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網際網路新創公司的價值評估與脫手策略

Valuation & Exit Strategies for Internet Start-ups



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中華民國九十六年九月

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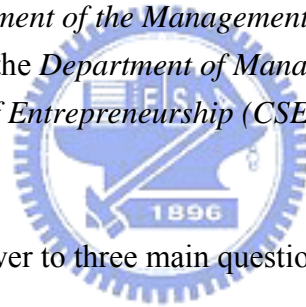
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## ABSTRACT

This thesis work examines possible *exit strategies* for new technology and Internet firms in its start-up phase, and how new technology and firms in the Internet industry will be valued at the prospect of an exit. The outline of the report is to analyze value potential and exit strategies linked to the value relevance of firm's with no earnings, no history, and no comparables. Six exit strategies are identified, all with different significance for start-ups, and two main paradigms in valuing Internet start-ups are identified and discussed. The report is made together with the *Department of the Management of Technology* at National Chiao Tung University, Taiwan, and the *Department of Management and Economics of Innovation (MEI)*, and *Chalmers School of Entrepreneurship (CSE)*, both at Chalmers University of Technology, Sweden.



The work is aimed to give answer to three main questions:

1. “What can a start-up firm do in order to become valuable, in terms of attractive investment object?” and “What operations are value related from the approach of an investing or purchasing firm?”
2. In which way, and how, will MindValue, the specific new technology firm, be valued
3. Which companies are potential buyers for MindValue, the specific new technology firm (who are the players)?

The work has been accomplished through literature studies, market data analysis, and specialist interviews. The study found two paradigms in valuing Internet firms that differentiates from each other, a *traditional* view in valuing firms, and a view based on *non-financial data*. The study identified a number of value drivers for Internet firms that are used for both valuation paradigms, and finally the report identified the most likely exit for an Internet start-up.

*Keywords: Valuation, Internet start-ups, value drivers, web metrics, exit strategies.*

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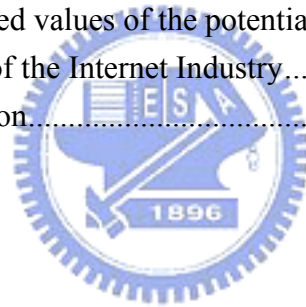
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# 1. Introduction

## 1.1. Background

In the 1990ies the term *New Economy* was stated to describe a whole set of forces that started to appear that called for new marketing and business practice. Globalization and Technology are two of several strong forces that play a major role in the reshaping of world economy, and information technology in particular (Friedman, 2005; Mann, 2006). Since Internet's entry on the world arena, it become possible to combine text, data, sound, and images into bits and transmit from appliance to appliance, and Internet became the "information highway" conveying the digital information (Friedman, 2005). Much of today's business is carried over networks connecting people and companies, and the progresses are developing fast.

It has become considerable easy to transfer digital information between people, which also had led to many new business opportunities all over the world. It is comparatively easier to start *new technology companies* than prior traditional firms, due to very low initial costs, which also have been the case during the last decade (Copeland *et al*, 2000; ITPS, 2006). Some of the *Internet start-ups* or *new technology firms* have demonstrated extremely good business models and have become really successful (DI, 2007; FT, 2006). However, most of the new ventures never succeed, but many of them survive and make progress (Damodaran, 2001).

Being successful in *new technology* business, in the sense of getting the company profitable requires, as for all continuous industries sustainable business ideas and very often, profound business plans (Kubr *et al*, 2005). Many of the Internet ventures witnessed a fatal ending by the Internet shakeout in year 2000, and one of the main reasons was naïve business ideas that did not fulfilled basic requirements for sustainable revenues (Lindstedt, 2001). Another main reason to the Internet hardship in early year 2000 was the irrational investments all over the world (Damodaran, 2001).

A business plan or investment plan comprises several chapters and one of them discusses the *exit strategy*. The *exit strategy* describes the long-term plans for the business and presents a realistic plan of how entrepreneurs successfully can exit a project. In the investor perspective *exit strategies* describes how investors are getting back their investments with substantial return. Ultimately, the most effective exit plans will take into account business, personal, and investor goals.

There are several potential opportunities for successful exits for *new technology* or *Internet firms*, which cause a demand for solid analyses of the best opportunities.

## 1.2. Aim

The aim with this thesis is to serve as an advisory document for a new start-up company in Sweden – *an Internet start-up project of Chalmers School of Entrepreneurship (CSE)* at Chalmers University of Technology, and serve as a basis for strategic exit discussions within the firm.

The outline of the thesis is to analyze value potential and exit strategies linked to the value relevance of firm's with no earnings, no history, and no comparables.

The thesis also contains a comparison analysis of two main paradigm approaches in valuing dot.com and Internet industries.

The thesis will finally conclude a strategic exit analysis of the start-up company, with consideration to the valuation approaches.

The outcome, presented in the chapter of "*conclusion & recommendations*" will result in a strategic operation plan considering *exits*<sup>1</sup> for the new start-up company MindValue. The thesis will contribute to the start-up's development program.

## 1.3. Purpose

The purpose with this thesis is to analyze strategies to successful *exits* for potential start-up companies within the Internet industry. This thesis is made together with MindValue, an Internet start-up project of Chalmers School of Entrepreneurship (CSE), and the thesis's outline is focused on the prospects of this specific company.

### 1.3.1 Why a report of exit strategies for start-up companies?

Thinking of exits during the start-up phase might seem paradoxical, but is at the same time highly relevant. Many start-ups in the new technology industry have shown high growth potential all ready in its cradle, but only some of the companies actually succeed (Koller *et al*, 2000). Being successful in business is influenced by many factors, all from throughout preparations to proficient talent and in some times, pure luck. Preparing the exit strategy already from the infant stage of the company life cycle will reduce unexpected situations in the future, and the actions towards a specific exit can be taken already in an early stage. The

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<sup>1</sup>An *Exit* is the way an investor closes out a specific position, usually by converting it to cash.

problem of valuing a new technology company in its early stage is a continuation of its hurdles of strategic planning, why this link is interesting to analyze. This specific topic seems also rare in financial and strategic literature, why an initial study like this is motivated.

## 1.4. Delimitations

The thesis will focus primarily on exit strategies for newly start-up companies in the new technology industry, that is Internet firms or e-business firms in its start-up stage. Definitions of the terminology are given in coming chapters. The thesis will not take other industries into consideration for *exit strategies*, than *new technology* industries.

I will emphasize two significant mechanisms, *Globalization* and *New Technology*, as the main drivers of the *New Economy* development. This view is shared of several monitors of the world's political and economical development (McKinsey Global Institute, 2002). There are other factors with impact on the development of the New Economy, but in relation to *the Globalization* and *the New Technology development*, they are of less significance for this report (McKinsey Global Institute, 2002). Since the term of *New Economy* concerns a major part of the world, there are many small factors of the concept to take into consideration, in order to cover a whole picture. Trying to map all causes in this context is too pretentious and will fell too far out from the core issue of this report.

The definitions of business concepts like e-business and e-commerce are taken from three sources (Laudon & Traver, 2003; Kotler *et al*, 2003; Weill & Vitale, 2001). There is no over-all consensus concerning the definitions of e-business and e-commerce, since the concepts still are in its cradle (Laudon & Traver, 2003). I find the three sources' definitions presented in this report well suited for the analysis' purpose, and will not explore these definitions any further.

The definitions of the strategic groups and the web metrics presented are commonly reported in the business press and are frequently mentioned as valuation parameters in analysts' reports (Trueman *et al*, 2000). I find these definitions well suited for the report and will not examine other potential web metrics.

The concept of Discounted Cash Flow (DCF) is a common technique of valuing future cash flows (Copeland *et al*, 2000). I find this technique most adequate for this report, representing the traditional approach of valuation, and will not elaborate other "traditional" techniques. Other "traditional" valuation models might be more sophisticated than DCF, but also requires

more financial information, which in this case not is available.<sup>2</sup> I will only describe the main concept of DCF, and will not elaborate it further for this report, e.g., I will not give examples of different uncertainty scenarios, measuring default risk and estimating default-risk adjusted rates, etc... Also, I will not elaborate the valuing of assets with equity risk or involve dividends into this report. These concepts are connected to the DCF approach, but will not spread any further light over this report.

The presentation of the specific start-up company, MindValue, will contain a short history brief, a presentation of a problem with solution that MindValue have based its business plan upon. Due to the secrecy of the detailed business plan I will not elaborate and present business models and revenue models any further.

Both before and after the Internet shakeout in 2001, several valuation models and techniques have been presented (Damodaran, 2001). Many of the techniques presented focus on how to avoid as much risk as possible, that is, rational investor behavior (Grinblatt & Titman, 2004). Focusing on risk management and portfolio investment gives the analysis a statistical approach, which is not the purpose. The risk eliminating techniques are not needed for this report, since the approach of this analysis is focusing on corporate strategy for new start-up companies with the ambition of a successful exit.

I use an online historical exchange converter, valid for the specific year and month of interest, when converting foreign exchange rates ([www.oanda.com](http://www.oanda.com)). The foreign exchanges are foremost discussed in chapter 11, where examples of acquisitions of other Internet firms are made. Some of the sources of the transactions are presenting the currencies differently, why I am converting domestic currencies into US dollars (\$ US).

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<sup>2</sup> The outline of the report is to analyze value potential and exit strategies linked to the value relevance of firm's with no earnings, no history, and no comparables.

## 2. Problem analysis

In order to fulfill the purpose of the master thesis, an analysis that covers practically all prerequisites and conditions concerning *exit strategies of Internet start-up companies*, is required. It has been necessary to divide the report in several chapters, as well as different blocks, that describes different areas, which all have impact of the final conclusion. The areas describes and elaborated in the report are supported by theoretical models and theories from prior studies and researches.

The organization and the disposal of the work is an assemblage of three blocks, which content are related to different stages in the analysis. First a block of general information, needed to be familiar with definitions and the main outline of the economical and technological development, is presented. Second, an analysis and discussion of the content from the first block, related to the specific firm of interest, MindValue, an Internet start-up project in Sweden, will be conducted, and finally, the third block will generate a conclusion together with recommendations.

The first block will contain background information and the foundation to the new technology industry. I will give a brief of the term of *new economy* and how this concept is related to the industry of today. Since the report is discussing strategies and outcomes from Internet firms, possessing knowledge of the forces that are present in the global economy today will facilitate the analysis. The outline of this thesis, *analyzing valuation and exit strategies for start-up firms in the new technology industry*, is a proactive reaction in a highly competitive environment like the new technology industry, already in a planning stage. The new technology industry differs from traditional industries, because of its fast pace, fast development and volatile nature (Brown & Eisenhardt, 1998). Proactive analysis of a firm's resources and capabilities is based on the theory of the *Resource Based View*, which will be further elaborated in chapter 3.

The concept of new economy is very close to the emerging new technology industries (Kotler, 2003). The first block therefore also contains facts of the Internet industry and why it differs from traditional industries, concerning corporate strategy. After describing the new economy's and new technology's impact on the traditional corporate culture in broad outline, I will describe the specific new technology firm of the report, MindValue. The details of the specific firm of the report, belongs to the block of *general information* that will give the report a body to relate analyzed information to. The theories presented in block 2 and 3 of this report will be applied onto MindValues strategy plan, concerning exit strategies.

The second block contains chapters of valuing new technology firms, and a brief of the *new economy* concept. High price valued firms are always targets for acquisitions, due to opportunities of high ROIC, *Rate on Invested Capital* (Damodaran, 2001). Acquisition is also a desirable exit opportunity for many start-up firms, since the operation is often connected with large amounts of economical benefits for the entrepreneurs of the start-up. One of the purposes of the thesis is to identify value drivers of a new technology firm, in order to put the specific firm, MindValue, in a more advantageous position than other industry competitors. Identifying the value drivers, the report will try to give answer to the first question of issue:

1. “*What can a start-up firm do in order to become valuable, in terms of attractive investment object?*” and “*What operations are value related from the approach of an investing or purchasing firm?*”

When analyzing new technology firms, which operate in a fast growing and volatile industry, there are several feasible alternatives for an exit (interviews, 2006). The exit alternatives are valued differently depending on the firm’s activities (interviews, 2006). The analysis will try to clarify the most important alternative in a valuable exit perspective, both for investors and for entrepreneurs.

A new start-up firm with ambition of a future acquisition has to clarify the exit strategy already in an early stage, that is, the start-up stage, in order to effectively manage adequate operations (Kubr *et al*, 2005). The approach to design a corporate strategy based on the firm’s external environment, is linked to the *Market Based View* of corporate strategy. The *Market Based View* is based on the outlook of the external environment as a factor that influences a specific company’s proceedings (Porter, 1980). The concept will be further elaborated in chapter 3. The *Market Based Approach* is a theory basically used to design marketing strategies (Porter, 1980). The concept of the *Market Based Approach* has some significance of the design of a competitive strategy for the specific firm, MindValue, but the focus of designing a corporate strategy will incline a greater part of the *Resource Based View*, since that approach is taken fast pace and a volatile nature to consideration, in contrast to the *Market Based View*.

Opposite to traditional industries, the new technology industry typically faces the different stages of its life cycle much earlier and faster, which requires planning of its whole life cycle already at an early stage (Damodaran, 2001; Kubr *et al*, 2005).

*Since the life cycle of a new technology start-up might be very short, the initial operations of the firm will reflect the outcome significantly.*

The statement is an attempt to a “*hypothesis*” or statement that I will “*test*” in the report. It is not a real hypothesis test, since the authentic dittos are tested under more controlled circumstances.

The great complexity and uncertainty of the industry, due to fast pace, fast development and its volatile nature, have given birth to divided opinions of what really drives value of the Internet firms (Damodaran, 2001). I will elaborate two main paradigms that are distinguished in the valuation of firms, as an extension of the *first question of issue* – identifying the value drivers. The extension will give rise to the analysis’ *second question* for this report, that is:

2. *In which way, and how, will MindValue, the specific new technology firm, be valued*

The two paradigms has been questioned and discussed frequently after the Internet shakeout in 2001, which will substantiate the second question of issue (Damodaran, 2001; DI, 2007; Cooke, 2006; FT, 2006; Interviews, 2006). The operations of the Internet users are valued differently, depending on companies’ profiles and business approaches, and the models and praxis used to determine a firm’s value (Damodaran, 2001). The *second question* aims to identify the main paradigms of Internet firm valuation and elaborate its attitude, as well as investigate and distinguish the differences in valuation of advertising, e-commerce, e-services, etc...

