Knee et al. (2009)
"The Curse of the Mogul"

5 The Internet Is Not Your Friend

If you ever have a hankering to get under a media mogul's skin, suggest that he is in the "old media" business and that the future lies in new media, as epitomized by the Internet. It is poignant to hear the desperation in media moguls' protestations that they are not yesterday's news. "Clearly the new media businesses seem to have more sex appeal than the old media businesses," observed Robert Iger shortly after taking the helm as CEO of Disney in 2005. "My goal is not to be treated like an old media company."[1] There is something cringe inducing—like when one's grandparent uses modestly contemporary slang in order to establish "street cred"—in these forceful assertions of continuing relevance.

Given our focus on whether a particular business has barriers to entry, it will not be surprising that we are not quite as preoccupied with whether media is old or new. But because of the overwhelming focus of moguls, investors, and the public on this topic, in this chapter we examine in more detail both the impact of the Internet and digital distribution on other media businesses and the strength of various Internet businesses themselves.

It is worth noting at the outset that there is something increasingly artificial in the new-media versus old-media distinction. If the birth of the commercial Internet era is dated from the 1995 IPO of Netscape, the medium is now well into middle age or at least past puberty. Although new, unproven Internet businesses continue to emerge whose aim is to undermine some existing established media franchise, today it is not unusual for that targeted established franchise to itself be an Internet company.

Let's look at Monster.com. Established in 1994, and employing essentially the same employer-advertising business model as the newspapers from which it has taken market share, the company quickly became the largest online destination for job search and employment classified advertising.[2] But, over the last decade, Monster understandably has attracted dozens of competitors. Other broad-based online employment sites like careerbuilder .com, owned by a consortium of affiliated newspapers, and hotjobs, a venture-backed competitor that was purchased by Yahoo in 2002, go head-to-head with Monster for the same customers. In addition, niche businesses like Dice .com, a recruitment destination for technology professionals, have been able to establish leadership positions in those narrower areas of focus. Finally, dozens of emerging companies employing a variety of different business models and technologies—ranging from a subscription service for high-end job seekers in the case of TheLadders.com, a referral service among like-minded colleagues in the case of LinkedIn, and a Web crawler that aggregates the listings of all the other services in the case of SimplyHired—have collectively begun to have a meaningful impact on the marketplace.

At this point, is Monster new media or old media? More important, is this even the relevant question?

The concept of competitive advantage applies only to *incumbent* businesses. How could a new entrant have a barrier to entry if it hasn't entered yet? "The existence of barriers to entry means that incumbent firms are able to do what potential rivals cannot. Being able to do what rivals cannot is the definition of a competitive advantage."[3] Monster, then, was a new entrant but became, as all successful new entrants do, an incumbent. As we turn to examine the impact of the Internet on the media environment, we would propose to dispense with the unhelpful new-media/old-media distinction and focus instead on the more germane entrant/incumbent distinction in conjunction with our framework for analyzing competitive advantage.

One objection to this approach may be that it discounts any number of potential entrant advantages frequently found in the new-media environment. The old-media incumbent may be saddled with an expensive physical infrastructure or labor costs and it may need to support a line of decaying legacy products and services. Furthermore, the entrant is likely not to be encumbered with the cultural baggage of the lumbering old media giants. More concretely, the nimble entrant may have developed exciting new technology, product design, or marketing materials to exploit the inability of the incumbent to react quickly.

One of the lessons of the original Internet boom is that the ability to harm an incumbent business does not in itself suggest an ability to sustain an attractive alternative model. Of the thousands of new media businesses that did some damage to the established media franchises, remarkably few have survived. Where there are incumbent disadvantages, there will certainly be new entrants. But if all potential new entrants share exactly the same advantages vis-à-vis the incumbent but no such advantages vis-à-vis one another, none really has any sustainable advantages at all. The entrant will barely have had time to savor its "success" at outmaneuvering the old-media barons before realizing that it must contend with all newcomers who want to get in on the act. Once a firm manages to enter the market, it has become an incumbent and will thrive or flounder based on the same laws of competitive advantage.

A company's perspective on the impact of the Internet depends significantly on whether it is an incumbent or a potential new entrant. In examining the Internet, then, we will consider separately the impact on incumbents on the one hand and the ability of new Internet businesses to actually establish their own defensible barriers to entry on the other.

THE INTERNET AND THE INCUMBENTS

To hear media moguls explain it, the advent of the Internet was the best thing for them. Their arguments have come in three related flavors.

First, the Internet is growing, and since all of their existing businesses have some digital manifestation or other, the net impact on their overall business will be to hasten growth. To the extent that there are new, independent, growing Internet businesses, these will likely be new customers who need the incumbent's content or expertise to support their growth, which will in turn further accelerate the incumbent's own growth. "As far as we are concerned," asserted Rupert Murdoch confidently, "the Internet is broadening our opportunity, as well as for other big media companies with huge resources in sports, entertainment and news. There's just more opportunity."[4] CEO Robert Iger similarly sees only upside from the emergence of Google, a company with many times the market capitalization of Disney. "I'm not worried about Google cannibalizing our advertising," he said. "Google's search capabilities are more important to us because they will drive consumers to our companies."[5]

Second, incumbent competitive advantage is transferable to the new medium. The brands, customer relationships, and content that support their existing businesses will create a barrier to others online as well. "The days of old media and new media are over," CBS CEO Les Moonves said confidently. "Now, it's just media."[6] The idea is that distinctions between old and new are artificial, the latter simply representing a seamless transition from the former, and that the basic rules of the game have not changed.

Third, the Internet will allow media companies to do what they were doing before but at much higher profitability levels. By reducing the cost of production and delivery, the theory goes, incumbent media companies will be able to grow margins as they shift product from the off-line environment to the online. Rupert Murdoch has been quite specific about the net impact on profits: "We are going to be seeing more [profits] in newspapers coming out of electronic delivery. The film industry may find that . . . the way it distributes films change[s]. It's going to force a lot of change in the business models. But the absolute demand for content won't change. We believe that puts us on the eve of a new era of opportunity."[7]

As reasonable sounding as these platitudes may be, they do not stand up to close scrutiny. Even if the Internet were a source of overall net top-line growth to the incumbent media companies—and all evidence is quite to the contrary—this begs the fundamental question of whether this would represent profitable growth. There is also little evidence that the incumbent media companies are the major source of the content consumed on the Internet. Indeed, user-generated content rather than mogul-generated content continues to be the fastest-growing category in the medium.[8] Take a look at YouTube's "most viewed" videos screen on any given day and you are likely to see that well over half of them represent user-generated content—and even that minority contributed by Google "partners" is not predominantly from the large media conglomerates. Only 4 percent of the clips on YouTube have been posted or approved by media companies.[9] More broadly, two-thirds of Internet users are spending their time on social networking sites.[10]

This perspective is consistent with the lopsided nature and modest scale of the revenue-sharing agreements that have been negotiated between digital media companies and the incumbent media conglomerates. iTunes may be very successful for Apple, but Apple manages the business to maximize sales of hardware, not revenue to media companies. So although the revenue split of 70/30 in favor of content providers sounds generous, Apple will not take videos unless providers agree to the very low and simple pricing policy they enforce.

