross bookings of just under \$800M. In other words, for every dollar in bookings completed by Travelocity, half of one cent is retained as earnings.

Travelocity’s competitors Expedia and Priceline have very similar numbers, with earnings a small fraction of gross bookings. As noted above, the traditional travel agency business has a similar cost structure.

The reason that Travelocity is notable as an Internet business is not that it has achieved something particularly new. Rather, the company is notable because of its ability to use the Internet as a large scale channel for an existing business model. Many Internet businesses were based on this

concept – the concepts were not new, rather the channel through which they were executed. Content sites, for instance, tried to replicate the media model through the new medium. It didn't work. Online retailers tried to replicate the suburban shopping center online. It didn't work. And these concepts failed not so much because of a lack of consumer demand, but rather because of the lack of profitable revenues flowing from that consumer demand. The travel sites are notable because they have managed to reach profitability at an industry wide level – in so doing placing real pressure on the incumbents.

So what's different about travel? Why has the model worked where others have failed?

We think there are three key 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.

The solid success of Travelocity – and online travel in general – makes it an Internet success story.

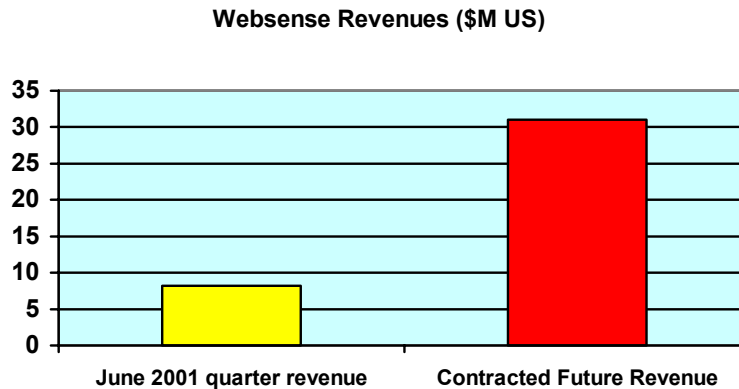
Websense

Websense is 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.

Companies that purchase a subscription to Websense do so in the hope that their employees will get more done online. Customers choose which categories of sites they wish to block from their employees. For instance, a corporation may decide not to allow access to music download sites. The Websense database of more than 2 million sites would then prohibit access to any site associated with music downloads. A report is generated for the company which details all requests and explains which requests have been refused, by type of site and user name.

It is fair to describe the product as somewhat Orwellian – but large corporations are finding it extremely useful. Websense has over 14,000 customers – including half of the Fortune 500.

We are particularly impressed by this company due to its annuity-type earnings stream. Websense sells subscriptions of 1-3 years duration, giving it a great degree of stability as much of its future revenue task is already completed. As the following chart shows, its contracted future revenues are almost four times its revenues in the June 2001 quarter.



Source: Company Reports

This high degree of revenue stability is one of the key advantages of the so-called ASP software model.

At the risk of repetition, we would also emphasise the very low COGs which Websense enjoys as a software company. Cost of Revenues was just on 11% in the most recently reported quarter.

The company reported a modest pro-forma profit in the most recent quarter, and is only now beginning to reach a scale where significant long term profit can occur.

Websense has invested quite heavily in marketing and product development activities in recent quarters, and there would appear to be room to move for the company as it seeks to tighten costs and increase earnings. There also is a substantial opportunity for the company to increase its revenues. On average, the company received less than \$600 US from each of its customers in the most recent quarter (note that, remarkably, it was able to maintain an 89% gross margin on such slender revenues). It appears to us there is room for the company to increase its pricing significantly over time.

For these reasons we take the view that Websense is an excellent example of a likely successful Internet business model. It is worth taking some time to consider why the Websense proposition has proven so compelling to customers.

Firstly, Internet productivity is a readily understandable concept. We have all seen people using the Internet inappropriately, we all suspect that person X

spends a lot of time surfing the web to the detriment of their work. It is an easy leap from there to an understanding that software which will limit this sort of activity can raise productivity.

Secondly, Websense's distribution strategy has ensured that it is front and center in the minds of IT decision makers. The software is accredited for use with products from industry leaders such as Microsoft, Cacheflow, Checkpoint and Cisco. All of these companies implement Websense for clients.

Thirdly, Websense has taken content filtering to a more sophisticated level. Many early attempts by content filtering companies lacked reporting mechanisms which allowed monitoring of an individual employee's use of the Internet. And few of these products allowed the blocking of content based on categories to the same degree as Websense.

While still a relatively small company, Websense's sound business model and understanding of customer needs exemplifies the success stories of the Internet.

Summary

Our first point is no surprise, and almost trite to observe. All of the success stories have strong economics – or, as we like to put it, a cost structure that provides a fighting chance of success. Most Internet companies were based on unsound economics which did not provide a fighting chance of success, no matter how good they were in day-to-day execution. This accounts for most Internet failures.

Secondly, the success stories have made it easy for their customers. Their proposition is always sensible – and because their economics are sound the proposition is sensible for the business too. Many Internet companies placed large hurdles in front of their customers – for example, joining a proprietary B2B exchange with limited flexibility to move. While in reality it is difficult to move from Checkpoint products once installed, this is not a notable feature of the sales process. Many Internet companies tried too hard to lock in a proprietary competitive advantage – and their lack of customers meant they ultimately enjoyed no advantages at all.

Finally, they have all been big in their outlook, but minute in execution. eBay built a community of 35 million users by worrying about what colour to design a logo, or what products to feature in the home page. Websense built software which accurately scoured the web for sites across scores of very diverse categories – no easy task. It is important to note, though, that these companies have displayed one of the most over-hyped elements of the Internet industry: vision. They have seen opportunities which were not readily apparent a few years ago and built substantial businesses. Their success has

been somewhat obscured by the litany of failures – but their success is very relevant to all businesses, and certainly worth noting.