Business models like *online gaming as poker* and *casino* related sites, which are typical examples of activities on Internet that are strictly transactional – the site users strictly visits these sites to bet and transact money, which might raise the turnaround of the Internet company more than an Internet companies with different business models. This statement is interesting to elaborate for this report why an examination of the following statement will be made:

*Specific transactional activities will be higher valued, than activities that only count visits and unique users.*

Close connected to the valuation models and paradigms of Internet firms are the arising *synergies* connected to new technology industry. The *synergies* of this analysis are defined as those external benefits that arise from the main operations. The *synergies* explain some of the rhetoric from the valuation models that have great implication on the answers to the main questions of issue to this report.

The gained resources derived from *synergies* have shown to be an important reason to an acquisition (DI, 2007). This means that specific benefits of acquiring a specific company, like *distribution channels*, *new technology*, or *new competence*, carries great weights towards other main activities of the acquired firm (DI, 2007). After identifying the value drivers of a new technology firm, and elaborate how a specific firm can be valued, I will give an example of actors that might be interested in an acquisition of a new technology firm. This will give birth to the third question of this report:

3. *Which companies are potential buyers for MindValue, the specific new technology firm (who are the players)?*

The question will generate a market structure in order to analyze potential purchasers, by following a pattern of acquisitions from the acquiring firms. The question will generate an example of potential companies of different markets that might be interested in purchasing activities. The structure aims to illustrate a diversity of parties attracted to acquire new technology ventures, which derives from contemporary financial press and media (DI, 2007; FT, 2006). From the third question of this report the relevance of following statement will be further examined: *The market structure of the potential buyers of a new technology firm is divided, that is, it is not only direct competitors or firms in the same market sector that are interested in acquisitions of new technology firms.*

The third block of the report is a *presentation of groups of interest*, which will gather the players at the market into different groups, in order to examine possible exit opportunities.

Finally in the third block, I will conclude the analysis and present possible *exit strategies* to MindValue. The report will present a structured picture in an area of strategy that is complex and have highly divided opinions.

The outline of the report, figure 2.1, is designed to represent the steps of the analysis. The first part covers the theory and models the report is based on together with general information, the second part is the analysis and discussion block and the third part is the concluding part of the report.



	No.	Chapters
<b>Block 1</b>	1	Introduction
	2	Problem Analysis
	3	Theory
	4	Method
<b>Block 2</b>	5	Valuing dot.coms
	6	The New Economy
	7	Traditional valuation
	8	Non-Financial Valuation
<b>Block 3</b>	9	MindValue - MV
	10	Synergies
	11	Structure Analysis
	12	Possible exits of MV
	13	Conclusion

Figure 2.1. Organization and disposal of the work

### 3. Theory and models

This chapter motivates and explains the theories and models this report is based upon.

Research within Strategy has to a large extent concentrated on the understanding of why some companies and organizations, from a marketing point of view, succeed better than others. The aim of the research is to identify the underlying factors that constitute the difference between those companies that are more successful and those companies that are less successful in their business.

The debate of the underlying factors of what constitutes the difference in success has mostly and traditionally been based on two concepts: *Market Based View* and *Resource Based View*. The concepts will be further elaborated in this chapter.

One of the leading theoretical frameworks in this report is the concept of *exit strategies*, which describes the last stages of a business in a specific phase (in this report: the start-up phase), and the prerequisite of a successful exit. The *exit strategy* contains both an investor strategy and a settle strategy, and a successful strategy enriching both sides.

Other analysis components that use theoretical frameworks are *Structure Analysis*, and *Scenario Analysis* together with *Mixed Strategy*.

#### 3.1. Exit Strategies

Kubr *et al* (2005) emphasizes in order to attract investors to a start-up project, a solid *exit strategy*, which describes how the investors will get their investments back with a substantial return and exit the project, will facilitate a company's progresses. Naturally investors are interested in growth and profit of the business, but the lack of a solid and realistic exit strategy demonstrating how investors can accomplish this goal can immediately turn off many sources of capital (www.bizplanit.com, 2006).

The exit strategy also describes the long-term plans for the business. Ultimately, the most effective exit plans will take into account business, personal, and investor goals. Much of entrepreneurial literature describes the importance of a solid exit strategy chiefly from the investors' perspective; how to demonstrate a realistic plan for investors to successfully leave the project and when to expect to reach liquidity.

A thorough *exit strategy* serves as a profound operation plan for the business, clarifying the projects future destination (www.bizplanit.com, 2006). To maximize the value of a new start-up it is essential to think, from an entrepreneur's perspective about how to leave it further down the line. A carefully planed exit from the business helps the entrepreneur to

successfully design the business into the ideal shape for the chosen exit option, and maximizing the value from it. It also helps to exit at a time of own choosing, when the business is doing well and the market conditions are advantageous (www.bizplanit.com, 2006). To be able to design the business to fit the plan, it is important to look backward, that is to discount back the ideal scenario five years from now and identify actions needed today until the strike date (www.bizplanit.com, 2006).

The *exit strategy* is important for both for the entrepreneur and in the eyes of the potential investor. When elaborating different exit strategies, there are several definitions of exits, some of them similar to each other.

BizPlanIt, a consultancy firm, have identified the most common exits strategies, which *are IPO (initial Public Offering), Acquisition, Sale of Company, Merger, Buy-Out, and Franchise* (www.bizplanit.com, 2006). The difference of the six strategies concerns different types of companies, which are at different stages of its Company Life Cycle. For mature companies and organizations, the concept of IPO might be a successful strategic move, but may be difficult for a new start-up firm to accomplish, because of its complexity, uncertainty and costly process (www.bizplanit.com, 2006). In this report I will mostly analyze the opportunities for *acquisitions*, since it the most common and used exit strategy of new start-up firms (www.bizplanit.com, 2006).

Looking at the buyers' side of an acquisition and asking the question why someone is interested in buying another company, there are several reasons for that. Most of the worlds companies have competitors in some extent, no matter if the business is big or small. Competing in a specific sector requires specific strategies to beat the industry average or close competitors. Among many strategies of how to gain market shares and succeed in the struggle of customers, growth is in many cases a successful strategy (Porter, 1980). As the company grows, the market share follows, and the revenues will probably follow as well. Large corporations are traditionally stronger competitors than small firms. A company can grow either by organic growth or by acquisitions. Organic growth means that the firm acquires its own customers and market share. An acquisition is a purchase of an existing corporation, and with the purchase comes the acquired firm's market share as well.

In order to be familiar with the other concepts of exits, I will outline the other strategies and its' characteristics stated by BizPlanIt (www.bizplanit.com, 2006):

## **Initial Public Offering, IPO**

Initial Public Offering or IPO implies selling the shares of the company to the public to be traded on a stock exchange. The advantages of an IPO is the conversion to cash for investors, major shareholders usually maintain control, and high potential return. The company must have tremendous growth potential to receive IPO, it is a costly process, and the outcome is uncertain, which all are seen as disadvantages of the IPO concept. Major shareholders may be limited as to how much, when, and how they can sell stock. This event is very rare for most start-ups (Benjamin, 1996).

## **Acquisition**

Acquisition means a business bought outright by another existing company. The advantages of acquisition are the receiving of cash or stock, it is often purchased by a strategic partner, and the management contract can be negotiated.

Disadvantages are: Fit must be appropriate, potential management changes, and corporate identity may disappear. Acquisition or buyout is the predominant method of achieving liquidity for small company shareholders (Benjamin, 1996).

## **Sale of Company**

Sale of Company means business bought by other individuals or entities. The advantage is that cash is received immediately. The disadvantages are that the company must find a willing buyer, and that a *sale of company* normally results in new management.

## **Merger**

Merger means join with an existing company. The advantages are that stock and some cash may be received, resources are combined, and current management may stay. The disadvantages can be new partners or bosses, less control, little or no cash are received.

## **Buy-Out**

Means that one or more stockholders buy out the others. The advantages are that seller receives cash, and other owners remain in control of the company. The disadvantages are that the seller must be willing to sell and the buyers must have sufficient cash to buy others.

## Franchise

Franchise mean selling business concept to others to replicate. The advantages are that cash is receive, the current management is retained, and the opportunity for large scale growth. The disadvantages are that the concept must be appropriate for franchising, and the concept is legally complex.

In the context of a new technology start-up firm, the most likely exit strategy may be an acquisition, that is: *the company of interest is purchased by a strategic partner* (i.g. another company) (Benjamin, 1996). The other exit strategies are not suitable enough, because of the requirement of healthy liquidity, which start-ups mostly do not benefit of (www.bizplanit.com, 2006).

## 3.2. Structure analysis

The structure analysis is divided into two frameworks, both stems from *strategic groups* in different levels, which helps to gather the players at the market in an adequate way. I will use *Strategic Groups* to separate *new technology* players' different operations at Internet, and structure the strategic groups further into brand and company name.



### 3.2.1. Strategic groups

The concept of strategic groups was first introduced into industrial organizational theory in the beginning of the 1970-ies, by M. S. Hunt (1972), to account for differences in profitability in firms competing in the same industry. The concept was further developed by Michael Porter (1980) in the 1980ies, and adopted by the fields of strategy and business policy. Porter's (1980) definition of a strategic group is "*the group of firms in an Industry following the same or similar strategy along the strategic dimensions.*" Strategic groups are defined as sets of firms in an industry who compete with each other on the basis of similar combinations of scope and resource commitments (Cool & Schendel, 1988). Porter and Caves (1977) advocated the presence of mobility barriers that prevent the free movement of firms from one group to another, because decisions made by firms within a group may not be imitable by firms outside the group without incurring substantial cost. The presence of these mobility barriers makes the strategic group structure of most industries relatively stable and distinguishable. Strategic group analysis provides insights into competitors' approaches to the market and the conclusion of the organizational and industrial performance (Harrigan 1985). Porter (1980) advocates that the profit margin in general differ between strategic groups

because of Porter's five forces have different importance for different strategies. Firm's real profit will theoretically be equal in the long run, assumed that firms do not differ in the ability to conduct the strategy. These kinds of differences will always appear though.

### 3.3. Discounted Cash Flow Valuation

#### 3.3.1. Discounted Cash Flow

The value of any asset is determined by its expected cash flows in the future, e.g. the present value of the expected cash flow from the asset (Damodaran, 2001).

Discounted Cash Flow (DCF) is a method of evaluating an investment by estimating future cash flows and taking into consideration the time value of money. This sub chapter will give a brief of the DCF-model and how it is linked to value an asset. The DCF-model covers the groundwork for how to value a firm and estimate the inputs that go into the valuation.

#### 3.3.2. Discounted Cash Flow Value

The value of any asset should intuitively be a function of three variables:

- How much the asset generates in cash flows
- When these cash flows are expected to occur
- What uncertainty is associated with these cash flows

By computing the value of any asset to be the present value of its expected future cash flow, DCF valuation brings all three of these variables above together (Damodaran, 2001).

$$Value = \sum_{t=1}^{t=n} \frac{CF_t}{(1+r)^t}$$

where

n = Life of the asset

CF<sub>t</sub> = Cash Flow in period t

r = Discounted rate reflecting the riskiness of the estimated cash flow

The cash flows vary from asset to asset – dividends for stocks, coupons (interest) and face value for bonds, and real projects' after-tax cash flows<sup>3</sup> (Damodaran, 2001). The discount rate is a function of the riskiness of the estimated cash flows, e.g. riskier assets carry higher rates, and safer projects carry lower rates.<sup>4</sup>

### 3.4. Non-Financial Valuation Measures

This sub chapter comprises a Structure Analysis, explaining and evaluating the present groups of operations on Internet, which have economic and financial functions. After the strategic groups, I will present the non-financial web metrics that have robust value-relevance.

#### 3.4.1. Classification of sectors at Internet – *different groups of operations*

The Internet industry can be divided into the following sectors: Portals, Content/Communities, and E-tail. These sectors are considered to have business models for which web traffic plays an important economic role. Chiefly, these sectors are B2C companies that are expected to earn revenues either directly or indirectly by attracting web traffic to their sites.

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<sup>3</sup> Dividends, coupons, and after-tax cash flows will not be further elaborated in this report. Readers interested are recommended to acquaint oneself with the references of this report.

<sup>4</sup> The *risk* and *uncertainty* are two of the ground stones in Finance. I will not elaborate the concept of uncertainty further, since it is too wide for this report. Interested readers who are not familiar with the concept are recommended to adequate Finance literature

### 3.4.1.1. Portals

Portals are providers of gateways to the Internet. Some of the most popular sites on the Internet, both for consumers and business users, are intermediaries, where *portals* count in. The intermediaries are sites that stand between the buyer and the seller. The number and variety of intermediaries are growing fast, and the business models become more and more sophisticated. Internet is home to a variety of intermediaries, each of which provides a different value proposition.

Figure 3.1 presents a framework for comparing intermediaries on the basis of the completeness of service offered and the number of buyers and sellers participating (Weill & Vitale, 2001). *Completeness of service* is the proportion offered of the full set of services that could potentially be proved by an intermediary. According to Weill & Vitale, 2001, the services include:

- **Search:** To locate providers of products and services.
- **Specification:** To identify important product attribute. Specifications reduce communication costs for both buyers and sellers.
- **Price:** To establish the price, including optional extras such as warranties. Options for setting the price include fixed prices, auctions, reverse auctions, and dynamic pricing based on demand or relationship.
- **Sale:** To complete the sales transaction, including payment and settlement.
- **Fulfillment:** To fulfill the purchase by delivering the products or service.
- **Surveillance:** To conduct surveillance of the activities of buyers and sellers in order to report aggregate activity and prices and to inform and regulate the market. This activity can include reporting on the results of completed transactions (e.g., stock market summaries or auction results) and on the depth of the market (e.g., the number of active buyers and sellers and the prices at which they are willing to transact).
- **Enforcement:** To enforce proper conduct by buyers and sellers, including resolving disputes and sanctioning improper behavior. Some intermediaries, such as stock exchanges, have guarantee funds to compensate for any loss.