With all of YouTube expected to generate barely $200 million of advertising revenues for Google in 2008,[11] it's safe to assume that the revenue available to media companies that together make up a small portion of YouTube's video inventory and usage is insignificant. Celebrity gossip columnist Perez Hilton, one of YouTube's original content "partners," reportedly received $5,000 in ad-sharing revenues during a three-month period in which his popular videos were viewed 25 million times. "Fuck you, YouTube. Fuck you," Hilton proclaimed in his farewell video.[12] Although media companies have belatedly rallied around Hulu as their official Internet venue of choice for video, the jury is very much out as to the potential size and profitability of this venture.[13]

Furthermore, the preexisting assets of incumbent media companies may be central to their homegrown Web properties, but there is no indication that this has served as a meaningful barrier to entry for competing Web businesses. And although the incumbents benefit from the cost reductions made possible by the Internet, on a relative basis, potential new entrants benefit even more. The source of economies of scale in media as elsewhere is the fixed cost nature of the business, which is reduced by precisely the cost phenomenon touted as a "benefit" by incumbents. In vertical after vertical we see the owners of the leading off-line brands unable to dominate the online medium and often they do not even have the leading position—for example, The Knot owns the online bridal category, while Condé Nast dominates the off-line world with *Bride's*, *Modern Bride*, and *Elegant Bride* magazines. The conglomerates certainly have the cash to buy the successful upstarts—as Disney did with Club Penguin, an online virtual world for kids—but then they have to wonder: Who will come next?

When one stands back and considers the impact of digital distribution on each of the specific sources of competitive advantage, not just economies of scale, the conclusion is the same: The Internet may be somebody's friend—most notably, the consumers of media—but it is not the friend of incumbent media companies. For the incumbent, any benefits from the Internet on either the cost or new revenue opportunity side are overwhelmed by the damage done by the lowering of barriers to entry.

We can identify no incumbent media businesses for which the introduction of the Internet strengthened a preexisting competitive advantage[14]—much less one in which the Internet, like a talisman, established an advantage where none previously existed. The case of the impact of the Internet on the newspaper industry is instructive in this regard. Newspaper executives initially claimed that the Internet would serve as a boon to them. "It's wonderful,"[15] exulted *New York Times* chairman Arthur Sulzberger when asked in an interview how the Internet would transform the economics of the business.

TABLE 5.1 Impact of Digital Distribution on Competitive Advantage

	Sources of Competitive Advantage			
	Scale	Customer Captivity	Cost (Proprietary Technology)	Government Protection
Impact of Digital Distribution	Available to more, sooner and cheaper	Lowers switching costs	More ephemeral than ever	You can still hire a lobbyist

All the basic arguments proffered in favor of the supposed benefits of the Internet should have applied to newspapers in spades. Daily newspaper circulation had been in decline since the late 1980s, while readership had been falling at least since the early 1960s,[16] so this sexy new medium seemed to provide a powerful tool to reverse these trends. The newspaper local advertising sales force or content collection could not be easily replicated, so Internet sites would need to either buy from or otherwise rely on the newspaper for its content and infrastructure. The newspaper itself would keep the best of this for itself, however, becoming the leading online source not only of news and information but of the fast-growing Internet classified businesses and a wide variety of potential transactional business that was previously out of the question. Best of all, over time, this industry, weighed down by the cumbersome business of actually printing a daily paper and driving the copies around in trucks for delivery—activities that were overwhelmingly in the grip of powerful unions and, on occasion, less savory elements of commerce—would free itself of these costly and inherently inefficient activities.

It didn't turn out that way.

The dawn of the modern newspaper industry in a sense coincides with the birth of the television industry. In earlier times, a major urban market could support literally dozens of newspapers, each with its own voice targeting its own demographic, political, or social-economic niche. With the adoption of television as a ubiquitous mass medium through which advertisers efficiently achieved coverage of an entire locality, there was simply not enough revenue left to support a multitude of newspapers.

Newspaper production has relatively high fixed costs. Because of the high volumes produced daily and the importance of timely arrival, the newspaper industry is one of the last publishing businesses to own and operate its own massive printing operations, rather than outsourcing this function. A state-of-the-art, color printing facility capable of producing a major market daily requires hundreds of millions in up-front investment. Furthermore, the infrastructure required to physically deliver the newspaper each day to subscribers and newsstands is substantial, as is the critical mass of salespeople needed to cover all the categories of potential advertisers in a locality.

As the economic realities of the new local news order took hold, it became clear that the surviving newspaper in each jurisdiction would be the one with the greatest reach across which to spread these fixed costs. The key to achieving a mass audience is to offend as few constituencies as possible. The result was a massive rush to the middle, with newspapers confining their viewpoint to a few slim editorial pages and the balance of the paper devoted to more anodyne "objective" reporting of the day's events. Journalists who cling to the notion of this style of reporting—which is a peculiarly American phenomenon—as stemming exclusively from high-minded professional values rather than economic realities generally have no sense of this historical context.[17]

When the smoke cleared, the last newspaper left standing in each market was an awesome business. Well-managed newspapers in small or midsize markets could achieve profit margins well in excess of 30 percent. In major metropolitan markets, even with higher labor and associated costs, on the one hand, and a variety of free or targeted local niche competitors, on the other, profit margins were comfortably and consistently above 20 percent. To understand what brought this happy state of affairs to an abrupt end we need to follow the money.

Newspaper revenues come overwhelmingly from advertising. On average less than 20 percent of newspapers' top line comes from readers actually buying copies of the paper. Most of the rest is represented by various forms of advertising: Local retail advertising is the largest single category, classified advertising (made up predominantly of help-wanted, auto, and real-estate classifieds) follows, and national brand advertising rounds out the picture. But from a profit perspective, all advertising is not created equal. Although classified advertising, even at its pinnacle during the dot-com boom, represented less than a third of newspaper revenue, it has long been responsible for well over half of the profit.

