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Bubble 2.0

Sep 22nd 2005 | NEW YORK
From The Economist print edition

A spate of expensive internet deals is creating a sense of déjà vu

NASTY memories have been stirred up by this week's reports that Microsoft is in talks to buy a big stake in America Online. After all, the last time that AOL was involved in a big deal—its $150 billion acquisition of Time Warner, a media giant, in January 2000—it soon came to symbolise the madness of internet-company valuations, during the turn-of-the-century dotcom bubble. Nobody expects Microsoft to repeat the near-suicidal folly of Time Warner. But if there is any truth to market rumours that its purchase will value AOL—now a shadow of its old self—at over $20 billion, or about $1,000 per AOL subscriber, then the deal would certainly fuel fears that irrational exuberance is returning to the pricing of internet-related firms.

A Microsoft stake in AOL—which it would merge with its MSN portal—would come hot on the heels of last week's purchase of Skype, an internet-phone company, by eBay, an internet-auction site. There is no doubt that there is huge commercial potential in internet telephony. But how that potential will come to fruition—and whether Skype will be the company that benefits—are very much open questions. Look at the raw numbers, and this seems like a deal with strikingly bubble-era economics: a price of at least $2.6 billion for a loss-making firm with unlimited ambition but expected revenues this year of only $60m.

Such a high price is hardly unique. Among other richly priced deals contributing recently to the bubbly mood are Barry Diller's IAC/InterActive's $1.9 billion acquisition of Ask Jeeves, a search engine, in July; News Corporation's purchase ofIGN, a video-gaming site, this month, and Intermix Media, a social networking site in July, for a combined $1.2 billion; and Yahoo!'s $1 billion purchase in August of a stake in Alibaba.com, a Chinese internet site that actually prides itself on its lack of a clear business model. Speculation that they will be gobbled up next has lifted shares in several other internet firms, including The Knot (an online wedding planner) and CNET Networks, a news site—both up by over 50% in the past six months.

“The Skype deal is absolutely a return to the 1999 mentality,” says Pip Coburn of Coburn Ventures, a technology-strategy firm. It and many of the other recent and mooted internet deals seem to be based on little more than the belief of management that everything is going to change dramatically in the next few years, in highly unpredictable ways, and so all options need to be covered. Given that mentality, says Mr Coburn, a manager “can pretty much justify paying any price”.

Valuing a firm is tricky at the best of times (as is making a success of a merger), but it is especially hard for a young firm. The rationale of Rajiv Dutta, eBay's chief financial officer, for the firm's valuation of Skype does little to inspire confidence. He first compared Skype with eBay's previous biggest acquisition, of PayPal, an online payment system that is not obviously comparable to a phone service (and which, unlike Skype, eBay knew intimately before the acquisition). PayPal cost 8% of eBay's market capitalisation in October 2002, said Mr Dutta, whereas Skype cost only 4.8% of eBay's current market cap. But is that the right measure? Skype's revenue growth in the 12 months in which it has charged for some of its services, he noted, was faster than eBay's at a similar stage in its development. Again, why is this relevant? Skype and eBay have completely different business models. Finally, its current losses notwithstanding, Mr Dutta thinks that Skype will have a long-term operating-profit margin of 20-25%—apparently for no other reason than that eBay also assumed that PayPal would achieve that same margin.

While Skype and eBay may yet develop lucrative synergies, the deal does not impress Hal Varian, an economist at Berkeley and co-author of an influential book, “Information Rules: A Strategic Guide to the Network Economy”. Skype's technology is not hard to replicate, and internet telephony is becoming highly competitive, he says. Skype's founders, Niklas Zennstrom and Janus Friis, were smart to take the money—just as earlier AOL's then boss, Steve Case, was wise to exchange AOL's hugely overvalued shares for Time Warner's undervalued old-economy assets.

Déjà vu or not, even the greatest pessimists do not think that history is simply repeating itself. Share prices today are nothing like as crazy as they were in 2000, at least in America. (To relive the full dotcom bubble experience, try China instead, where America's erstwhile “internet queen”, Mary Meeker of Morgan Stanley, has just been anointing her local favourites.) American investors no longer have much appetite for initial public offerings of shares in firms with nothing more than a bright idea and half a business plan. The price-earnings (p/e) ratios of shares in some of the best-known internet firms are certainly sky high—Google's is 90, and eBay's is 54, compared with a p/e of 18 for the Dow Jones average. They need to boost profits spectacularly to justify these prices;

but at least nowadays there are lots of earnings to include in the p/e ratio.

Google is so highly priced in large part because of its mastery of one of the few truly profitable internet business-models: the sale of effective online advertising. But its striking success is alerting rivals to the dangers that Google and other peddlers of online advertising pose to their businesses—which is prompting them to explore how to fight back, which in turn could hurt the now thriving firm's profits, and expose any overvaluation.

Newspaper, television and radio companies, for instance, have all recently started to understand the threat posed to their traditional advertising revenues by online advertising. A speech by Rupert Murdoch earlier this year on the need for media firms to embrace the internet showed that the industry is not willing to give in easily to its new enemy. The traditional telecoms and cable companies have also started to wake up to the potentially massive threat posed to their revenues by cut-price internet telephony of the sort offered by Skype. They, too, are looking for ways to fight back.

As these industries and firms collide, it is far from clear which firms will emerge on top, and how profitable they will be. That makes valuing their shares extremely hazardous. In January 1999, asked to sort out the hype from the fundamentals in internet shares, Alan Greenspan, the chairman of the Federal Reserve, compared owning shares with buying a lottery ticket. Each share had a small chance of securing a great reward, but a high probability of failure. “What lottery managers have known for centuries is that you could get somebody to pay for a one-in-a-million shot more than the value of that chance,” observed Mr Greenspan. Hence, the more volatile the business outlook, the more likely “you will get a lottery premium in the stock”.

One difference between today and the late 1990s is that today many of the fancy prices of internet firms are being paid by companies buying them, rather than by investors merely buying their shares. Their motives are understandable: to protect themselves from the potential risks and position themselves for the potential rewards of a maturing internet. What remains to be seen is how much some of these embattled firms will pay in their pursuit of the winning lottery ticket.