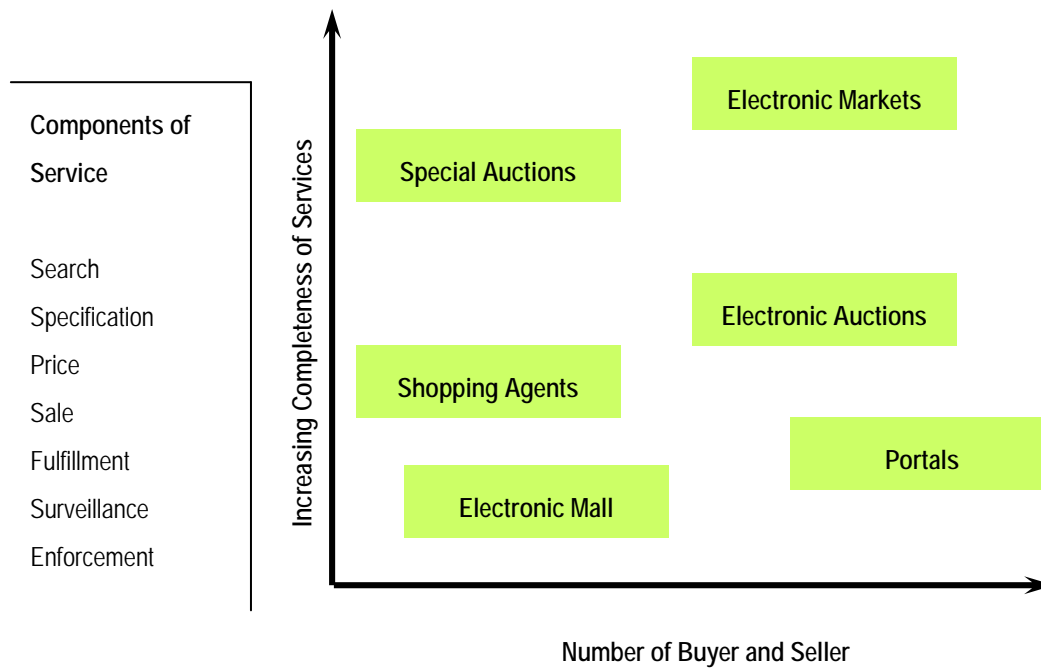


Figure 3.1. Intermediary Business Models for e-business, *Weill & Vitale, 2001*.

Chiefly, portals earn revenues from advertising on its own pages and from click through referrals to the sites listed. The basic requirement for survival as a portal is sufficient volume of usage to cover the fixed costs of establishing the business and the required infrastructure. Attracting and retaining a critical mass of customers/viewers/users of the portal is therefore the primary critical success factor (Weill & Vitale, 2001). Two other success factors Weill & Vitale (2001) advocates is the capability of building up infrastructure quickly enough to meet demand as it increase. The third critical success factor is to the *customer relationship* and producing a portal with a high degree of *stickiness*<sup>5</sup>, which is the need or desire to return to the site.

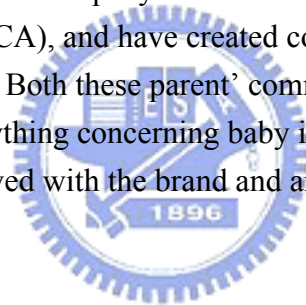
### 3.4.1.2. Content/ Communities

Content and Communities provides catering to certain segments of the population or to groups of people with specific interests. In this text, a content provider is a firm that creates and provides content (information, products or services) in digital form to customers via third parties (intermediaries). The primary source of revenue for a content provider is fees from its third parties, based on fixed price per month or on the number of times a user uses the content. The business models of content providers are constantly progressing. Chiefly, there are three critical success factors connected to content providers:

<sup>5</sup> The concept of *stickiness* will be presented in chapter 11.2.

- **Branding** – The content must be recognized by a label in order to maintain a long-term presence at the market.
- **Recognized as best in class** – content providers must deliver state of the art content. This recognition is close connected to a brand, which announces a sense of quality and reliability.
- **Network** – The establishing and maintaining of a network of third parties is crucial for the distribution of the content.

Communities, or virtual community business models offers members the opportunity to interact electronically with like-minded individuals and to both create and consume content relevant to a topic of personal or professional interest (Weill & Vitale, 2001). Many commercial web sites, both new technology firms and traditional firms with web-sites, uses communities to sell goods and services or to provide information. The communities are important marketing tools as well, gathering special niche groups of customers that are willing to discuss and interact with the products the firm is providing. An example is Procter & Gamble (P&G), an American fast moving consumers goods firm, and SCA, a Swedish global consumer goods and paper company. Both firms are providing baby diapers, branded *Pampers* (P&G) and *Libero* (SCA), and have created communities on in the Internet focusing on the segment of new parents. Both these parent' communities have remarkable impact on the segment, who discuss everything concerning baby issues to pure product development. The customers are really involved with the brand and are important “marketers” of the *word of mouth* (Kotler *et al*, 2003).



The firm can gain revenues of the community from:

- Membership fees
- Direct sales of goods and services
- Advertising
- Click-through
- Sales commission.

### 3.4.1.3. E-tailers

E-tailers sell goods and services on the Internet. The e-tailers benefits form the direct-to-customer business model and fall into four categories. In each category the products or services are sold directly to the customer. The products or services could be physical and delivered by regular mail or parcel services, or digital and delivered instantly over the Internet. The four categories are:

- Space-based firms,<sup>6</sup> or pure Internet firms selling their own branded products, such as *RealNetworks*.
- Place-based firms<sup>7</sup> also operating over the Internet, selling their own branded products. Compare with traditional mail order versus online ordering.
- Place-based firms selling third-party products both in physical outlets and on the Internet.
- Dot.coms selling third party products, such as *Amazon.com*.

The benefits of the direct-to-customer business model are significant for both the customer (low prices, faster response time, self-service, etc.) and the seller (lower selling costs, online customer data collection, larger geographical reach, etc.) (Weill & Vitale, 2001). The business model of direct-to-customer and the concepts of e-commerce and e-business that e-tailers benefits of enables the online retailers to provide huge ranges of carefully specified and described products on their web sites, take orders, receive payment, and arrange delivery the items. The direct-to-customer business model offers the prospect of higher margins, expanded markets, and greater information about customers to the firm of interest. To the customer, the business model of direct-to-customer offers greater choice, increased convenience, and lower costs.

The main source of revenue is usually direct sales to customers. Higher margins than traditional *bricks-and-mortar*<sup>8</sup> firms may be attained either by reducing the cost to serve the customer directly or by cutting steps out of the distribution chain (Weill & Vitale, 2001). The e-tailers operate in a highly competitive space, and according to a study of 221 e-tailers in year 2000, *Boston Consulting Group* (BCG) found that only 40 percent were profitable, mostly due to extremely huge marketing costs (Weill & Vitale, 2001).

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<sup>6</sup> *Space-based firms*, refers to Weill & Vitale's definition of Internet firms that exclusively operates on the Internet, or in the *cyber-space*.

<sup>7</sup> *Place-based firms*, refers to Weill & Vitale's definition of traditional firms who not have migrated their business to *space*, but are running the operations on *place*. Many of the assets (e.g., brand, cash, relationships, market share) of successful place-based businesses will serve equally well in space (Weill & Vitale, 2001).

<sup>8</sup> *Bricks-and-mortar* is a description of a company with a physical presence, as opposed to one that only exists on the Internet ([www.investorwords.com](http://www.investorwords.com), 2006).

### 3.4.2. Web Metrics

Web metrics are commonly used performance benchmark for Internet firms and have now become standard. The web metrics are commonly reported in the business press and are frequently mentioned as valuation parameters in analysts' reports. Prior reports (Trueman *et al*, 2000) have proved evidence on the value-relevance of raw web metrics for Internet stocks. Interviews with two specialists in 2006 at a global Accounting and Financial Advisory firm in Sweden, showed on a contradiction of the interpretation on using the non-financial data, and other literature on the topic advocates more traditional valuation techniques (Copeland *et al*, 2004). Web metrics are applied on analysis in both popular press and in business reports, and even if studies have showed evidence for value-relevance, the use of web metrics has not reached consensus (Demers & Lev, 2001; Trueman *et al*, 2001).

Demers & Lev (2001) use factor analysis and presents three web traffic metrics in their report. The study investigates the separate valuation role of these three different dimensions of web traffic performance. The results of the study are examined both before and after the Internet shakeout in year 2000. This examination before and after the shakeout is pertinent because some analysts and practitioners have suggested that web traffic metrics are no longer important (Briginshaw & Higson, 2000). A viewpoint, shared with the specialists interviewed for this report.

Three key dimensions of traffic generating performance are: the attraction of new visitors to a website, the retention of visitors at the website, and the ability to generate repeat visits from surfers who have been attracted to the website in the past (Demers & Lev, 2001). These three dimensions of web traffic performance are commonly referred to as: *reach*, *stickiness*, and *customer loyalty*.

#### 3.4.2.1. Reach

Reach is generally defined as the number of unique individuals who visit a site (Demers & Lev, 2001). The measure is stated both in percent of the active web population or in real numbers, indicating how many unique visits a website has the ability to attract. Reach is the most frequently cited web metric in the business press and has been studied in prior researches (Trueman *et al*, 2000; Hand, 2000; Rajgopal *et al*, 2000). In Demers & Lev's (2001) report, the performance measure reach is positively associated with the value of the B2C Internet companies, due to the importance of scale in the B2C sector.

#### 3.4.2.2. Stickiness

Stickiness refers to a site's ability to retain a visitor at their website once an individual has

arrived there. The web metric stickiness is a desirable performance measure because a sticky site may be able to generate higher advertising rates since the visitors are spending more time at one place. The higher advertising rates are motivated of believes that surfers might be more influenced of specific advertising due to longer exposure (Demers & Lev, 2001).

### 3.4.2.3. Customer Loyalty

The loyalty measure generally refers to the site visitors willingness to revisit a website that the already has been visited before. The measure is relevant because a website's ability to re-attract current visitors is expected to be an important determinant of its ability to sustain and/or ultimately grow to the critical mass of traffic that is necessary to attain profitability. A visitor who returns several times is important for e-commerce firms, because of a high probability of steady income.

Both stickiness and customer loyalty reflect important dimensions of an Internet firm's brand value.

## 3.5. Market based view

The way of designing an exit strategy already in the start-up stage of a company's life cycle is a conscious act in order to design a competitive strategy. If the aim of the exit strategy is a company sale, an IPO, or an acquisition, a company in its early stage has to identify its external surroundings, in order to successfully design a strategy that will meet the requirements from a potential buyer (Porter, 1980; BizPlanIt, 2006). The approach of identifying an industry's external environment and adapting the corporate strategy to it is close connected to the Market Based View (Porter, 1980). Later studies have accused the approach of having some limitations, because the presumptions in this theory proceed from a stabile industry structure (Brown & Eisenhardt, 1998; Grant, 1991). The disagreement will be discussed in this chapter.

The *Market Based View* has only significance in some part of the *exit strategy* outline of this report, mostly because of its idea of adapting to external environment, in this case - the potential buyer's requirements. The design of a corporate strategy for a new technology start-up firm has more inspiration to gain from the *Resource Based View*, because of its volatile and unstable nature, also describes in this chapter (Brown & Eisenhardt, 1998; Grant, 1991).

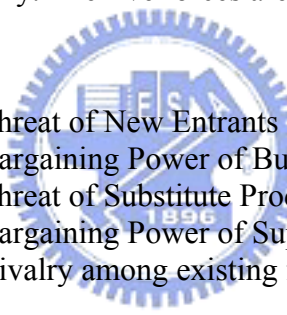
*Market based view* is based on the outlook of the *external environment* as a factor that influences a specific company's proceedings. Market based strategy manages the company's reactions to the external environment that are required to maximize the internal resources

efficiency. The *market based approach* uses the external environment as basis to design a successful corporate strategy. Supporters of this approach (Porter (1980)) advocates that differences between different markets and companies concerning profitable success, depends on external factors. Competitive advantage depends on a company's ability to adapt to its external environment (see figure 3.1) (Porter, 1980).

The competitive advantage that lead to profitable success is in the *market based approached* derived from thee factors:

- Establishing hurdles
- Monopoly and competition
- Power of negotiation

Porter (1980) developed the concept further and introduced the *Five-Force Model* (figure 3.1) as a strategic tool for competitive advantage. The model describes five forces, which have impact on every specific company. The five forces are defined as follow:

- 
- Threat of New Entrants
  - Bargaining Power of Buyers
  - Threat of Substitute Products or Services
  - Bargaining Power of Suppliers
  - Rivalry among existing firms

The Five-Force Model is illustrated in the figure below:

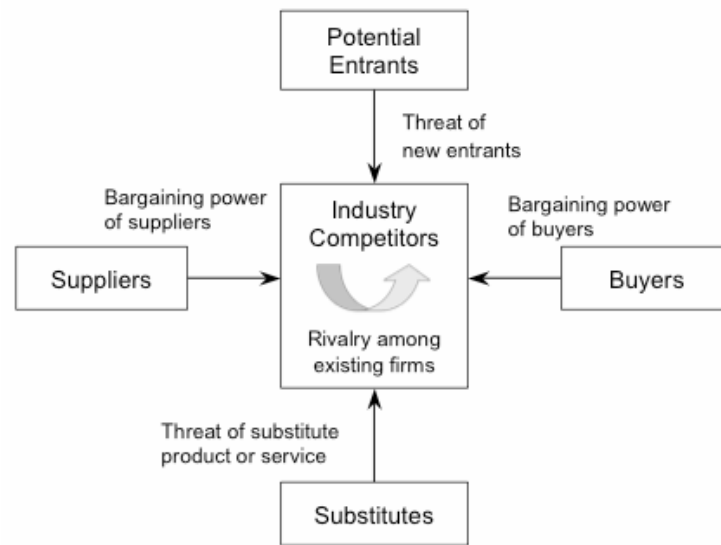


Figure 3.2 Five-Force Model, Porter (1980)

Porter's Five-Force model is basically a framework for analysis of markets and competitors and views the profitability of an industry as determined by five sources of competitive pressure (Grant, 2005). The model is a tool objected to clarify the relation between a company and its external environment. The forces of the model, illustrated in figure 3.1, are according to Porter, the main factors that affect the competitive situation in an industry. The joint impact of these forces, on a company determines the potential profitability in the industry. Because every competitor is exposed of the force's impacts, it is crucial to be aware, and analyze the source of every force, to be able to develop a successful specific corporate strategy. The collective affection of the model's five forces has various impacts on companies depending on specific industry. In order to develop a successful competitive strategy, the specific industries have to be defined. Porter (1980) defines an industry as a group of companies, which produce products and services that are close substitutes to each other, as an example. Added to the specification of the industries there is a question of time as well. The five force's impact on the company is depending on what stage the company is, in the industry lifecycle.<sup>9</sup> A lucrative and prosperous business with little competition, can during time realize tougher competition and less space and market share for small actors, as more competitors enters the market and the industry matures. This scenario is typical for the majority of industries. The consequence of Porter's Five Force's is that the analysis works best in matured and stable

<sup>9</sup> See chapter 6.1 for a discussion of Industry Life Cycles

industries, because the presumptions in this theory proceed from a stable industry structure (Brown & Eisenhardt, 1998).