What made classified advertising so different? If you were looking to sell your house or your car, how else could you get the word out effectively? Other kinds of advertisers might use direct mail, TV, or radio, maybe put up a billboard or take out space in the yellow pages. But for an individual with a single item to sell quickly, none of these came close to the impact of a tiny classified advertisement in a daily newspaper. Newspapers, as a result, could charge extraordinarily high rates for a few well-chosen words buried in the classifieds. In addition, unlike other advertising, no sales force is needed. Just someone to take the call and jot down what you want to say—along with your credit-card number. Think they are charging too much or annoyed that the person who answered the phone was rude or misspelled words in your ad? Get over it. You had no practical alternative. And at those prices and that cost structure, the publishers were laughing all the way to the bank.

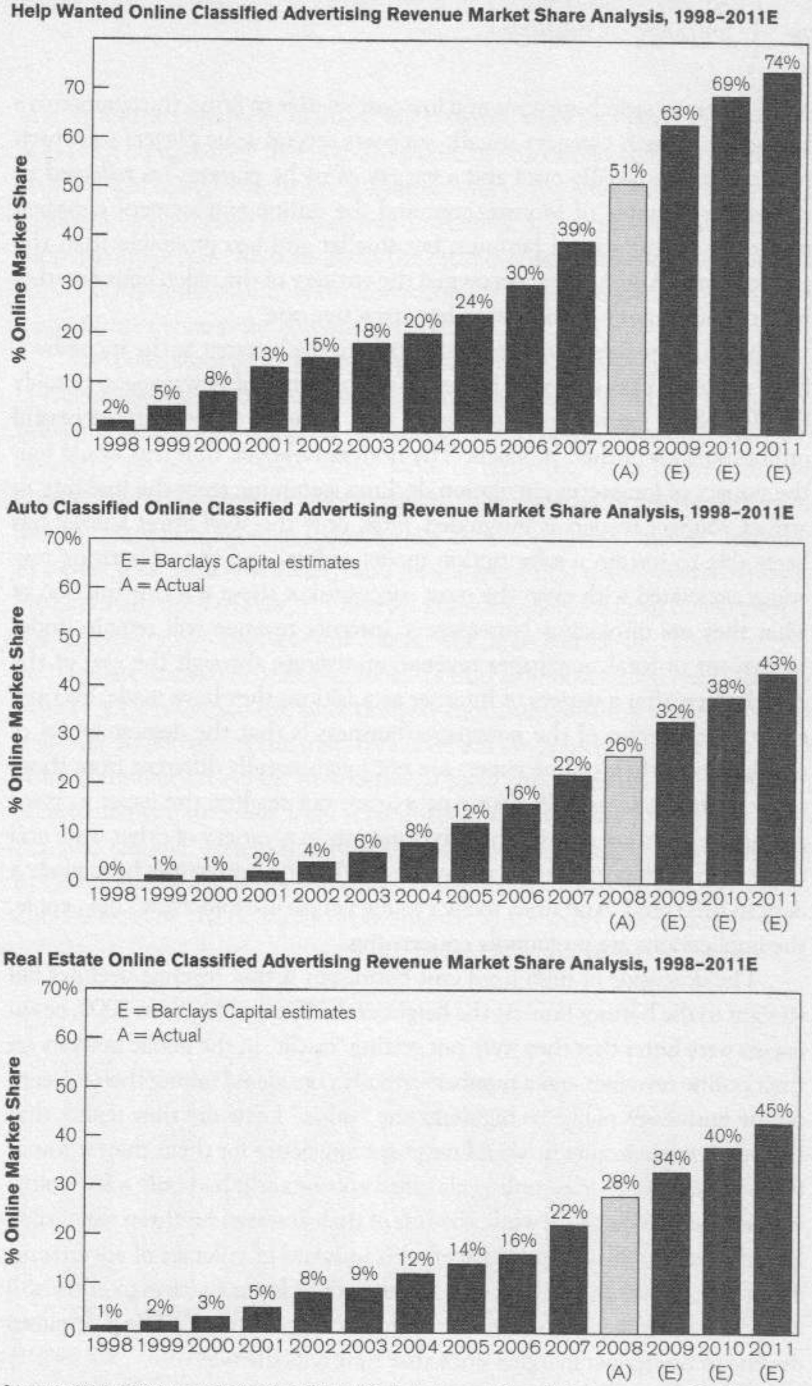
There is something counterintuitive about the notion that these oft-ignored small-print pages at the back of the paper constitute the financial heart of the great newspaper franchises. Surely it is great journalism that is the lifeblood of great newspapers. And at some level this is true: Without readers, there will be no advertisers of any kind. But the scale nature of the business was such that, as a practical matter, no serious competitor could profitably launch an alternative, so publishers had a huge amount of discretion as to what stories to run in the paper without posing a risk to the franchise. With plenty of money to go around, editors and journalists were largely left to their own devices. They have written many fine articles that may or may not have been of great interest to their core audience—studies have consistently shown readers are overwhelmingly focused on more mundane topics like local community events[18] than those favored by graduates of journalism schools—even as readership has been in consistent decline since the 1960s. Such was the power of the core business engine fueled by classified advertising, however, that circulation declines were easily more than compensated for by advertising rate increases. Why rock the boat?

Then came the Internet. The first killer moneymaking application of the net was classified advertising. Although there are certainly Internet content businesses, the core power of the medium relates to its extraordinary packaging capabilities. The online environment lends itself to easily searching a database for products and services with the specifications desired. And with none of the fixed cost infrastructure requirements of a newspaper, Web sites dedicated to every conceivable category of classified advertising emerged.

The cost of placing an online listing was a fraction of the print version (or actually free in the case of craigslist). Newspapers were well positioned to compete in this world, but in their own world they hadn't really had to compete at all. And the last thing they wanted to do was trade in high-priced print advertisements for low-priced online ones. So many newspapers set up a Web site and either gave away an online ad "free" with a print ad or up-sold a low-priced online ad with the high-priced off-line one. Very few initially offered an "Internet-only" option.

In the off-line world, newspapers had well over 90 percent of the classified advertising pie, with a smattering of free apartment, home, or automotive "shoppers" representing most of the balance. In the online world, the newspaper might be the leader in some categories and not in others, but the competitive landscape and relative shares were both constantly shifting and difficult to track. The huge price differential between online and off-line classified advertising ensured that it would take time before online would take a significant share of the overall revenue pie, even as it undermined the pricing flexibility of print classified advertising. But in the last decade the share impact has been dramatic in all the key classified categories.

If the newspapers had been less reactive and more aggressive in pursuing the online opportunity, it might have had an impact on their ultimate share, but it would not have altered the structural dynamics of the industry. There are some network scale economies of online classified businesses, but because



Sources: NAA, Forrester, and Barclays Capital. Craig Huber and Greg Stein, "Newspaper Fact Book, April 2009," Barclays Capital.

