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## Communications: Evolution of the Internet



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At Janus, our goal is to deliver alpha by taking an unconstrained, in-depth approach to fundamental research. We extend this commitment to our clients and partners by providing access to the insights and opinions of Janus' seven global sector research teams via monthly analyst interviews. In this edition of *Analyst Viewpoints*, Janus' Brad Slingerlend discusses the Internet landscape with Client Portfolio Manager Adam Schor. Slingerlend explains how onlinerearch and display advertising is evolving, and how social networking sites and their growth are impacting Internet companies.

**Q: What is the current “state of the union” of the Internet and media?**

**Brad Slingerlend:** For the last few years, the Internet has been in a period of discovery. Search engines have become very popular, widespread and highly penetrated. People are getting comfortable finding things on the Web. This is a big change from five or 10 years ago when consumers needed portals and aggregators to steer them toward the content they were looking for.

That has caused a large fragmentation of content and services on the Web, and subsequently, a big opportunity and challenge for advertisers to get in touch with consumers and create the brand impressions that they want. Now, instead of just a generic display ad or a paid search ad, advertisers have a huge opportunity to reach consumers through social networking, video ads and direct interactions—through sites like Facebook, Twitter, YouTube and Hulu. It is a very exciting time for advertisers as they navigate through the various online options.

**Q: Can you explain the changes happening in display advertising?**

**Brad Slingerlend:** Display advertising has been available on the Internet for a long time. It was one of the original drivers of online

revenue opportunities from an advertising perspective. It supported the creation of a lot of content online. However, starting five or six years ago, the proliferation of content created a glut of inventory, which drove pricing down. It also created a lot of bad experiences for the consumer. What is really starting to snowball today is this renaissance in display advertising, where the low-quality display advertising experience is being cleaned up.

So inventory problems are being solved by taking out low-quality ad impressions, and demographic targeting is being layered in. Advertisers are getting excited again about the creative aspect of what they can accomplish through advertising online—in display and also in rich media and video ads.

One fairly significant change that has happened recently is Yahoo and Google have formed what is called the demand-side platform, where they have display advertising exchanges much like the NASDAQ is an exchange for stocks. Through these exchanges, they are trying to match advertisers with publishers that have content online. So a publisher can put inventory into a display advertising exchange run by Google or Yahoo, and then advertisers can go to these exchanges and make an advertising buy very similar to the way that they are used to making an advertising buy in traditional media.

**Q: How are the social networks impacting online advertising?**

**Brad Slingerlend:** The social networks are creating a whole new opportunity for advertisers. For example, Facebook has a targeting engine online. A florist that is trying to target women ages 25 to 34 who just got engaged in Denver can go in through Facebook's advertising engine and reach them. That is a huge return on ad dollars spent to be able to find exactly who an advertiser is looking for, especially compared to the alternatives, which might be a more generic advertisement like a billboard or a weekly circular that goes out to the neighborhood.

**Q: How is Internet search advertising evolving?**

**Brad Slingerlend:** Search has been an amazing growth story on the Internet, and in some ways, it is a very immature business model. It has existed for less than 10 years, so from that perspective it is subject to a lot of change and evolution.

One of the things we are seeing in search is that it is proving that other forms of advertising work. People see ads, they have brand impressions, and search is what proves that those impressions have sunk in. So we are seeing a marrying of display advertising data, search query data and, in many cases, offline advertising data, which is proving that advertising works.

What search engines are now trying to explain to advertisers is that search is really important, but that advertisers also need to make sure they are winning in brand impressions, both online and offline. That will drive up monetisation in other areas outside of search, such as display advertising and video advertising on the Web.

**Q: What do these changes mean for the business models of big Internet companies?**

**Brad Slingerlend:** The changes on the Internet have placed a big focus on high-quality content creation. We are seeing the major publishers that have scale, like Yahoo and AOL, really focusing on creating high-quality content that advertisers want to be associated with and that consumers want to consume on a regular basis. These companies are making significant investments on the content creation side, which makes a ton of sense because there is an appetite for high-quality content on the Internet.

With respect to search advertising, consumers are going to do a lot of searching. Searches have probably become one of the most important tools in our daily lives, and they are becoming more important because we can access them through smartphones.