Even if the market based approach puts the company's external environment in focus, Porter (1980) emphasizes the importance of industry structure analysis. The external environment shall limit to the environment of a specific industry structure. The forces of the environment outside the industry structure are only relative, because every competitor in the industry faces these forces. Porter (1980) also describes the importance of the internal structure and organization of a company, and introduced the *Value Chain*, which is an analysis model aimed to map the functions that add value within a company (Grant, 2005). Conducting a value chain analysis of a company, the framework of Porter can expand to encompass more factors that a company can take into consideration. This will present an even more comprehensive analysis as basis for decisions.

When elaborating the market base view, there are those who consider the approach to narrow and emphasize other approaches to a strategic foundation of a corporation. One of the views is the *Resource Based Approach*.

### 3.6. Resource based view

The key to a resource based approach of a sustainable corporate strategy formulation is an understanding of the relationships between resources, capabilities, competitive advantage and profitability (Grant, 1991).

Porter's strategic development process starts by looking at the relative position of a firm within a specific industry. This can be formulated as, starting by considering the firm's environment and then try to assess what strategy is the one that may maximize the firm's performance. In the specific context of this report – designing an exit strategy of a new technology firm, after assessing what actions and operations that may maximize the firm's performance is on par with the *Market Based View*.

The *Resource Based* view, by contrast, can be seen as an “inside-out” process of strategy formulation. Brown & Eisenhardt, 1998, advocates that the *Resource Based* approach is more suitable for business in volatile and typical uncertain industries, like new technology industry, which is why the Resource Based view has significance for this report. Starting by looking at what resources the firm possesses. Then assess their potential for value generation and end up by defining a strategy that will give allowance to capture the maximum of value in a sustainable way. The *resource based* strategy is sustainable successful if the resources which build the strategy foundation, is rare, not can be imitated, or be replaced (Grant, 1991; Barney,



1991). Figure 3.2 outlines the framework of a *resource based approach*:

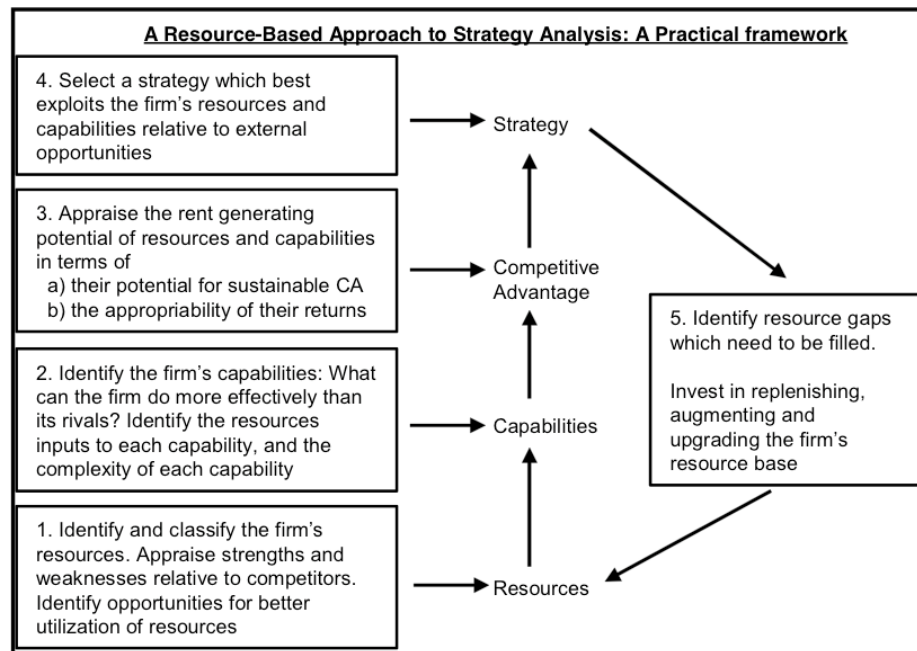


Figure 3.3. A Resource Based Approach to Strategy Analysis. (Grant 1991).

Formulating a strategy, the starting point must be some statement of the firm's identity and purpose. From a market based approach this takes the form of the mission statement, which answers the question: "What is our business?" Traditionally the definition of the business is in terms of the served market of the firm, e.g. focusing on customers demand (Grant, 1991). In a world where customers preferences are highly volatile, customers' identity are changing, and the technology for serving customer requirements is constantly evolving, the externally focused strategy does not provide a adequate foundation for formulating a long-term strategy (Grant, 1991). Grant (1991) further advocates that the firm's resources and capabilities may be a much more stable basis on which to define its identity, when the external environment is in a state of flux.

In the context of this report, designing a strategy with the ambition of a successful exit, the approach is first inspired by the Market Based View, when examining what acquisition firms and investors are purchasing and paying for. When the start-up firm of interest, here

MindValue, has a clear picture of what environment to compete in, the exit strategy are turn to examine it own resources and capabilities, since those may be a much more stable basis, referring to Grant's statement (Grant, 1991).

Typically, companies' management systems lack of identification routines that clearly identifies a firm's capabilities and resources. Financial statements and balance sheets only provides a fragmented and incomplete picture of a firm's resource base, and clearly disregard intangible resources and people-based skills. Looking at American companies in 1982, some 62 percent of corporate assets were physical assets, but by 2000, that figure had shrunk to a mere 30 percent (see figure 3.4.). At the beginning of the 1990ies, in Europe, intangible assets accounted for more than a third of total assets (WIPO, 2003).

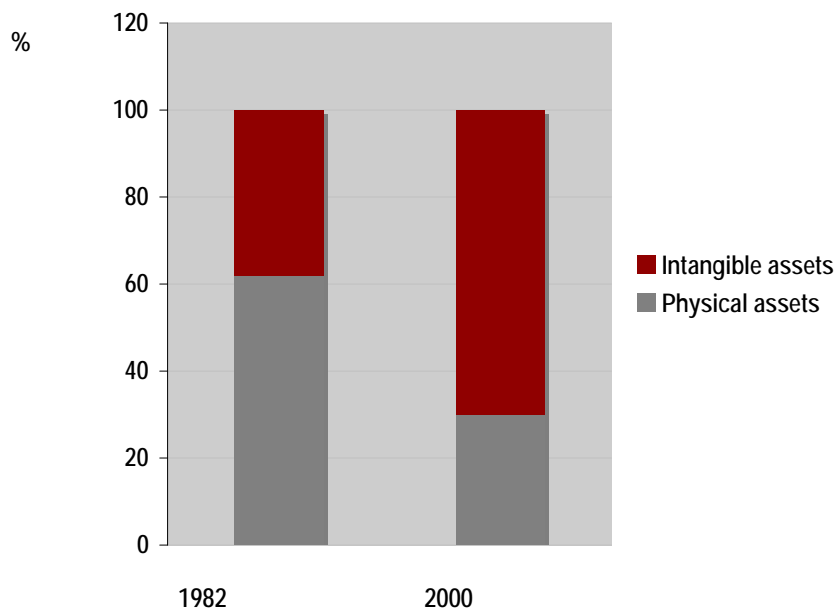


Figure 3.4 U.S. Companies' intangible assets as a percentage of total assets, *WIPO 2003*.

In the new economy, wealth is generated through creating and capturing the value of knowledge, which requires profound strategies to identify and analyze measures of knowledge based resources and capabilities (WIPO, 2003). The technology boom of the late 1990-ies encouraged a mindset of new thinking about business strategies, which strengthen the significance of the resource based view (Grant, 2005).

Grant (1991) presents six major categories of resources for classification of tacit knowledge

and intangible assets:

- Financial resources
- Physical resources
- Human resources
- Technological resources
- Reputation
- Organizational resources

Figure 3.5. summarizes the relationships between resources and profitability:

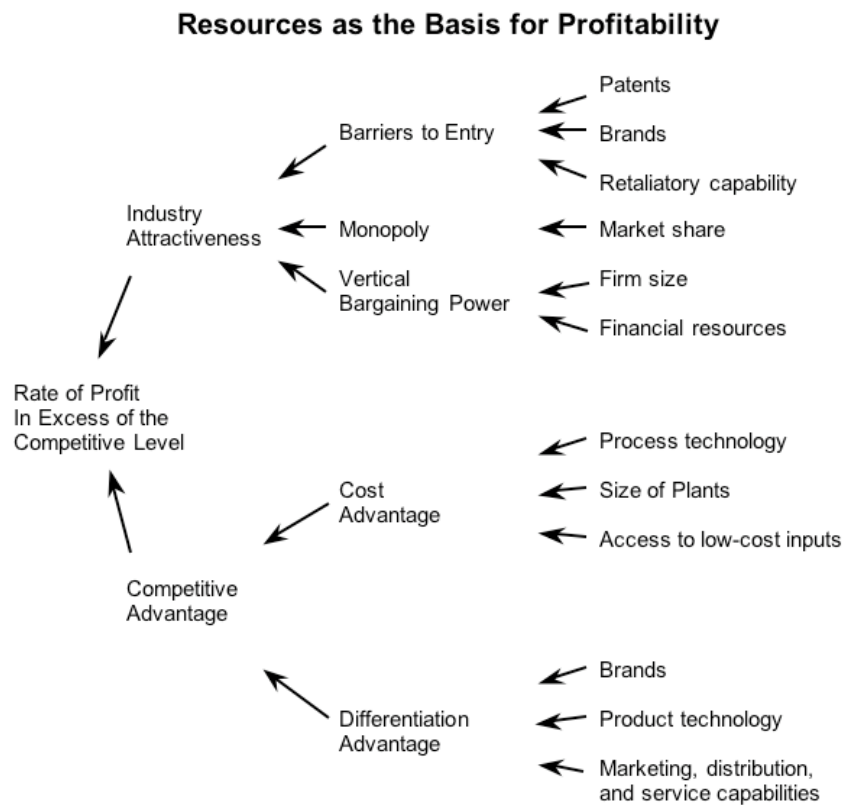


Figure 3.5. Resources for the Basis for Profitability, Grant (1991).

### 3.7. Scenario analysis

When assessing volatile industries and companies with no comparables, no earnings, and no history, like many new technology firms, the actual facts to use are limited. In order to produce robust assessments in this environment a usable tool is *Scenario Analysis*. The

*Scenario Analysis* will be used due to the lack of real data in the assessment of the specific firm, MindValue.

Whenever a company is seeking to adapt to external change or to shape industrial evolution, an understanding of the forces driving the industry development is important. It is crucial to forecast the industrial development as close to the truth as possible, in order to carry out proactive actions and react on critical changes in advance. It is not possible to predict the future with a 100 percent probability, but it is possible to think about what might happen. Using information of what is already known about current trends and signals to future development, in a systematic way, gives series of highly probable outputs. This is what scenario analysis is. Scenario Analysis is a process for thinking and communicating about the future development (Grant, 2005).

The scenario analysis was first defined as “*hypothetical sequences of events constructed for the purpose of focusing attention on causal process and decision points*” (McNulty, 1977). The multiple scenario approach constructs several distinct and internally consistent views of how the future may look like in coming years ahead. Typically the multiple scenario approach constructs three to or four alternatives. The time range to analyze pertains from 5 to 25 years in traditional industries, and shorter time range in fast-moving sectors. Its key value is in combining the interrelated impacts of a wide range of economic, technological, demographic, and political factors into a few distinct alternative stories of how the future might reveal. Scenario analysis can be either qualitative or quantitative, or a combination of them (Grant, 2005). Grant (2005) advocates “quantitative scenario analysis models events and typically runs simulations in order to identify distinct and likely outcomes. Qualitative scenarios typically take the form of narratives and can be particularly useful in engaging the analytical abilities and imagination of decision makers.”

Scenario Analysis is used in companies to explore industry evolution, to examine developments in particular country markets, and to analyze the prospects for specific investments projects, for the purpose of strategy making. Scenario Analysis has been a useful tool in identifying possible threats and opportunities, generating flexibility of thinking by managers. The Scenario Analysis gives decision makers time to react proactive in advance, developing practical approaches to the management of risk. Grant (2005) advocates that scenarios applied to particular industries, can help clarify and develop alternative views of how changing customer requirements, emerging technologies, and new firm strategies may influence industry structure, and what the implications for competition and competitive advantage will be.

I will use the Scenario Analysis together with other frameworks in this report, with purpose to portray possible outcomes, and to demonstrate what the consequences in a financial perspective will be. The ordinary scenarios in this report will be three to four outcomes, *one poor, one OK, one good, and one extremely good*. The usage range of Scenario Analysis goes far beyond trivial cases just mentioned, though. The strength with Scenario Analysis in this report is the organized process to determine series of outcomes and predict possible outcomes, and not necessarily bringing together different ideas and insights about business environment and building consensus, that Grant (2005) highly advocates. On par with Grant (2005) though, scenarios can help to evaluate alternative strategic options. By assessing how a strategy might perform under different scenarios, they can help identifying which strategies are most robust and can assist in contingency planning (Grant, 2005).

### 3.8. The Industry Life Cycle

The Industry Life Cycle is presented due to the terminology of the types of firms the report is discussing. A company faces different stages during the company life cycle (Grant, 2005; Damodaran, 2001). The start-up phase is in the infancy of the company life cycle, and after that follows a row of phases on par with the development of the firm. The concept of company life cycle is presented in order to highlight the phases and to identify the difference between the stages. The difference of the phases implies more solid financial analysis the further the company matures. At the start-up phase the value of the firm rests entirely on its future growth potential, and valuation poses the biggest challenge, since there is little useful information to go on (Damodaran, 2001). The concept of the industry life cycle indicates phases where the valuation analysis of the firm is more or less solid. The valuation is generally easier in the last stage than in the first, due to historical data and accumulated knowledge of the industry (Damodaran, 2001). The valuation is clearly more of a challenge in the earlier stages in a life cycle, and estimates of value are much more likely to contain errors for start-ups or high growth firms (Damodaran, 2001).

One of the best-known and last-longing marketing concepts is the product life cycle, figure 3.2, (Grant, 2005). Like products, which are born, their sales grow, they reach maturity, they go into decline, and finally they die, industries that produces them follows the same cycle. The industry life cycle is the supply-side counterpart of the product life cycle. The industry produces a range and sequence of products, though, which makes the industry life cycle likely to be of longer duration than a single product. According to Grant (2005) the life cycle comprises four phases: *introduction* (or *emergence*), *growth*, *maturity*, and *decline* (figure 3.2).

The industry life cycle and its phases are defined primarily by changes in an industry's growth

rate over time. The characteristic profile is an S-shaped growth curve, and is close connected to the *innovator theory* of E. M. Rogers from 1962. E.M. Rogers (1962, 1995) classifies consumer attitudes towards purchasing products in a *normal distribution curve*, and into five categories according to how quick consumers are to purchase new products; *innovators* (2.5%), *opinion leaders* or *early adapters* (13.5%), *early majority* (34%), *late majority* (34%), and *laggards* or *late adapters* (16%). E. M. Rogers (1962, 1995) compared the normal distribution curve to the S-shaped curve formed by “cumulative frequency distribution of product diffusion.” The 16% line marks a cut-off point between innovators, opinion leaders, and early majority and roughly coincidence with the point where the S-curve starts to increase dramatically (Rogers, 1962,1995).