FIGURE 5.1 Online Classified Advertising Revenue Market Share of the minimal switching costs and low cost relative to print, the competitive landscape in each category usually supports several scale players (of which newspapers are usually one) and a variety of niche players—as reflected in the earlier example of Monster.com and the online employment classified market. It is still a good business, but smaller and less profitable than the previous one. And newspapers owned the entirety of the older, better market but are one of many in the newer, less attractive one.

None of the other supposed benefits from the Internet to the incumbent have come to pass either. It is true that a number of newspapers, notably the *Wall Street Journal* and *New York Times*, have developed very successful online versions of their products. The notion, however, that this would halt the impact of long-term circulation declines stemming from the inability to attract younger readers is misguided. First, only the *Wall Street Journal* has been able to sustain a subscription model online, and the advertising revenues associated with even the most successful of these is a tiny fraction of what they are displacing. Newspapers' Internet revenue will remain under 10 percent of total newspaper revenue on average through the end of the decade even after a variety of Internet acquisitions they have made. Second, a dirty little secret of the newspaper business is that the demographics of the readers of their online papers are not meaningfully different from those of their off-line versions.[19] Young people are not reading the paper in print or online. They are getting their information in a variety of other ways and there is no evidence that any newspaper's Web-savvy strategies have made a dent in this trend. And since today's young people are tomorrow's old people, the implications are profoundly concerning.

The downside of high fixed cost businesses is that revenue declines fall straight to the bottom line. At the height of the Internet boom in 2000, newspapers were bitter that they were not getting "credit" in the public markets for their online revenues and a number seriously considered taking their nascent online businesses public to highlight the "value." Little did they realize that the business environment would never get any better for them than it was at that very moment—new online classified entrants still had only a few points of classified market share while the rest of their Internet brethren were using IPO proceeds to fill the print paper with unheard-of volumes of advertising. The point is that in the long run, the impact of lower barriers to entry will always overwhelm any cost benefits or growth opportunities. The precipitous decline in newspaper margins since that time tells the tale.

What does all this mean for our theory of the structure of competitive advantage generally and the future of the newspaper business specifically? The emergence of digital distribution did not eliminate significant economies of scale for the newspaper business, but it significantly lowered the barriers for non-print competitors. In a post-TV world, most local markets could support only a single newspaper. In a post-Internet world, the emergence of non-print competitors has raised the question of whether any print newspaper can be supported in certain markets given the fixed cost requirements. A number of papers both domestically and internationally have already announced the suspension of their print editions altogether.[20]

The precipitous drops in newspaper profit margins reflect both the extent of the change in the industry structure and the extent to which their managements were poorly equipped to respond. When margins are high, the hard questions are often avoided. What kinds of reporting, for instance, are true competitive advantages for a local paper? How many such newspapers really add anything distinctive to international or national news. Indeed, in a state like New York, with almost fifty daily local papers, how many separate Albany bureaus really need to exist?[21] There are three arguably national newspapers in the United States—the *New York Times*, *Wall Street Journal*, and *USA Today*—and they are among the least profitable. The other almost fifteen hundred daily papers (not to mention the more than six thousand weeklies) which represent well over 90 percent of the industry's revenues are local or at most regional.[22] From a content collection perspective, a local paper has scale advantage in dominating the intensely local scene—high-school sports, local crime, politics, and schools. This may not be what the journalists are mostly interested in covering, but if print newspapers are to survive, it will be through single-minded focus on the only area of coverage in which they have an advantage.

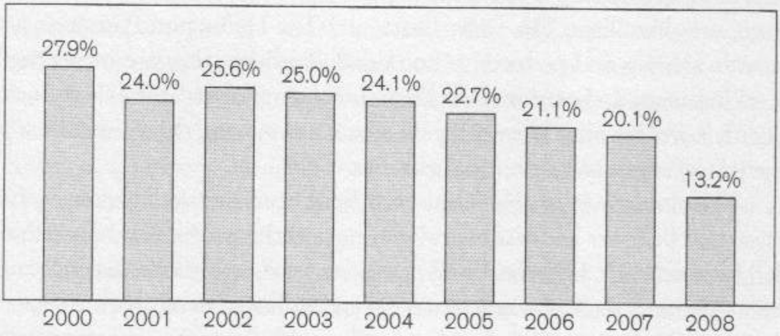


FIGURE 5.2 Newspaper Margins

Sources: Barclays Capital Newspaper Factbook (November 2008); Deutsche Bank Research Estimates, Company Filings.

Note: Includes Belo/A. H. Belo, Dow Jones, E. W. Scripps, Gannett, Knight Ridder, Lee, McClatchy, New York Times, Tribune, and Washington Post.

Becoming more responsive to the needs of the local audience is only part of the restructuring newspapers need to operate more efficiently. The biggest operating costs of a daily newspaper are on the production and distribution side. The cost structure of a newspaper is more reminiscent of a manufacturing business than a media business. It is the high fixed cost nature of this part of the business that created the barriers to entry in the first place. But just because these fixed costs represent a barrier to entry doesn't mean that the business was operated efficiently. Given that these media companies did not operate the news and content operations efficiently, it should not surprise anyone that their production and distribution operations are less than stellar. In theory, a newspaper could optimize this infrastructure by going aggressively into the third-party commercial printing and distribution businesses. Indeed, most newspapers do some of this. But there are other businesses that specialize in these areas that do this sort of thing far better. Increasingly, you are seeing major newspaper publishers—like Hearst outsourcing the printing of the venerable *San Francisco Chronicle* to Canadian printer Transcontinental—saving tens of millions by outsourcing these functions.[23]

Many who benefited from the easier life associated with the old economic order decry the "death" of newspapers. But what they are really decrying is the unpleasantness of facing real competition for the first time. The competition is not only from online classified sites but from local niche news, community sites, and even local user-generated blogs that provide alternative sources of information. The Internet has made it cost-effective for others beyond print newspapers to share their perspective on, and information about, the local scene. The local media environment in a sense will return to the era before television, when many voices are heard. Even in the national or international stage, sites like Slate, The Daily Beast, and The Huffington Post don't just provide analysis and perspective not found elsewhere, they are increasingly breaking news. Industry insiders know how many news "stories" are really slightly rewritten press releases. In the new environment, this cannot be supported any more than reportorial ego trips.