These changes are very positive for the content producers and the destination Web sites. It is an opportunity for them to reinvent themselves and re-engage with consumers.

**Q: Talk about your research effort and how you get insight into these companies.**

**Brad Slingerlend:** My motto as a research analyst is, "Talk to an industry participant every day, or I fail." If I am not on the phone or meeting in person with someone who works in the industry that I cover then I have failed as an analyst that day. So I spend a lot of my time trying to create a mosaic of research by finding as many people in the industry who are working day to day with advertisers, publishers and content creation—[people] who are excited to talk about what they do.

I try to go to an industry trade show at least every month or two. At these trade shows, I am able to meet all sorts of people who are very passionate about what they do—[people] who I can connect with on an ongoing basis to really understand what's happening in the industry. What are advertisers really excited about? What are publishers really excited about? What kinds of opportunities are out there?

One of the things about the Internet is that the entire industry can change in a matter of a few months. That's not true of a lot of other sectors. So, I have to be very dialed-in to what industry participants are doing, what they are seeing, what they are saying and what the trends are.

**Q: Can you talk about the social networks and the potential implications of their growth?**

**Brad Slingerlend:** The social networks have started to change the online business models and will likely continue to change them dramatically. Facebook and Twitter are new communication platforms, and they are very powerful and effective. They make it easy to broadcast and communicate in both a one-directional and multidirectional way—with a few people or with lots of people—all at the same time.

Through these social networks, identity information has been introduced for the first time on the Internet. Users don't have to have their identity information available and they can control who sees it. But for the first time, Facebook knows a lot more about its users than anyone else does. That is a gold mine on the advertising side, as long as these companies are careful with the way they are using data and giving users the tools they need to control who has access to their information.

It's a long way to go from Point A to Point B, but I can imagine a scenario a few years from now in which people are comfortable sharing a little bit of information about themselves. If companies have access to this data, consumers—when they do a search query—are likely to have a much higher probability of getting the answer they want on the first try. If it is a search query with a commercial intent, advertisers will be able to find consumers a lot easier than ever before. That makes online advertising more interesting to both direct market advertisers and brand advertisers.

Another interesting phenomenon is how Twitter is becoming the ultimate survey tool. I don't think that's the way people think about it when they are communicating through Twitter, but it has become a huge set of unstructured data, and Bing and Google are very focused on trying to structure that data. Both companies have created deals with Twitter to get access to that data so they can try to understand what's important, what's a trend and what they should pay attention to.

It has also provided an opportunity for Janus to use it as a research tool. Much of what we do is surveying and trying to understand what people think about new products, new services, new tools that are out there. We can use Twitter in a similar fashion as some of the large search engines: to find people, opinions and information, and then feed that into our research process.

**Q: Can you give us your perspective on the “big three” in e-commerce, including the opportunities and challenges they face?**

**Brad Slingerland:** In the world of e-commerce, there are three sites for finding products to buy: Google, eBay and Amazon. There are a lot more sites, but by and large, these are the three that people tend to use to find what they are looking for. All three

companies offer various levels of service wrapped around e-commerce, whether it be payments, search, shopping cart, order fulfillment or third-party merchant platforms.

Right now, Amazon is doing an extremely good job executing on all fronts, and it has created the best user experience in our opinion. The company is gaining a lot of market share in e-commerce.

eBay has done a lot to clean up its site and is very focused on the buyer experience, which is something that the company had failed to deliver on as it traditionally focused more on the seller experience. But we think eBay still offers one of the best e-commerce search engines, and as it improves the buyer experience and offers a better opportunity to sellers in doing so, it stands a very good chance of continuing to be a dominant e-commerce platform.

Google remains the largest e-commerce platform and we think it will continue to provide a really strong user experience in the world of e-commerce search.

**Q: What is your view on the relationship between the Internet and traditional media?**

**Brad Slingerland:** There has been a consensus view by Wall Street and even many folks in the industry that old media will not find a way to survive. We believe that consumers want high-quality content. And it can be print, through magazines. It can be the radio. It can be the newspaper. It can be television. It can be YouTube and Hulu and all of the blogs that people love reading every day.