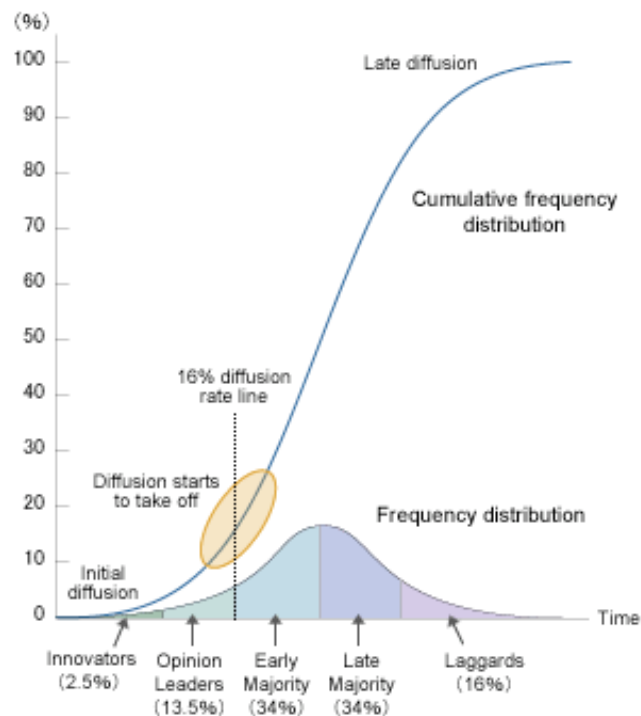


Figure 3.6. S-curve and consumer attitudes in the normal distribution curve.

*E. M. Rogers 1962, 1995.*

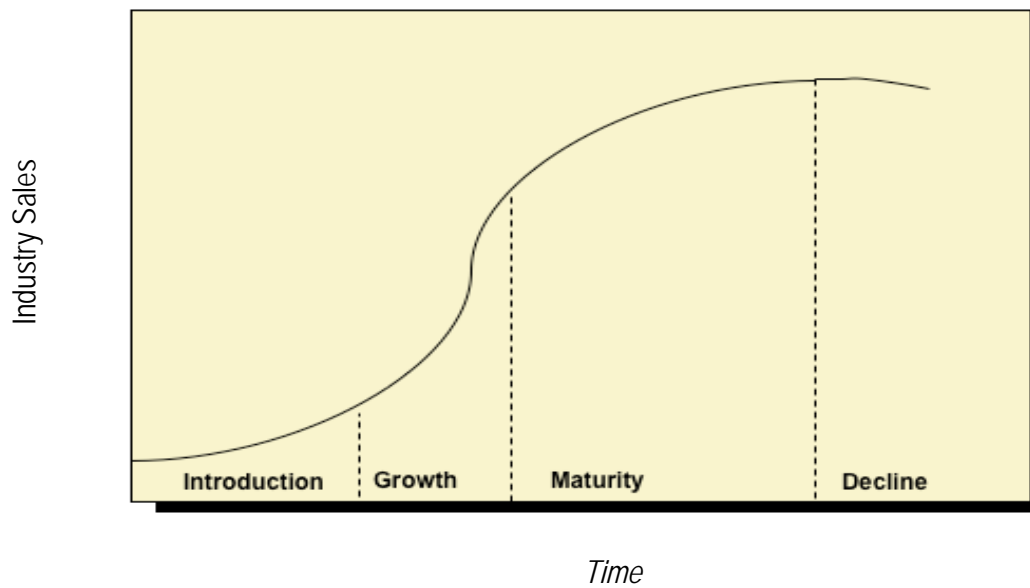


Fig 3.7.. The Industry Life Cycle – S-curve. Grant, 2005.

Grant (2005) characteristics of the *industry life cycle*'s different phases:

- In the *introduction stage*, sales are small and the rate of market penetration is low, due to the industry's products are little known and the customers are few. In this stage, the costs are high and the quality is still relatively low, due to novelty of the technology, small-scale production, and lack of experience. Customers for new products in this stage tend to be affluent, innovation-oriented, and risk-tolerant. With definitions of E.M. Rogers (1962, 1995) the customers would be classified as innovators, opinion leaders, and early majority (Rogers, 1962, 1995).
- The *growth stage* is the phase of the *early majority* and is characterized by a fast growing market penetration as product technology becomes more standardized and prices fall. The mass market has taken over the ownership from higher-income customers.
- Increasing market saturation causes the beginning of the *maturity stage*. The stagnating growth as new demand gives way to replacement demand. Once saturation is reached, demand is solely for replacement. The replacement is either direct or indirect, by customers who are replacing old products with new products, or new customers who are replacing old customers.
- Finally, the industry is challenged by new industries that are more innovative and produces technologically superior substitutes, and the industry enters its declining stage.

### 3.8.2. Entrepreneurial approach of industry life cycle

D. Zahorsky, a writer of *About.com*, a part of *The New York Times Company*, divides the industry life cycle in seven stages, instead of Grant's four, and E. M. Rogers five phases, when he describes the stages of business life. The seven stages of Business Life, according to Zahorsky is: 1. *Seed Stage*, 2. *Star-up Stage*, 3. *Growth Stage*, 4. *Established Stage*, 5. *Expansion Stage*, 6. *Decline Stage*, and 7. *Exit Stage*. Damodaran (2001), also defines the stages of the industry life cycle into five phases, but adds a valuation approach onto the life cycle concept.

The stages of Zahorsky ([www.about.com](http://www.about.com)) are very similar and close connected both to Grant's (2005) and Rogers' (1962, 1995) approaches, earlier presented.

1. *Seed stage* indicates the phase when the company is just a thought or an idea. Most companies in this stage will have to overcome the challenge of market acceptance and pursue one niche opportunity. The financing of seed stage companies will mostly rely on cash from owners, friends and family and government grants.
2. In the *start-up stage* products or services are in production and the firm legally exists. Start-up firms require a customer base and market presence along with tracking and conserving cash flow. The operations are still mostly financed from the owners, friends and family and government grants.
3. During the *growth stage* revenues and customers are increasing with many new opportunities and issues. This phase requires effective management and new employees will have to be hired to deal with the influx of business. Growth businesses are focused on running the business in a more formal fashion to deal with the increased sales and customers. In the growth stage the financing of the firm constitutes of banks, profits, partnerships, grants and leasing options.
4. When the business has matured into a thriving company with a place in the market and loyal customers, it has reached the *established stage*. Sales growth is not explosive but manageable, and the business life has become more of a routine. An established life cycle company will be focused on improvement and productivity. Competing in an established market requires better business practices along with automation and outsourcing to improve productivity. The financing constitutes of profits, banks, investors and government.
5. A next stage, can be the *expansion stage*, is characterized by a new period of growth into new markets and distribution channels. The *expansion stage* is often the choice of the small business owner to gain a larger market share and find new revenue and profit channels. Moving into new markets requires same planning and research as of a *seed stage* or *start-up stage* company. Typical strategies of the *expansion stage* can be adding new products or services to existing markets or expanding existing business into new markets and customer types. The financing of this stage constitutes of joint ventures, banks, licensing, new investors and partners.



6. Businesses in the *decline stage* of the life cycle will be challenged with dropping sales, profits, and negative cash flow, due to changes in economy, society, or market conditions. The biggest issue is how long the business can support a negative cash flow. The vital focus has to be on cutting costs and finding ways to sustain cash flow. The money source of financing the firm now typically relies on suppliers, customers, and owners.
7. The *exit stage* is the opportunity for the entrepreneur and investors to cash out on all the effort and years of hard work. Or it can mean shutting down the business. Selling a business requires your realistic valuation and it is crucial to have a solid *Exit strategy*.

According to Zahorsky (2005), each stage of the business life cycle may not occur in chronological order. Some business will go quickly from start-up to exit, while others will choose to avoid expansion and stay in the established stage.



## 4. Method

The method references on how to approach the subject of issue to write about and how one intend to treat the subject (Ejvegård, 2003). In chapter 2, I gave a brief and discussed the issues of this analysis. In this chapter I will describe how the work have been done. I will also give further details of how the progress for the report's scientific conditions has been worked out.

### 4.1. Requirement of Scientific Conditions

Every scientific work, or any report produced within a University or Collage, shall be objective, impartial and written in a balanced way (Ejvegård, 2003). I will define, according to Ejvegård (2003), what this requirement represents:

#### 4.1.1. Objective conditions

Objectivity means that information that is presented shall be truthful and correct. This means that no author unexpectedly is allowed to accept information or fact without check and guarantee the reliability of the source. The check-up or control can be realized differently according to what kind of information to treat. A principal rule is always to seek the primary source. The author can also consolidate the reliability in information, by quotations of other authorities in the field of issue. If extensive conclusions are made, by given information, it is extra important to control the reliability of the information (Ejvegård, 2003).

#### 4.1.2. Unprejudiced conditions

The difficulty of being unprejudiced is in a psychological dimension, where underlying biases and preconceived notions often are difficult to sort out. The ambition of unprejudiced conditions requires that standpoints from different angles all are expressed, in debates where opinions are divided. Other ways to hedge against unprejudiced conditions is to explicit state that information is taken from sources that may be partial (Ejvegård, 2003).

#### 4.1.3. Balanced conditions

The concept of balance is, according to Ejvegård (2003) himself a vague concept in order to describe scientific conditions. Both the *objective conditions* and the *unprejudiced conditions* are included in the concept of Balance, but the concept also treats the approach of how to

portion each topic right. Unessential details shall not be given space in a report, at the expense of more important discussions, as well as one party in a discussions shall not be given more space than other parties, in order to keep the report unprejudiced (Ejvegård, 2003).

#### **4.1.4. Guarantee of Objective, Unprejudiced, and Balanced conditions**

In order to guarantee required objectivity for this report, I have applied used information carefully and in an accurate way. In this field of study, which is relatively new compared to mature industries I have found it necessary to be careful in managing information. The carefulness of managing this type of information is also required, since much of it comes from daily press and media, due to its novel creation. Every single source that are used in this report have therefore been reviewed in a structured way, with held of Ejvegård's (2003) recommendations for source reviews.

- *Is the material authentic? Has the material been falsified?*

In order to control the accuracy of the information used, I have tried to control the information channels. Written books have been lent from the Library of Chalmers University of Technology and the library of Gothenburg's School of Law & Economics, which vouch for an accurate information channel. Other books used for this report are either recommended books that are used in prior university courses, or books that are bought from established distribution channels. Scientific reports and articles used for this report have been taken from established databases or are acquired after recommendations. Authors who not where familiar prior to this study have been checked-up on Internet (Google.com) in order to get a perception of how quoted the authors are, and how used the material are in other studies. This method of checking the authors may not be strictly scientific, but I have classified the material accurate and reliable, since much of the material are well used, well known, and recommended by high ranked<sup>10</sup> international business schools. Much of the material stems from contemporary articles in daily financial press and weekly magazines, due to the field of Internet's novelty. The articles used stems from established press.

- *Is the material impartial?*

In the ambition to keep the report impartial, I have chosen to manage this by

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<sup>10</sup> The ranking of Universities and Business Schools are made by *BusinessWeek*, *The Economist*, *Financial Times*, and *Shanghai Jiao Tong University*.

examining if the source is a primary source or not. In those cases where the source not is a primary source, I have tried to replace the source with its original. If any source is a secondary source, I have tried to made an assessment of any changes in angles and views. Much of corporate information or quotations in media may have a different agenda, than to be objective, due to specific firm's marketing, etc. I have not found that there exists any such risk in the sources used for this report, though.

- *Is the material new?*

The requirement of the freshness of the sources used means that newer sources should be used prior to older material. The material has to be that novel that it covers enough facts of the field of issue. Due to the novelty of the topic of the report, it is highly relevant to get as contemporary material as possible. In this case I have found that ordinary libraries and databases sometimes lack of contemporary information, why Internet search, and daily press in such cases can give a more contemporary picture of the field of issue.

## 4.2. The Implementation of the Study

This section describes the methodology used in this work. Methodology refers to the approach of how to collect material in order to be able to compare, test hypothesizes, or predict results (Ejvegård, 2003).

I have chosen to collect information primary by two ways: by *literature search* and by *interviews*. The literature search was required in order to get as broad and extensive empirical information as possible, and to be able to get useful theoretical models, suitable for this report. The interviews were important in order to get a contemporary picture of the field practice of the field of issue. Due to the fast development of the Internet industry, it is difficult to gain sufficient contemporary information only from literature.

### 4.2.1. Literature search

In scientific context, literature to a great extent means every printed material: *books, articles, reports, essays, papers, etc.* (Ejvegård, 2003).

The literature channels used for this report:

- Library of Chalmers University of Technology and Gothenburg's School of Law & Economic.
- Electronic databases and articles connected to the libraries
- Internet: Internet has been used in order to search primarily for two types of information:
  1. *Corporate information.* From company websites have annual reports and company specific information from press releases been collected in order to stay updated about recent activities. Facts and figures from these company sites have been classified accurate and reliable, due to their establishment.
  2. *News articles.* From daily financial press have online articles been used, in order to stay contemporary with the recent development in the field of study. Information from these online newspapers has been classified accurate and reliable, due to their establishment. Ejvegård (2003) states that this kind of information has a higher degree of risk in its accuracy, why only international established press only has been used in this report.
- *Branch specific magazines of the Internet industry.* These branch specific magazines have been used in the same extent as the other online daily press. The reliability of these magazines has the same classification as for the daily online press used in this report.

#### 4.2.2. Interviews

Two types of interviews for this report have been used: Interviews with professionals in Finance, and interviews with start-up entrepreneurs. Jointly for both types of interviews is that both are related to specialists interviews.

- *Interviews with professionals in Finance.*

When elaborating the concepts of valuation principles, it felt necessary to get a contemporary picture of the valuation practice, why a specialist interview was held. The interviews with specialists in each area can be seen as a significant complement to the written information.

The two interviews were held face-to-face during the work progress, and after the sessions I had occasional contact with both parts. The interviews turned out to be more effective if the sessions were of an "open discussion" kind, around a few central questions. Due to the delicacy of the chosen subject, the specialist discussions with *Finance professionals* have to be kept anonymous. Both interview objects works for an international *finance advisory and accountant firm*, which vouch for adequate competence in the subject. Due to the divided opinions of the valuation principles,

none of them could revile any corporate policy, why their comments not are any official company policy.