The newspaper of the future will have competitive advantages, but these will be fewer and less overwhelming and the product and operations will look radically different. Local newspapers will get their scale economies from their sales force and news coverage and will need to rely on the responsiveness of their content to their local audience's interests to secure customer allegiance. National or regional papers have always had fewer competitive advantages and may need to develop both more differentiated content and a more distinctive editorial voice to attract or even maintain a loyal readership. The fact that the highly opinionated and purely online Huffington Post recently raised equity at valuations greater than the equity of many public newspaper companies today is potentially suggestive of how the nature of newspaper content in general is likely to shift over time.[24]

In international trade, the theory of comparative advantage explains why all will be better off if countries focus on what they are best at in combination with unfettered exchange among themselves. An analogous theory is that the Internet will result in a broader and deeper reservoir of ideas for the public by virtue of the increased specialization of news providers, both online and off-line. There are some legitimate alternative theories and arguments about whether society is better or worse off without a single powerful local voice in the form of the dominant daily newspaper. There are no legitimate arguments, however, to support the notion that the Internet has helped the owners of these newspapers.

THE INTERNET AND THE ENTRANTS

For the new entrant the Internet would appear at first blush to represent a potential boon. Yet the same qualities that create opportunity for a new entrant where they previously did not exist make it difficult, if not impossible, for that new entrant to maintain barriers against the others who will surely follow. This is not to suggest that there can be no successful Internet businesses with sustainable barriers to entry. It does suggest that, if anything, establishing successful online businesses is harder, not easier, than establishing off-line businesses. And the rate of failure of these ventures is consistent with this view.[25]

Ironically, many of the qualities of Internet businesses that are viewed as particularly attractive are the qualities that make enforcing barriers to entry so challenging. Precisely because the fixed costs required to launch an online business are so low, it is difficult to achieve economies of scale. Precisely because Internet businesses are growing so fast, the benefits of any customer captivity are limited because so much of the customer base is new. The obvious convenience of Internet access and ease of navigation from site to site also undermine captivity.

Unfortunately for their investors, many executives have allowed the allure of high growth and an apparently efficient business model to cloud their strategic judgment when it comes to the Internet.

Let's take the case of comparison shopping sites. Almost all manufacturers of consumer products have their own Web sites through which they sell an increasing portion of their products directly to consumers. Retailers now also offer their full line of products to the public through their Web sites. The sites for obvious reasons do not encourage users to compare their prices with those of their competitors. It did not take long for Internet entrepreneurs to fill this gap by creating sites that would enable such a comparison across the Internet.

Given the trends of Internet usage, the Internet shopping engines experienced explosive growth even after the bursting of the Internet bubble. In addition, the capital required to launch such a business is minimal—developing a user-friendly interface on top of a search engine tailored to this purpose is not a complicated assignment. The search engine could be developed in-house or the basic technology licensed from any number of sources and then customized.

Unlike an off-line retailer, the comparison shopping engine makes money from delivering traffic to other Web sites where the transaction occurs rather than directly selling merchandise. But just as a manufacturer generally has an incentive to make its product ubiquitously available through the maximum number of potential retail outlets, e-commerce sites want traffic from as many different sources as possible. In both cases it is unusual for the source of "inventory"—whether the product itself or the online offer—to make it available exclusively through a single outlet. And not surprisingly, such exclusive arrangements, when available, come at a cost that fully compensates the manufacturer or e-commerce site. Creating sustainable, meaningful distinctions among participants, particularly in an online environment where the lowest price rather than the "shopping experience" is usually dispositive, is extremely challenging.

Shopping comparison sites have competition not only from the Web sites of the retailers and manufacturers but from various broad-based e-commerce sites like Amazon.com or even eBay. Furthermore, the giant competitors in terms of delivering traffic to other sites are the broad-based search engines like Google and Yahoo.

The sheer number of these shopping engines made it seem unlikely that any had a true sustainable competitive advantage. Although each boasts a unique "pitch" for being somehow distinctive and the "leader," at the end of the day they all do largely the same thing. It is hard to argue that there are high barriers to entry when people just keep entering. More broadly, the economics of the retail business in the off-line world are notoriously difficult, with even market leaders struggling to achieve double-digit operating margins. In the online world, with greater transparency to both the consumer and the retailer/manufacturer, one would imagine that long-term margins would be worse, not better. It is much easier and more likely to run a search on another site than to walk across the street to compare price. In summary, it is hard to imagine a business less likely to achieve a sustainable competitive advantage than comparison shopping sites.

During the first Internet boom, a number of overvalued companies overpaid for comparison shopping engines, to their ultimate embarrassment. CNET, for instance, bought a site called MySimon.com for $700 million in 2000. CNET had gone public in 1996 as an online technology information portal. At the time of the acquisition, MySimon.com was "a leading comparison shopping service on the Internet." The justification for the deal, according to the MySimon.com CEO, was that "CNET brings unparalleled experience in integrating content, community and commerce to help us create the shopping category killer."[26]

MySimon is no longer a significant player in the online shopping arena. Indeed, CNET's own business description in its last 10-K filed before its acquisition by CBS in 2008 does not even mention MySimon under either the list of "major brands" in its portfolio or even its itemization of "other brands" beyond the leading ones.[27]

Despite this track record and the structural industry characteristics, just a few years later, during the space of barely a year between 2004 and 2005, four major but completely unrelated media companies paid between $500 million and $700 million for four different comparison shopping sites with broadly similar characteristics. All the sites were experiencing revenue growth of over 20 percent and had profit of around $20 million, reflecting margins of well over 20 percent. And each of the acquirers convinced itself that these metrics justified paying over twenty times profit.

The good news about these transactions is that, unlike the previous Internet boom, valuations were based on profit rather than eyeballs or some other ethereal metric. If one believed that the current profit margin, market share, and growth trajectory were sustainable, the price paid for these properties would be quite justifiable. But if our analysis of the lack of potential competitive advantage in these businesses is correct, we would expect to see long-term margins very similar to those of off-line retailers and significant continuous movement in relative market share. Under these circumstances, these properties would be worth a small fraction of what was paid for them. The brief history of these transactions confirms our view of the fundamental nature of these businesses.