Consumers want the content, and on a lot of levels, we need the content as we go about our day-to-day business. And to the extent that we need content—we always have and we probably always will—then advertisers will want to be associated with that content because they have goods and services that they want to sell us.

We believe the Internet will enhance a lot of traditional media and finally start to create new revenue opportunities now that there are platforms in place for advertisers to make large, targeted reach and frequency buys online, which really hasn't been available to them in the last 10 years.

**Q: There has been a lot of discussion about the sustainability of free content online. What are your thoughts?**

**Brad Slingerlend:** The Internet has suffered from fragmentation. It has also suffered from the view that there will be this ongoing, sustainable business model of free. We don't share that view. Quality content is hard to produce, and we think it can be monetised. There is a lot of quality content that makes sense to be supported by a subscription model.

Search has created a lot of fragmentation, and now we are seeing advertising exchanges being built by Yahoo, Google and a lot of really smart entrepreneurs that are aggregating the pieces. They are presenting them to advertisers in a way that they can understand. That is very new, and we think it will help monetise content and get people away from the notion that everything will be free, because the reality is very few things will be free. That's just not a realistic business model.

**Q: What is happening in this industry outside the United States?**

**Brad Slingerlend:** We are seeing a very big growth rate in e-commerce outside the United States. It's what really drives the search industry. In emerging markets, we are seeing platforms being put in place on the banking systems and on the logistics systems needed to make e-commerce work, and that is driving a lot of search activity.

Traditionally, there has been enormous search activity outside the United States, but it hasn't been commercially focused. We are now seeing a lot of commercial search queries growing outside the United States, especially in emerging markets, and within that, in South America and Asia. That provides a real opportunity for large search platforms and large e-commerce platforms.

We are also seeing significant growth in Internet consumption outside the United States, and a lot of that is taking place on smartphones and handhelds rather than in a traditional desktop or laptop environment. That [technology] allows new companies a lot of opportunities to develop (and for traditional companies to reinvent) their business models so they can reach users through a smaller screen size and in a more mobile way.

**Q: What kinds of companies are capitalising on the trends internationally and in emerging markets? Are they U.S.-based companies or are they local, non-U.S. companies?**

**Brad Slingerlend:** Both multinational companies and local companies have a real opportunity as Internet penetration grows around the world through desktop and mobile competing platforms. Google, Yahoo and Microsoft all have very large opportunities as does Amazon and eBay with its eBay platform and PayPal business. Most of these companies derive about half of their revenues from outside the United States, so for many it is already a very big business that is growing very nicely.

We have also seen local companies develop through some great entrepreneurs around the world. For example, Tencent in China, which runs the largest instant messaging platform, has evolved into the largest social network in China and in many ways, one of the largest social networks in the world. We are also seeing some great e-commerce companies like MercadoLibre in South America do a very good job meeting the needs of the local consumers—perhaps better than some of the multinationals could.

Baidu, which is a Chinese company but U.S.-listed, is the largest search engine in China. It has about 60 percent market share, which is close to the scale that Google has in the rest of the world and, in particular, here in the United States. So far, Baidu has done a very good job capturing the dollars available in the search market in China. That said, the e-commerce market is very nascent in China, but growing very quickly, which is creating opportunities for other companies like Google and Tencent to enter the search market in China and try to gain market share.



### ***About the Featured Analyst***

#### **Brad Slingerlend, CFA**

Brad Slingerlend is an equity research analyst, primarily focusing on the media and communications sector. Mr. Slingerlend started at Janus as an intern during the summer of 1998 covering primarily the technology, retail, and entertainment industries. He joined the company full time in September 2000, took a brief leave in May 2007 and returned in November 2007. From January 2003 until February 2006, Mr. Slingerlend served as the head of the technology research analyst team and from February 2006 to May 2007 he co-managed both the technology research analyst team and the Janus Global Technology portfolios. Mr. Slingerlend received his bachelor of arts degrees in economics and astrophysics from Williams College, where he focused his research on Active Galactic Nuclei, otherwise known as the supermassive black hole centers of distant galaxies. He holds the Chartered Financial Analyst designation and has 12 years of financial industry experience.

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