- *Interviews with start-up entrepreneurs*

In the interviews with the start-up entrepreneurs, I have had constant contact during the work progress, and the interviews have all had the character of “open discussions”.



## 5. Valuing dot.coms

*The value of a firm is based on its capacity to generate future cash flows and the uncertainty associated with these actions (Damodaran, 2001).*

The value of a firm is also influenced by a number of variables (Sevenius, 2003). Each variable have different signification for different interested party, which make valuing more complex (Sevenius, 2003).

When valuing a firm, traditionally there are three sources of use to gain information (Damodaran, 2001).

- The first is the *current financial statements* for the firm. This statement is used to determine how profitable a firm's investments are or have been, how much it reinvest to generate future growth, and for all the inputs that are required in any valuation.
- The second is the *past history of the firm*; both earnings and market prices. A firm's earnings and revenue history over time makes it possible to make judgments on how cyclical a firm's business has been and how much growth is has shown. The firm's price history can also improve the judgments on how to measure its risk.
- Finally, the firm's *competitors or peer group* to estimate how much better or worse a firm is than its competitors. Looking at comparables also estimates key inputs on risk, growth, and cash flows.

The difference of new technology firms from traditional firms is in many cases the three traditional sources to gain information from are missing, due to the new technology firm's insignificant age (Damodaran, 2001). They usually have not been in existence for more than a year or two, leading to very limited history. Second, they reveal very little of their expected growth in their financial statements that contributes the most of their value. Third, these firms often represent the first of their kind of business, which makes it hard to find any competitors to benchmark (Damodaran, 2001).

When valuing new technology firms all sources of information are constrained, due to the reasons bulleted above. Damodaran (2001) states that these constraints have caused different types of responses on how to deal with the problem with new technology valuation. Some of the investors have decided that these kinds of stocks cannot be valued and should not be held in a portfolio. Other analysts have argued that these companies cannot be valued with traditional valuation models (Damodaran, 2001).

## 5.1. Valuing from derivatives

Two common metrics when measuring the value of an investment is the *Price-Earnings* ratio (P/E ratio), the ratio of the market price of a security to its expected earnings, and *Price-to-Sales* ratio (P/S ratio), the ratio of the market value of equity in a business to the revenues generated by that business.

The *Price-Earnings ratio* is, according to InvestorWords (2006) “the most common measure of how expensive a stock is.” The P/E ratio is equal to a stock’s market capitalization divided by its after-tax earnings over a 12-month period, usually the trailing period but occasionally the current or forward period. The value is the same whether the calculation is done for the whole company or on a per-share basis. The higher P/E ratio, the more the market is willing to pay for each dollar of annual earnings. . Companies that are not currently profitable (that is, ones which have negative earnings) don't have a P/E ratio at all, why the majority of new technology start-ups cannot be measured by P/E ratio.

The *Price-to-Sales ratio* is according to InvestorWords (2006), a stock's capitalization divided by its sales over the trailing 12 months. The value is the same whether the calculation is done for the whole company or on a per-share basis. A low price to sales ratio (for example, below 1.0) is usually thought to be a better investment since the investor is paying less for each unit of sales. However, sales don't reveal the whole picture, since the company might be unprofitable. Because of the limitations, price to sales ratio are usually used only for unprofitable companies, since such companies don't have a P/E ratio (www.investorwords.com, 2006).

On both measures, technology firms distinguish remarkable, compared to the rest of the market (Damodaran, 2001).



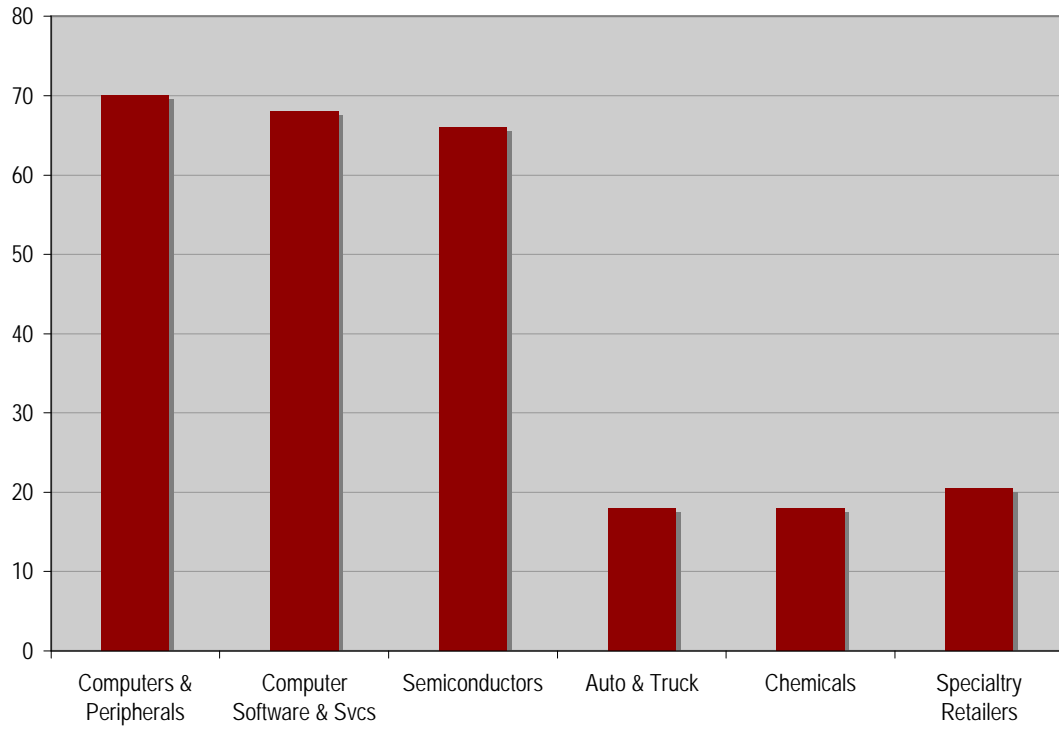


Figure 5.1. P/E Ratio Comparison across sectors. *Damodaran, 2001.*

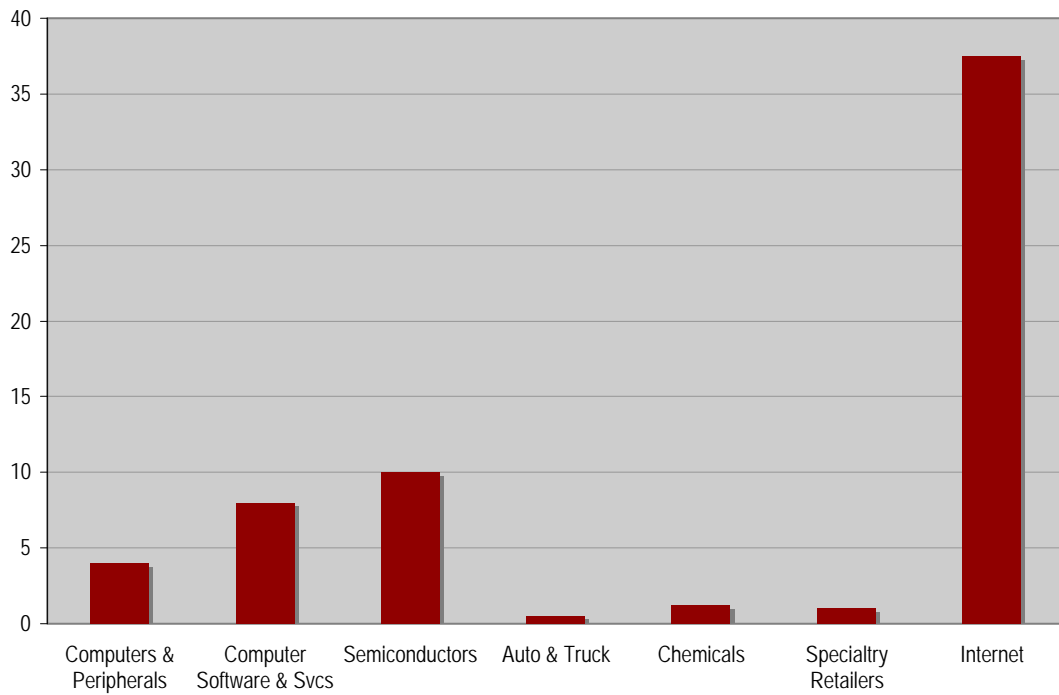


Figure 5.2. P/S Ratios by Sector. *Damodaran, 2001.*

The Price-to-Earnings ratio is the most common and widely used measure of all multiples (Damodaran, 2001). The P/E measure is attractive to choose in pricing initial public offerings because of its simplicity, but it is also highly limited. Its relationship to a firm's financial fundamentals is often ignored, which may lead to significant errors in applications (Damodaran, 2001). The P/E ratio is a measure for public companies, that is, companies that already have conducted an IPO, which makes the measure very limited to new start-ups, since they suffer from public stocks. The concept of the P/E ratio will not be further elaborated because of its limitations to new start-up companies.

## 5.2. Two approaches of valuing new tech firms

When exploring prior research in the topic of Internet valuation, there are two main approaches argued about which is the best way to use. First there is the *traditional financial statement* approach, which claims the best and accurate way of valuing, since it has financial and often historical substance. The other approach is the *non-financial measurement* approach, which claims measurements like “*unique visitors*” and “*page-views*” are crucial variables that drives value creation. Since the two ways of valuing, are controversial to each other I will present both approaches further on.

### 5.2.1. Paradigm 1. A financial statement approach – *Cash is King!*

The value of any asset is a function of the cash flows generated by that asset, the life of the asset, the expected growth in the cash flows, and the risk associated with the cash flows. Generally, the higher profit the firm makes, the more valuable it is, compared to firms less profitable. This approach appeals to traditional businesses, and sounds reasonable to apply on all industry. The conflict of the view to value firms only with this tool is based on the environment where new technology firms are operating. During the Internet shakeout in year 2000 and afterwards in year 2006 the prices of new technology firms boomed and are still booming, and skeptics asserts that the business is overvalued, because of the extreme difficulties to reach break-even for all investments. An example of this overvaluation is Amazon.com, an online bookstore<sup>11</sup>.

When looking at new technology firms with significantly great losses, like Amazon.com prior year 2002, the proposition of *high profitability – high valuation* seemed to be turned on its head, that is firms that lose money seem to be valued more than firms that make money, at least on the surface.

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<sup>11</sup> Amazon.com started their online bookstore in America, but has afterwards extended their assortment to the characteristics of a wholesale.

Using only traditional measurements will get valuations that hardly match the value the market *de facto* is paying<sup>12</sup> (FT, 2006). Since it is difficult to forecast and analyze internal business strategies and business models from the outside of a firm, an analyst hardly gets all information that justifies abnormal prices. Traditional valuing has a great advantage in credibility, since the numbers of the valuation stems from real transactions. The disadvantage of traditional valuation is that it makes it hard to put a price on activities that not specifically drives value in the organization. These activities might still be very crucial for the process, but they tend to have of no value.

In an interview with an accountant at a well-known and world-wide accountant firm with office in Sweden, the accountant claims that the traditional approach must apply, also in the new technology industry.<sup>13</sup>

### **5.2.2. Paradigm 2. A non-financial approach – *The value of an eyeball***

Using the non-financial data to get a snapshot of a firm's economical development is a delicate inquiry that divides the opinion in two groups – *those who advocate the traditional view and those who claim that a renaissance of valuation models is needed*. Studies have shown that some non-financial measures have significant value-relevance in some operations, but also no or limited significant value-relevance in other areas (Trueman *et al*, 2000). Trueman *et al*'s (2000) study were discussed after the paper was published and resulted in an article on "*Discussion of The Eyeballs Have It: Searching for the Value in Internet Stocks*" by Keating (work paper, undated) who stressed that the Internet is a nascent industry, the previous analysis is constrained by the short trading history, limited financial and non-financial data, and a small sample size. In Keating's commentary she add econometric, modeling, and interpretation-related concerns with the Trueman *et al*'s (2000) paper and offers suggestions for future research on "New Economy" firms.

The non-financial measures play a significant role, and healthy commentaries are driving the concept further. Still, the added commentaries are accounting related issues, concerning econometrics, and do not interfere with the concept of non-financial data, but polish and improve the way of thinking.

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<sup>12</sup> Examples of Skype and YouTube

<sup>13</sup> The accountant and the firm must be kept anonymous according to company policy.

### 5.3. Renaming Old Principles or embracing New Paradigms

Referring to Damodaran, he also argues that the search for new paradigms is misguided (Damodaran, 2001). He asserts that the problem with technology firms, in general, and new technology firms in particular, is not that they lose money, have no history, or have substantial intangible assets. The problem, according to Damodaran (2001) is that these new technology firms, which show on strong high-growth potential more often are exposed for valuation activities, than traditional industries in their early phases. They have often to be valued before they have established market for their product. Early valuing of new companies in novel industries contains a large portion of uncertainty, due to the lack of historical information about the company. Damodaran (2001) further claims that the problem is not conceptual, but is an estimation problem, due to the large estimation and managing of risk. The value of a firm is still the present value of expected future cash flows, but those cash flows are likely to be much more difficult to estimate (Damodaran, 2001).

## 6. The New Economy

When entered deeper into the analysis of the Internet industry and the discussion of how to value it, it becomes reasonable to describe a wider scope of the IT sector. Elaborating the Internet industry requires an understanding of the factors and terms that are pushing the development forward. This chapter will give a brief of the last 10-15 years development in economy and technology, in order to make further reading more comfortable.

### 6.1. Definition of the new economy

The term '*new economy*' was stated in the 1990ies to describe what was happening to the economy in the United States and other developed countries. The claim of a 'new economy' was a consequence of a "faster productivity growth fueled by investments in information technology hardware and software" in the United States, as McKinsey Global Institute states, in combination with a more globalized world (McKinsey Global Institute, 2002; Eklund *et al*, 2000). The term is referring to the change from an industrial/ manufacturing-based wealth producing economy into a service sector *wealth consuming asset*-based economy. During the period 1995-2000 the U.S. productivity grew astonishingly. From 1972 to 1995 the productivity in the United States grew annually 1.4 percent, and in the second half of the 1990ies the annual productivity leaped to a 2.5 percent rate, which caused the demand of a new manifest, to distinguish the environment prior to the new era (McKinsey Global Institute, 2002). The post-1995 productivity acceleration is explained by fundamental changes in the way that companies deliver products and services. However, IT was only one of several

factors at work that caused the increase in productivity (McKinsey Global Institute, 2001). The ‘new economy’ trend was indicated all over the world during the period of 1995-2000. The productivity rate in Sweden during this time was slightly below USA, but above the EU average (Eklund *et al*, 2000; The European Commission, 2002)

The changes in technology and economy bring a new set of beliefs and practices on the part of business firms. Table 5.1. present the major business beliefs, according to Kotler *et al* (2003), in the old economy and how these beliefs are shifting.