What is most striking about the miniboom of ill-advised comparison shopping deals is that they were undertaken by fundamentally different businesses, each of which was convinced of the strategic nature of the transaction. How likely is it that the same business could be "strategic" to a

2004–2005	Today
Yahoo! / kelkoo — 3/26/2004 (~$575mm) • Top-line growth north of 50% and margins of roughly 30% • Yahoo launched its own site in the U.S. (Yahoo Shopping) and acquired Kelkoo in Europe	Yahoo! / kelkoo • Sold for less than $125mm in November 2008, less than one-quarter of the original purchase price • Revenue growth estimates for Kelkoo over the next few years are less than 5% per annum, and EBITDA margins estimates range from 10% to 20%
SCRIPPS / shopzilla — 6/6/2005 (~$560mm) • Opening line of press release noted that Scripps "was moving to capitalize on the rapid growth and rising profitability of specialized Internet search businesses" • Top-line growth of 30% and roughly 25% margins	Scripps networks INTERACTIVE / shopzilla • Revenue forecast to decline in 2009 with margins less than 20% • The company in 2009 announced its intention to "competitively reposition" Shopzilla in response to poor performance
Experian A world of insight / PriceGrabber.com Comparison Shopping Beyond Compare — 12/14/2005 (~$485mm) • Acquisition rationale in press release was that PriceGrabber (1) operates in high-growth markets, (2) has strong organic growth prospects, and (3) brings potential revenue and traffic synergies	Experian A world of insight / PriceGrabber.com Comparison Shopping Beyond Compare • Terminated unsuccessful sale process in October 2008 after announcing its sale intentions in February 2008 • Research analysts forecast revenue declines over the next couple of years
ebay / Shopping.com — 6/1/2005 (~$480mm) • Topline growth forecast north of 20% with margins of approximately 20%	ebay / Shopping.com • Sharply decelerating traffic and revenue since acquisition, with revenue expected to decline in 2009

FIGURE 5.3 Case Study: 2004–2005 Online Comparison Shopping Acquisitions

diversified entertainment company, an Internet portal, an online auction site, and a credit information company? This suggests that the relentless quest for growth can blind moguls not only to the structural strength or weakness of the business they are acquiring but also to the question of whether these businesses are even relevant to their own operations. The comments of the CEO of Scripps, a small media conglomerate with cable channels, newspapers, and TV stations, at the time of the Shopzilla acquisition reflects this confusion: "In many ways, like our other media businesses, Shopzilla is a content company."[28] If content is king and growth is good, how could he go wrong?

The same fallacies that drew these companies to purchase comparison shopping sites initially attracted investors to Barry Diller's renamed InterActiveCorp, once he sold most of his traditional media properties.[29] The simple notion was that the problem with media conglomerates was that they were "old" media and that the solution was to instead cobble together largely unrelated Internet businesses.[30] The real trouble, though, was that many of the individual businesses purchased, ultimately representing over sixty different brands in at least a dozen different business segments, had no real competitive advantages.[31] Some of the acquisitions were in segments, like online search, where, as we discuss shortly in the context of Google, competitive advantage was possible. But InterActive's chosen vehicle to pursue this business, Ask Jeeves, which was purchased for $1.85 billion in 2005, was hopelessly subscale. Diller has since split the company into five separate entities, which may attract acquirers for the pieces, but unfortunately will do nothing to help the underlying strength of the businesses.[32]

The Internet has not uniformly been a destroyer of media profitability. But the structural attributes of the Internet make the nature of the specific competitive advantages that support sustained superior profitability look somewhat different than they look in off-line media businesses. Where off-line media businesses are more likely to rely on fixed cost economies of scale to support barriers to entry, Internet businesses are more likely to achieve scale through the benefits of network effects. And where attractive off-line media businesses often have high switching costs or other "demand" advantages, Internet businesses are more likely to benefit from the "supply" advantage of proprietary technology that leverages the scale network effects to facilitate continuous technological improvement that other competitors—no matter what their programming skills—cannot match.

The business model of eBay is emblematic of Internet businesses with a sustainable competitive advantage. In general, it is online businesses that successfully draw their sustenance from the ability to quickly attract a critical mass of users to an "exchange" of some kind that seem to be able to create barriers on the Web. But not all exchange-type businesses draw so many users or demonstrate an ability to keep them. What the Internet giveth it also taketh away—the same qualities that facilitate the rapid establishment of critical mass enable an equally precipitous rush for the door. Unless the business establishes another leg to its competitive advantage proposition—whether through proprietary technology, some form of customer captivity, or both—the early venture backers should wait before popping the champagne. Or they should find a greater fool to sell to before it becomes apparent that the early success is not sustainable. This phenomenon is analogous to that which we see in off-line media where fixed cost scale economies are the source of advantage: Unless there is an additional element of advantage, others can eventually catch up.

Any examination of competitive advantage in Internet businesses must consider the elephant in the room: Google. Google's self-described mission of "organizing the world's information" makes clear that it is a quintessential "packaging" business, not a content company. Although Google is the poster child for an Internet business with high, and apparently increasing, barriers to entry, it is such a unique phenomenon that, unlike eBay, we cannot really say that it is emblematic of anything. Although it has not been in operation for all that many years, Google's financial and operating track record is complete enough to strongly suggest the satisfaction of our two-pronged test for the existence of competitive advantage—supernormal returns and stable or growing market share.

TABLE 5.2 Google Financials ($ in millions)

	2004	2005	2006	2007
Gross Revenue	$3,184	$6,139	$10,605	$16,594
Operating Income	$842	$2,017	$3,550	$5,084
Operating Margin	**26%**	**33%**	**33%**	**31%**
ROA			19%	20%

Source: Company 10-Ks.

Google's share of U.S. paid searches has more than doubled over a four-year period, and in 2007, it dominated with a 75 percent share.

Google has created extraordinary value in ways that are not the traditionally accepted avenues of media success, either on- or off-line. The company is considered one of very few, historically, where technology not only supports the business, but defines its strategic opportunities.[33] Although elements of the

TABLE 5.3 Google Share of U.S. Paid Searches

2004	32.8%
2005	46.9%
2006	58.7%
2007	75.6%

Source: http://www.iab.net/insights_research/iab_research/1675/113268.

Google success story are analogous to the success of a number of other media businesses, the collective strength of the franchise is difficult to analogize to much of anything. This very distinctiveness of the Google phenomenon has led many commentators—academics, journalists, bloggers, and even Google itself[34]—to try to pinpoint the origin and nature of Google's "secret sauce."

The quest to identify a single ingredient that explains Google's remarkable results and resilience is itself misguided. Google is the rare company that seems to have strong elements of all three of the most important sources of competitive advantage identified—economies of scale, customer captivity, and cost. More remarkable is that Google displays multiple manifestations of each of these categories of advantage: Google achieves scale both by the relative size of the fixed cost and network effects, it retains customer captivity of both consumers and advertisers because of habit and switching costs, and it secures a major cost advantage through proprietary technology and learning. It is worth examining each of these in some detail to better understand how Google became the shining exception to the media industry rule.

For search users, Google offers results that are superior in completeness, speed, and, most important, relevance to those of other search engines. The technologies that underlie these performance advantages have so far proved impossible for its competitors to replicate. Google's "crawler" programs, which automatically search the Web and download pages to Google data centers, are the product of continuous improvement. Google's technology in this area, which determines the completeness of search results, benefits from both its greater experience—learning-related proprietary technology—and the greater R&D resources Google is able to devote to active pursuit of innovation economies of scale. The same applies to Google's "indexer" programs, which organize the downloaded material into its databases, and the design of the hardware and software of Google's massive data centers. The efficient organization of Google's massive data centers is itself subject to a technology patent. These together account for the superior speed of Google searches. The "query processor," which organizes search results for presentation to users, benefits from similar forces that are especially difficult for competitors to replicate. Because of its greater experience with search behavior and its greater research resources, Google has a significant advantage in customizing the presentation of search results for individual users. And as Google's share of search queries expands, these advantages are enhanced.

Customer loyalty to Google's search engine is a second important factor. In the early days of Internet search, programs were relatively unsatisfactory and were unfamiliar to most Web users. Today, Google works well for most users and almost everyone has experience with search engines. As a result, the receptiveness of users to alternative search engines has been greatly reduced. At the same time, users become more effective at using particular search programs with experience. The potential sacrifice of this experience in moving to a new search engine is a further source of loyalty to Google.

The existence of this large, loyal base of customers is what enables Google profitably to devote more resources to search-related R&D than its rivals. Google's larger user base also reduces its unit fixed costs of promotion, administration, and physical infrastructure, which together with R&D represent the lion's share of its overall costs.

Finally, in search, Google benefits from certain network effects. Because Google's search engine is ubiquitous, new users are likely to be introduced to it and trained to its use, before even learning of its rivals. Portal Web sites are also more likely to use Google because of its strong position with users. These tendencies, in turn, then increase the number of Google users, which is further reinforcing.

In advertising, too, Google benefits from these same factors of proprietary technology, customer captivity, economies of scale, and network effects. The presentation of paid advertising on Google is determined by algorithms that are based on extensive response experiences and customized for advertising and individual users. The steady improvement in these proprietary algorithms over time has led to both increasing click-through rates for Google ads and steadily higher conversion rates for advertisers from clicks to sales. The latter improvements have, in turn, led to steadily higher key-word prices. In both areas, Google significantly outperforms its competitors, and the gap appears to be increasing over time. As in the case of search technology, Google advertising technology benefits from proprietary learning enhanced by economies of scale in advertising data availability and R&D investments in the active pursuit of improvements.

Although it's impossible to determine where the R&D money is spent—on improving advertising, search, or in some other highly publicized but notably unprofitable areas—the absolute numbers and increasing percentage

TABLE 5.4 Google R&D

	2004	2005	2006	2007	2008E
R&D ($ in millions)	$225	$484	$941	$1,550	$2,225
% revenue	7%	7.9%	8.9%	9.3%	9.7%

Source: Public filings; Deutsche Bank equity research, July 10, 2008.

of its skyrocketing revenues are noteworthy. The net result is that between 2004 and 2008, R&D expenditures are expected to have increased almost tenfold. Capital expenditures, estimated at almost $3.5 billion in 2008, have grown even faster during this period.

Experience with Google advertising and Google's automated programs for placing ads leads to advertiser loyalty in the same way that experience reinforces searcher loyalty. The magnitude of this loyal customer base means that Google spreads the fixed cost infrastructure associated with its ad sales and placement over far more advertisers than its rivals. Google's unit costs are correspondingly lower. Finally, in advertising, Google benefits from more than just the ubiquity-related network effects that apply to search. For example, its AdSense program, which places ads on blogs and other relatively small decentralized sites, is especially attractive to advertisers because of its wide access to such sites and ability to customize placements based on extensive experience with these sites. At the same time, Web sites are drawn disproportionately to AdSense because that is where the greatest concentration of advertisers resides. This kind of virtuous cycle, reinforced by Google's proprietary technology, customer captivity among both users and advertisers, and traditional cost-based economies of scale in R&D and other areas, suggests that its current economic performance is likely to endure. Notwithstanding the fact that Google founders Larry Page and Sergey Brin's original innovation embodied in their PageRank algorithm is fully available to their competitors.

Despite this clear story about the real sources of competitive advantage, there is an overwhelming sense in press accounts that Google must credit at least a soupçon of its success to the special mogul muscles of Page and Brin. Partly this may be because Google maintains a studied mystique around its business strategies, limiting its public utterance to enigmatic high-level platitudes like "don't be evil."[35] The company discloses only the minimum legally required, carefully guarding as trade secrets not only its software algorithms but the nature and location of its facilities and even the precise responsibilities of its leading executives.[36]

One slightly more specific core notion is a 70/20/10 rule under which 70 percent of workers' time is directed toward search, 20 percent toward adjacent areas, and 10 percent toward completely unrelated realms.[37] In theory, building adjacencies that genuinely leverage an existing competitive advantage to create a new franchise is both attractive in itself and serves to protect the core. In practice, for Google as much as others, the line between the supposedly adjacent and the clearly unrelated can be shifted to justify all manner of empire building. There is little doubt that Google's ability to manifest such a compelling and comprehensive array of competitive advantages is in part a function of the fact that it has focused—as most successful companies in and out of media do—on a highly specialized field. The fact that search broadly conceived turns out not only to be essential for most Internet users but to have remarkably broad application to a variety of tools and services required by enterprises as well explains how the business has become much larger than anyone, including the founders, imagined possible. But this should not distract from the fact that it is the specialization that facilitates the advantages.

Google's efforts to create Internet products that will be used by consumers beyond search (such as e-mail, instant messaging, maps, video, news alerts, shopping, etc.) have been active and extensive, but have not created much, if any, shareholder value. Indeed, it is rather startling just how unsuccessful a broad range of new ventures has been, despite the widespread expectation that these could leverage the Google search franchise.[38] Are Google founders Larry Page and Sergey Brin showing early signs of acting like traditional media moguls and believing that the company's economic engine is based on their personal and unique abilities? To the extent that they do stray from putting their considerable resources into digging the moat of competitive advantage ever deeper, the cost to Google shareholders from unrelated enterprises to which they deploy that genius is likely to be substantial.

The shadow of the Internet colors all conversations about the media industry. As we now turn to the specific dynamics of the individual segments that make up the sector, it should be clear that despite the handful of defensible digital business models that have emerged, this shadow is a dark one. Foundering businesses that embrace the siren song of the Internet as a lifeline do so at their peril. Moguls following this path seem unaware that the Internet can be expected to accelerate their descent into the icy depths of permanent unprofitability. Newspaper executives and analysts, for instance, maintain an obsessive focus on the point in the future when the growth from online businesses will exceed the revenue losses from their print operations. The assumption is that this moment will represent a happy turning point for newspaper publishers. In fact, if anything, it will more likely represent a dangerous point of no return as the benefits of scale and customer captivity become a distant memory.