Table 6.1. Some value indicators by economies, Kotler *et al*, 2003.

Old Economy	New Economy
Organize by product units	Organize by customer segments
Focus on profitable transactions	Focus on customer lifetime value
Look primarily at financial scorecard	Look at marketing scorecard
Focus on shareholders	Focus on stakeholders
Marketing does the marketing	Everyone does the marketing
Build brands through advertising	Build brands through performance
Focus on customer acquisition	Focus on customer retention
No customer satisfaction measurement	Measure customer satisfaction and retention rate
Overpromise, underdeliver	Underpromise, overdeliver

Kotler *et al* (2003) focus on a marketing perspective when highlighting the differences of old economy versus new economy characteristics. Nevertheless, it is still valuable to view their value indicators (Table 6.1) to get sense of the two concepts discerns. Below, an elaboration of two examples of table 6.1 will follow:

**From organizing by product units to organizing by customer segments**

As well as a company making two or more products normally assigns product managers or product divisions to manage them, it makes sense to add marketing groups that address the needs of different customer groups, who buy differently. The change from old to new approaches means a switch from being product-centered to being customer-centered. (Kotler *et al*, 2003).

**From focusing on profitable transactions to focusing on customer lifetime value**

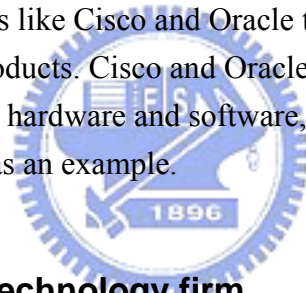
Companies traditionally focus on individual transactions to make a profit on each transaction. New economy companies add a focus on estimating individual customer lifetime value. It has

been important to keep a customer over a long period of time, why firms are designing their market offerings and prices to make profit over the customer's lifetime (Kotler *et al*, 2003).

The other characteristics in table 6.1, that have gone thru a change from old to new economy have similar development as the two stated above. The marketplace today is more complex and customers are more disloyal than before (Kotler *et al*, 2003). The essence and summary of Kotler *et al*'s (2003) table 6.1 are therefore - *Companies who cannot serve customers on the customers' demands will meet tough competition.*

## 6.2. Definition of a technology firm

The declaration of what differentiates technology firms from other firms is not easy to define. As more firms use technology to deliver their products and services, the definition becomes more difficult to state. As an example of the difficulties, Wal-Mart has an online presence but is considered to the retail sector. Car manufacturers, as General Motors are having websites where customers can order cars, but they are still considered the automobile industry (Damodaran, 2001). Companies like Cisco and Oracle though are considered technology companies, because of their products. Cisco and Oracle deliver technology-based or technology-oriented products – hardware and software, but do not differ that much in other aspects to a car manufacturer, as an example.



### 6.2.1. Two aspects of a technology firm

Referring to Damodaran (2001), there are two groups of firms that are designated as technology firms. The *first group* includes the companies like Cisco and Oracle that *deliver technology-based or technology-oriented products*. Companies like high growth telecommunications, Nokia and Ericsson, can also be classified to the first group.

The *second group*, referring to Damodaran (2001), contains firms that use technology to deliver products or/and services that were delivered by more conventional means until a few years ago. In the relative short era of IT-business, Amazon.com has become a symbol of the *second group* of technology firms, and worldwide successful e-commerce. Amazon.com, is a retail firm that *sells only online*, leading to its consideration as a technology firm, whereas Barnes & Noble<sup>14</sup> is considered a conventional retailer (Damodaran, 2001).

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<sup>14</sup> Barnes and Noble is the world's largest [traditional, in this context] bookseller, and the United States largest specialty retailer, originated from 1873 and operates chiefly thru its Barnes & Nobles Booksellers.  
Wikipedia, 2006.

In the group of technology firms, there is a wide scope of subcategories like B2B (*Business to Business*), B2C (*Business to Consumer*), C2C (*Consumer to Consumer*), and C2B (*Consumer to Business*), e-commerce and e-business, which are defined in this chapter.

### 6.2.2. Old tech to new tech

When looking at the overall market, it is obvious that there has been a shift to technology in a strong majority. At the end of the 1990ies and in the beginning of year 2000 there was a strong trend of newly start-ups, all over the developed world, which immediately classified as new technology firms. Following Damodaran's (2001) definitions, there are again no consensus of what categorizes to this group, but there are some common features shared by these new technology firms that have significance for the definition of a *new technology firm*, in this paper. *New technology firms are younger, they tend to have little revenue when they first come to the market, and they are often reporting substantial losses* (Damodaran, 2001). The "definition" of new technology firms was stated at the end of the 1990ies, which explains the characteristics of them. After the "Internet bubble's" burst in year 2000, following start-ups do share some of the characteristics, except for the acceptance of substantial losses (Cooke, 2006). The new technology firms are also categorized as Internet firms.

Another key difference between new technology firms and other firms in the market is that new technology firms do not make significant investments in land, buildings, or other fixed assets. New technology firms seem to derive the bulk of their value from intangible assets. To image this, the simplest way is to illustrate this divide by view at the ratio of market value to book value at both technology firms and non-technology firms. The price-to-book-value at technology firms is much higher than it is for other firms. Figure 5.2 compares the price-to-book-value ratio for technology sector to that of non-technology sector.

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[http://en.wikipedia.org/wiki/Barnes\\_&\\_Noble](http://en.wikipedia.org/wiki/Barnes_&_Noble).

Company webpage, Barnes & Noble, 2006.

[http://www.barnesandnobleinc.com/our\\_company/history/bn\\_history.html](http://www.barnesandnobleinc.com/our_company/history/bn_history.html)

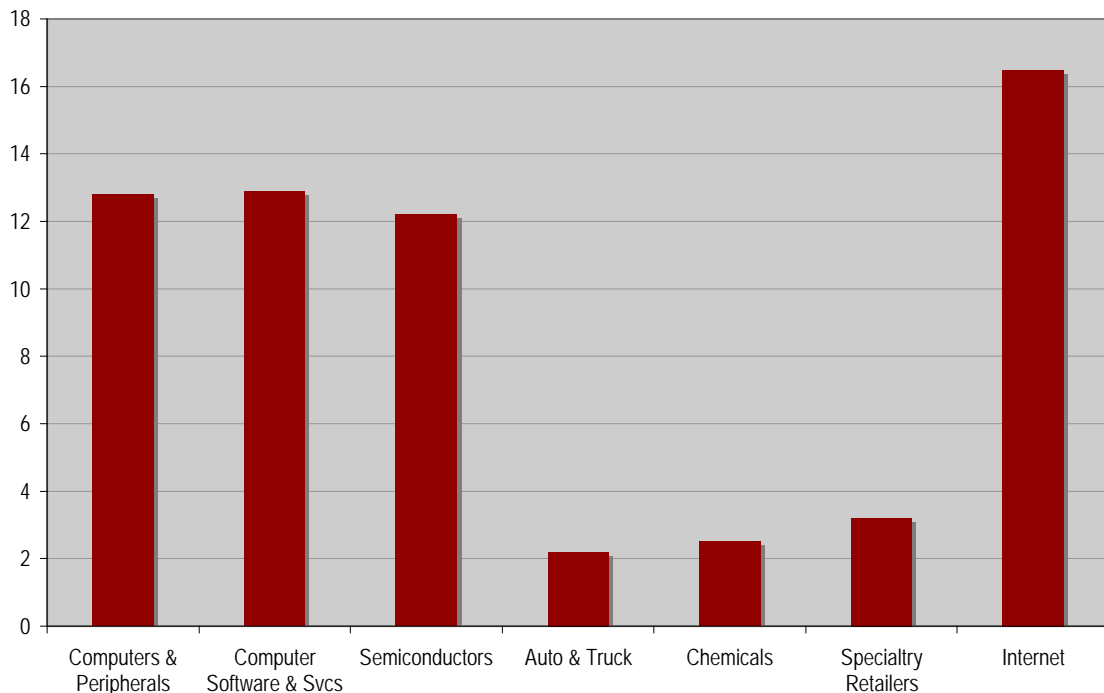


Figure 6.1. Price-to-Book-Value Ratios by Sector, *Damodaran (2001)*.

### 6.3. Definition of some business concepts of the New Economy

There is a debate among consultants and academics about the meaning and limitations about the concepts of e-business and e-commerce. Some argue that e-commerce comprises the entire world of electronically based organizational activities that support a firm's market and exchanges – including a firm's entire information system's infrastructure (Rayport & Jaworski, 2003). Other claims that e-business encompasses the entire world of internal and external electronically based activities, including e-commerce (Kalakota & Robinson, 2003). It is important to define both concepts and make a working distinction e-business and e-commerce because they refer to different phenomena (Laudon & Traver, 2003).

#### 6.3.1. E-business

E-business can be expressed by completing business processes over easily accessible electronic infrastructures (open networks), and thereby substituting information for physical business process. The definition of e-business is broad, comprising business-to-business (B2B), business-to-consumer (B2C), and consumer-to-consumer (C2C) interactions (Weill & Vitale, 2001). Kotler (2003) means that e-business even encompasses a forth Internet domain, consumer-to-business (C2B), which is evidence of an emerging industry that still is on its growth period and new business models are developing.



The working definition of Weill & R. Vitale and their complementors is:

*“Marketing, buying, selling, delivering, servicing, and paying for products, services, and information across (nonproprietary) networks linking an enterprise and its prospects, customers, agents, suppliers, competitors, allies, and complementors.”*

To cover Kotler’s (2003) fourth Internet domain consumer-to-consumer (C2B) in the definition, C2B describes the function of consumers communicating with companies. Companies often encourage communication by inviting prospects to send questions, suggestions, and even complaints via e-mail or instant messages online.

The essence of the definition above, according to Weill & Vitale, is the conduct of business and business processes over computer networks based on nonproprietary standards. The Internet is an example of a nonproprietary network used today for e-business. The Internet will be the major infrastructure for the foreseeing future, due to its low cost and universal access. However, new access technologies like the use of wireless application protocol from mobile telephones, will supplement the Internet infrastructure (Weill & Vitale, 2001). The essence of e-business is completing business processes over easily accessible computer networks that will all become nonproprietary over time, no matter the supporting technology.

E-business strategy is complex, focused on internal processes, and aimed at cost savings and improvements in efficiency and productivity. Examples of internal processes are: production, inventory management, product development, risk management, finance, knowledge management and human resources (Bartels, 2000).

Laudon & Traver (2003) makes the distinction between e-commerce and e-business by referring the term e-business to the digital enablement of transactions and processes *within* a firm, involving information systems under the control of the firm. For the most part, according to Laudon & Traver, e-business does not include commercial transactions involving an exchange of value across organizational boundaries. *“For a example, a company’s online inventory control mechanisms are a component of e-business, but such internal processes do not directly generate revenue for the firm from outside businesses or consumers, as e-commerce, by definition, does.”* (Laudon & Traver, 2003). However, a firm’s e-business infrastructure provides support for online e-commerce exchanges, that is, the same skills and sets are involved in both e-business and e-commerce. E-business applications turn into e-commerce precisely when an exchange of value occurs (Laudon & Traver, 2003).

The Weill & Vitale, 2001 view, cited above, is tangent to the definition of e-commerce when they advocate, “*buying, selling [...] and paying for products, services...*” However, they also state “*E-business can be expressed by completing business processes over open networks,*” and that the “*...essence of e-business is completing business processes over easily accessible electronic infrastructures,*” focusing on business processes which is a larger scope of a firm’s operations than just buying and selling. In the book, “*E-commerce*” (2003), Laudon & Traver develop the concept further, and makes a clearer distinction between *internal business processes* and *external revenue generating processes*, but admit that both the e-business concept and the e-commerce blur (Laudon & Traver, 2003).



### 6.3.2. E-commerce

E-commerce is “*digitally enabled commercial transactions between and among organizations and individuals*”, according to Laudon & Traver, (2003). Specifying each component of the definition, *digitally enabled transactions* include all transactions mediated by digital technology; *commercial transactions* involve the exchange of value across organizational or individual boundaries in return for products or services. For the most part digitally enabled transactions occur over the Internet and the Web, but on par with Weill & Vitale (2001), the definition opens for future electronic infrastructure alternatives. The exchange of value, that is money, is a crucial part of the e-commerce concept, thus without the value exchange, no commerce occurs (Laudon & Traver, 2003).

Philip Kotler *et al* argues that e-commerce has given rise in turn to *e-purchasing* and *e-marketing* (Kotler *et al*, 2003). *E-purchasing* describe companies decide to purchase goods, services, and information from various online suppliers. Smart e-purchasing can be a cost saving strategy. *E-marketing* refer to company efforts to inform, communicate, promote, and sell its products and services over Internet.

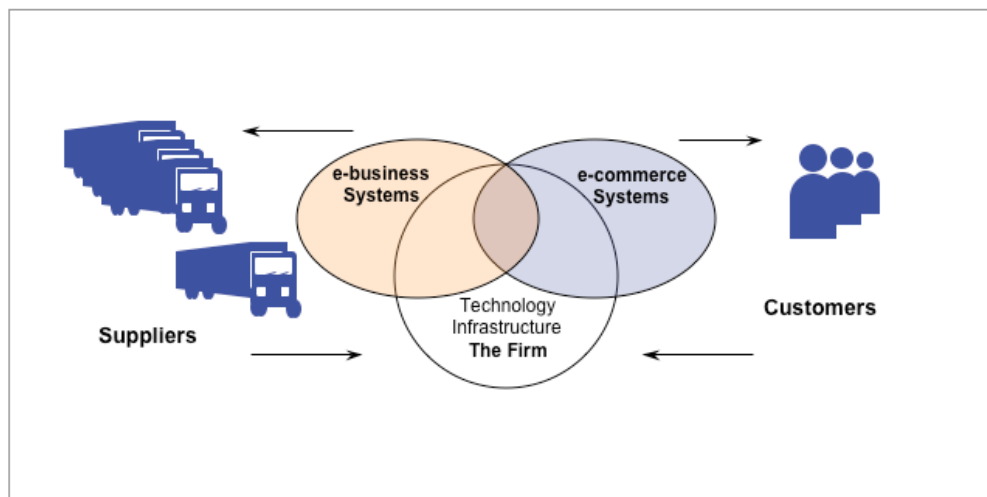


Figure 6.2. E-commerce primarily involves transactions that cross firm boundaries. E-business primarily concerns digital technologies to business processes within the firm. (Laudon & Traver, 2003).