Chapter 5: The Internet Is Not Your Friend

1. Speaking at Deutsche Bank Securities Inc. Media Conference, *June 7, 2005.*

2. The Monster board was founded as part of a human resources company called Adion owned by Jeff Taylor. Initially the site simply listed job descriptions from its other customers. In 1995, a yellow pages advertising agency founded by Andrew McKelvey in 1967 called TMP (for Telephone Marketing Programs) bought Adion for less than $1 million along with Online Career Center (OCC), a larger Web site started in 1992. TMP went public in 1996 and the two Web sites were merged and rebranded as Monster.com in 1999. After purchasing and divesting a number of other businesses, TMP became a pure online recruitment business and changed its name to Monster Worldwide in 2003. Saul Hansell, "The Monster That's Feasting on Newspapers," *New York Times*, March 24, 2002, p. 1.
3. Bruce Greenwald and Judd Kahn, *Competition Demystified* (New York: Portfolio, 2005), p. 6.
4. Johnnie L. Roberts, "Murdoch's New Groove; A Conversation with the News Corp. Chairman, Who's Emerged as a Leader in Digital Media After Some Smart Bets," *Newsweek*, February 13, 2006.
5. John Consoli, "Disney's Iger: No AOL Bid; CEO Says Search Engines Are His Company's Allies," *Adweek*, March 12, 2008.
6. Jefferson Graham and Michelle Kessler, "Question: What Are These? Answer: They're All Media Players; Video Leads the Parade as Old Media and New Media Hook Up," *USA Today*, January 8, 2007, p. B1.
7. Roberts, "Murdoch's New Groove."
8. See Paul Verna, "User Generated Content: Will Web 2.0 Pay Its Way?," *eMarketer*, June 2007. Projects worldwide user-generated content advertising to grow from $1.6 billion in 2007 to $8.2 billion in 2011.
9. Kevin Delaney, "Google Push to Sell Ads on YouTube Hits Snag," *Wall Street Journal*, July 9, 2008, p. A1.
10. August 2007 Comscore data shows 118 million unique visitors to social networking sites out of a total of 181 million total U.S. unique visitors, which is representative of recent trends.
11. Delaney, "Google Push to Sell Ads on YouTube Hits Snag."
12. Daisy Whitney, "Perez Hilton Pulls Videos from YouTube," TVWeek.com, December 20, 2007.
13. Ronald Grover, "CBS: Outside the Hulu Huddle," BusinessWeek.com, May 4, 2009.
14. A possible exception to this is the billboard industry discussed in chapter 7.
15. Michael Schrage, "Arthur Ochs Sulzberger Jr.," *Adweek*, June 28, 1999.
16. The Newspaper Association of America Web site has most of the key historical data at www.naa.org.

17. Jonathan A. Knee, "Should We Fear Newspaper Cross Ownership?," *Regulation*, Summer 2003, p. 16.
18. *2006 Pew Research Center for the People & the Press News Consumption and Believability Study*, p. 28.
19. Interview with senior national newspaper executive. According to the Pew Center study, "people ages 50–64 are just as likely as the youngest cohort to read online newspapers." *2006 Pew Research Center for the People & the Press News Consumption and Believability Study*, p. 20. The issue is that only 29 percent of those eighteen to twenty-nine years old read a newspaper in any medium and this percentage has not changed for a decade—although the Internet may have helped stem the decline.
20. One of the oldest newspapers in the world in Sweden suspended publication in 2007. "World's Oldest Newspaper Goes Purely Digital," Associated Press, February 5, 2007. In the United States, some titles have become online only, as the *Christian Science Monitor* has announced it intends to do in April 2009, while others have closed down entirely. A number of hybrid strategies have also emerged, like limiting home delivery to subscribers to selected days of the week and providing electronic access otherwise. "Bold Transformation of Detroit Free Press and the Detroit News Lead Nation and Industry with Expanded Digital Offerings," PR Newswire, December 16, 2008.
21. http://newslink.org/nynews.html.
22. http://www.naa.org/info/facts04/dailynewspapers.html.
23. Transcontinental, the Canadian printer under contract to Hearst, announced the establishment of a separate U.S. newspaper division in February 2007; http://www.transcontinental-gtc.com/en/5-news-centre/07-02-21.html.
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26. CNET Press Release, January 20, 2000.
27. CNET 2007 10-K.
28. E. W. Scripps Company Press Release, June 6, 2005.
29. "USA Interactive to Change Name to InterActiveCorp.," Business Wire, June 19, 2003. In renaming the company, Diller articulated his goal "to be the world's largest and most profitable interactive commerce company by pursuing a multi-brand strategy."

30. Ronald Grover, "From Media Mogul to Web Warlord: Will Barry Diller's Cherrypicking Succeed on the Net?," *BusinessWeek*, May 19, 2003.
31. Diller did articulate a number of criteria for buying Internet businesses. But some of these, like market fragmentation, were probably reflective of the lack of competitive advantage. Julia Angwin, "Boss Talk: Faith in Online Magic—Though Many Others Failed, Barry Diller Sees a Big Future in Internet Shopping, Services," *Wall Street Journal*, May 6, 2003, p. B1.
32. Andrew Edgecliffe-Johnson, "End of an Era for IAC/InterActive," *Financial Times*, July 31, 2008. Ironically, even after spinning off four separate companies, the remaining IAC will still have over thirty different brands without any central theme. In the press release, the new streamlined IAC has an even more amorphous vision—"a truly integrated Internet conglomerate"—than the original IAC did at its creation almost five years earlier. "IAC Announces Plan to Spin Off HSN, Ticketmaster, Interval and LendingTree as Four Publicly Traded Companies," PR Newswire, November 5, 2007.
33. Bala Iyer and Thomas H. Davenport, "Reverse Engineering Google's Innovation Machine, *Harvard Business Review*, April 2008, p. 59
34. In a blog on the company's official site, Google's chief economist, Hal Varian, rejects a number of explanations proffered by others and offers up "learning" as the sole distinguishing feature of the franchise. A close reading of the posting suggests that Varian does not really believe that this single quality explains Google's success and a cynic might be forgiven for thinking that he is intentionally playing semantic games to further Google's well-known penchant for secrecy about the underlying nature of its strategy and strength. Hal Varian, "Our Secret Sauce," The Official Google Blog, February 25, 2008.
35. Chris Gaither, "The One Bit of Info Google Withholds: How It Works," *Los Angeles Times*, May 22, 2006; Chris Ayres, "Shrouded in Secrecy: An Awe Inspiring Fount of Information," *The* (London) *Times*, June 15, 2006.
36. Adam Lashinsky, "Who's The Boss," *Fortune*, October 2, 2006.
37. "The 70 Percent Solution: Google CEO Eric Schmidt Gives Us His Golden Rules for Managing Innovation," *Business 2.0*, November 28, 2005.
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