## 7. Traditional Valuation Models

*“Although DCF may sound suspiciously retro, we believe that it works where other methods fail, reinforcing the continuing relevance of basic economics and finance, even in uncharted Internet territory” (Koller et al, 2000).*

Both before, and during the Internet shakeout in 2001, multiples of web-traffic of several kinds were in vogue and were used in order to value Internet firms (Koller, 2001). The opposition of the non-financial measures, that is multiples of web-traffic, could be designated as *traditional valuation* measures. The concept of valuing companies in a traditional way can also include metrics that could be regarded as shorthanded, such as price-to-earnings multiples, which are metrics used for comparing stocks (Koller et al, 2000). Spokesmen of the traditional valuation models advocates that the non-financial models, and approaches of multiples of web-traffic do not consider a company’s particular characteristics, nor do they account for the way investments in intangible assets (such as the cost of acquiring customers) flow through income statement rather than the balance sheet (Koller et al, 2000). The best way, according to Koller et al (2000) is to return to economic fundamentals with the DCF model, which makes the distinction between expensed and capitalized investment. The lack of historical data and positive earnings does not matter, according to Koller et al (2000), because the DCF approach can easily capture the worth of value-creating businesses that lose money for their first five years. The DCF model cannot eliminate the need to make difficult forecasts, but it does address the problems of high growth rates and uncertainty in a coherent way (Koller et al, 2000).

Valuing new technology companies in a traditional way is more complex than valuing mature “old economy firms” or “old” technology firms (Damodaran, 2001). To make the DCF model more useful for valuing new technology companies, three twists are required, according to Koller et al (2000) whom developed a DCF approach for new technology companies.

- First, starting from a point in the future and working back to the present
- Using probability-weighted scenarios to address high uncertainty in an explicit way
- Exploiting analytic techniques to understand the underlying economies of the specific companies and to forecast their future performance

Instead of starting from the present, which is the usual practice in DCF valuations, using the *DCF-future-forecasting* approach starts by thinking of what the industry and the company

could look like when they evolve from today's very high-growth, unstable condition to a sustainable, moderate-growth state in the future; and then extrapolate back to current performance (Koller *et al*, 2000). The future growth should be defined by metrics such as ultimate penetration rate, average revenue per customer, and sustainable gross margins (Koller *et al*, 2000).

The DCF approach, by Koller *et al* (2000) contains probability-weighted scenarios, instead of single forecasts, which is more useful in highlighting the uncertainty in valuing high-growth new technology companies (Koller *et al*, 2000). Koller *et al* (2000) further advocates that these scenarios should include extreme outcomes, such as very high returns and, conversely, bankruptcy. Also, tools as *customer value analysis* can be useful in the understanding how value is actually created.

## 7.2. Probability weighting scenarios

Uncertainty is a one of the hardest part of valuing high-growth companies (Damodaran, 2001). The use of probability-weighted scenarios is a simple and straightforward way to deal with the uncertainty (Koller *et al*, 2000).



### 7.2.1. Case study of Amazon.com

To demonstrate the probability weighting, a case study of Amazon.com will be displayed. The case study is made by Koller *et al* (2000), and describes the *potential outcomes* in four scenarios, the *expected value*, the *volatility of the expected values*, and finally a *customer analysis*.

## Amazon.com: Potential outcomes

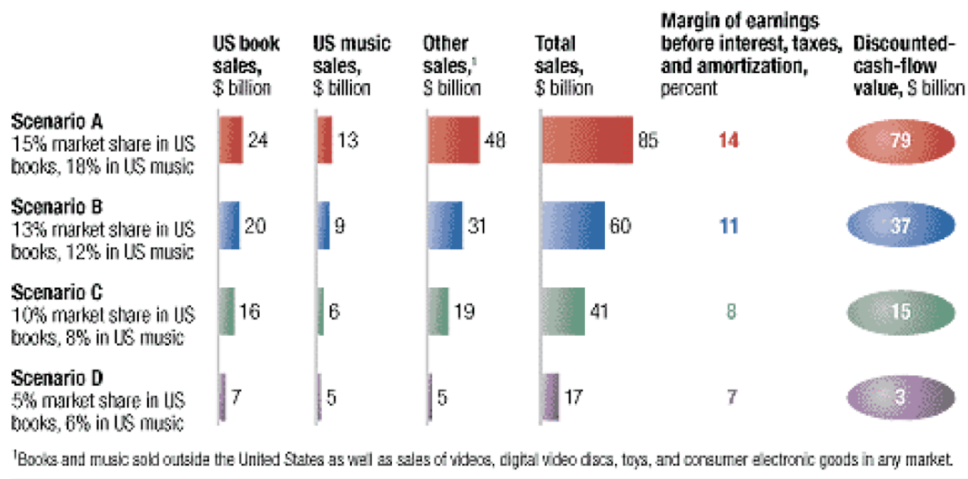


Figure 7.1 Amazon.com: Potential outcomes – Scenario Analysis. *Koller et al, 2000.*

Figure 7.1 describes the four scenarios, where scenario A, let Amazon become the second largest retailer (on- or off-line) based in the United States.

In scenario A, Amazon.com uses much less capital than traditional retailers do because it is primarily an on-line operation. It captures much higher operating margins because it is the on-line retailer of choice; even if its prices are comparable to those of other on-line retailers, it has more purchasing influence and lower operating costs. This scenario implies that Amazon.com was worth \$79 billion in the fourth quarter of 1999 (*Koller et al, 2000*).

In scenario B, Amazon.com has captured revenues almost as large as it does in Scenario A, but its margins and need for capital fall in the range between those of the first scenario and the margins and capital requirements of traditional retailer. The second scenario implies that Amazon.com had a value of \$37 billion.

In scenario C, Amazon does not become as large retailer as in scenario A and B, though Amazon still is a large retailer. The company's economics are closer to those of traditional retailers. The third scenario implies a value for Amazon.com of \$15 billion.

Finally, in scenario D, Amazon.com becomes a fair sized retailer with traditional retailer economics. On-line retailing imitates most other forms of the business, with many competitors on each field. This scenario implies that Amazon.com was worth only \$3 billion.

In this case study we have four scenarios, in which the company's value ranges from \$3 billion to \$79 billion. Although the spread is large, each scenario is reasonable (*Koller et al,*

2000). Next step is more critical because it manages the phase of assigning probabilities and generating the resulting values for Amazon (Koller *et al*, 2000). In this case study the probabilities assigned are 5% to Scenario A, 35% assigned to Scenario B and C, and 25% assigned to Scenario D.

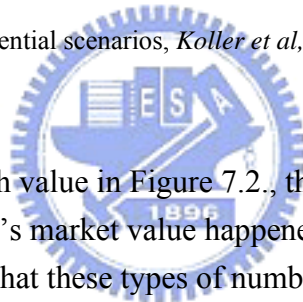
**Amazon.com: Expected value**

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	Discounted- cash-flow value, \$ billion	X	Probability, percent	=	Expected value, \$ billion
Scenario A	79		5		3.9
Scenario B	37		35		13.0
Scenario C	15		35		5.3
Scenario D	3		25		0.8
					\$23.0 billion

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Figure 7.2. Expected Value of the potential scenarios, Koller *et al*, 2000.



When adding the weight of each value in Figure 7.2., the sum ends up with \$23 billion. In October 31, 1999 Amazon.com’s market value happened to be \$23 billion, which gives this theory significance and shows that these types of numbers not are impossible to forecast (Koller *et al*, 2000).

Endowing accurate probabilities to the scenarios is still the most difficult part of the valuing (Koller *et al*, 2000). When looking at the sensitivity of this valuation to changing probabilities, Figure 6.3 shows that relatively small variations lead to big swings (Koller *et al*, 2000). Koller *et al* (2000) further advocates that this volatility cannot be adjusted, and implies that the volatility of the share prices of new technology companies like Amazon.com has been precipitated by small changes in the market’s view of the likelihood of different outcomes.

### Amazon.com: Volatility of expected values

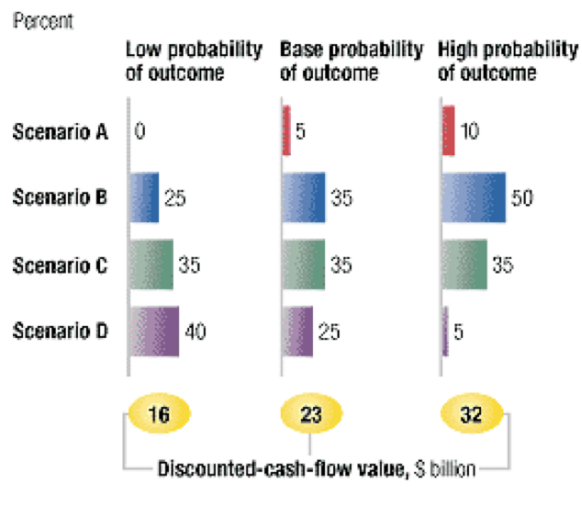


Figure 7.3. Volatility of expected values of the potential scenarios, *Koller et al, 2000*.

#### 7.2.1.1. From future forecasts to present reality

As mentioned earlier, the last difficult aspect of valuing new technology companies and high-growth dittos is to manage the uncertainty, and relating future scenarios to current performance. *Koller et al (2000)*, implies that building sound scenarios for a business, both requires an understanding of the business, and knowledge of what really drives the creation of value. In this case study of Amazon.com and for many other Internet companies, customer-value analysis is a useful approach. *Koller et al (2000)* presents five factors that drive the customer-value analysis of a retailer like Amazon.com:

- The average revenue per customer per year from purchases by its customers, as well as revenues from advertisements on its web-site and from retailers that rent space on it to sell their own products
- The total number of customers
- The contribution margin per customer (before the cost of acquiring customers)
- The average cost of acquiring a customer
- The customer churn rate (that is, the proportion of customers lost each year)

#### 7.2.1.2. Dealing with uncertainty

By using the DCF approach of *Koller et al (2000)*, “reasonable valuations for seemingly unreasonable business” can be conducted. Authors of articles and books of this topic,



everyone agree that it is the presence of uncertainty that is the core challenge to overcome, and the problem of identifying a winner in a large competitive field (Damodaran, 2001; Koller *et al*, 2000; Trueman *et al*, 2000). In many industries, and in Internet industry in particular, history shows that a small number of players will win big while the vast majority will not (Koller *et al*, 2000).



## 8. Non-Financial Measures

The non-financial measures presented in this report, *reach*, *stickiness*, and *customer loyalty*, are web metrics that are most frequently used in the business press and prior studies (Demers & Lev, 2001). There are several reasons to expect usage levels at an Internet firm's web sites to be positively related to its revenues. First, higher web usage likely reflects greater online demand for the firm's products and services. Second, increased web traffic leads to greater revenue bookings from existing advertisers. Third and finally, higher web usage attracts more advertisers, and indirectly allows the firm to raise the rates charged for future advertising.

### 8.1. The Value-Relevance of Non-Financial Information

The problem with "non-financial" measures is that they do not indicate any details of the future cash flow, which is fundamental of a firm's value. The three dimensions of web traffic performance presented earlier, *reach*, *stickiness*, and *customer loyalty* are all important measures, but they do not give clear picture of the revenues.

Demers & Lev (2001) suggest that the *reach* and *stickiness* performance measures are value-relevant to the share prices of Internet companies, while *loyalty* is not a significant value measure. The result of Demers & Lev's (2001) study also shows that the web traffic metrics have significant value-relevance both before and after the Internet shakeout of year 2000. They further claims that their findings have significance as value-relevant, contradicted the claims of some analysts that web traffic measures are no longer important (Demers & Lev, 2001).

#### 8.1.1. Specialist Discussion

To get a contemporary and accurate commentary of the issue on the value-relevance of non-financial measures I interviewed two specialists, an Accountant and a Corporate Finance Analyst of a global accounting and advisory firm in Sweden. Their comments concerning the value-relevance of non-financial measures contradicts the results of Demer *et al's* (2001) study. The specialists claim that it is not the non-financial measures in particular that have value-relevance, but it is the operations behind the data, the opportunities to generate profit that have value-relevance. For them, raw non-financial data does not mean anything, unless it is based upon a profound business plan. With the specialists' comments in mind, which must serve as real practice of the industry, it is interesting to analyze prior research that advocate the value-relevance of non-financial data. Demers & Lev's (2001) study presents evidence for the value-relevance of the non-financial information, but obviously there is still discordance of the use of definitions in the area of valuation of Internet firms. For practitioners, a profound

business plan is the most important tool when valuing a business (Interview, 2006). This is also on par with the statement of investors in 2006, who claims that funding is harder to get comparing to the late 1990ies, and that Internet entrepreneurs of today have to have proper and thorough business plans and revenue models presented (Cooke, 2006)

The non-financial data like *reach*, has of course no value-relevance if no one are making business out of the potential numbers. But if someone is doing business, by attracting many unique visitors, the measure *reach* suddenly is crucial data. In this context it must be obvious that the non-financial measures are related to business. The specialists do not want to phrase it that way though, but are emphasizing that the data of *reach* must be translated into potential sales of an audience (if e-commerce) or exclusive exposures for advertising (ad sales). It is obvious that this view of valuing firms, no matter industry, is traditional. The aversion to non-financial data stems from the volatility of the measures and uncertainty. That is to say, the numbers are not equivalent from business to business. It is therefore difficult to get an equitable comparison between different businesses and firms. Prior studies are showing on value-relevance of non-financial measures, but there is obviously difficulties in using and interpret the numbers. In valuation of firms the non-financial data must be used with care (Interview, 2006).

The discussion and interview with the specialists is on par with common opinions recognized in financial papers and specialist magazines during year 2006. The articles concerning Internet valuation has during year 2006 dealt with the relevance of non-financial measures and the justification of the astonishing high prices of the Internet firms sold in year 2006 (FT, 2006. & Cooke, 2006.). It is interesting to analyze this behavior, since academic studies has shown on relevant significance of the non-financial measures. This behavior is similar to the investors' irrational behavior of the late 1990ies. The difference from then is of course a more mature industry, but that would also affect the investments with more certain valuation models.

### 8.1.2. Valuing with Market Expectations and Comparables

Damodaran (2001) gives examples of how the seeking of new methods to value uncertain industries like new technology, were made by some analysts in the late 1990ies. One of the measurements was to divide the market capitalization<sup>15</sup> with the numbers of unique visitors of

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<sup>15</sup> **Market Capitalization, Definition:** MCAP. Market capitalization represents the aggregate value of a company or stock. It is obtained by multiplying the number of shares outstanding by their

a website (*reach*<sup>16</sup>) in order to get the single *unique visitor value* at a website. By using this measurement the analysts could compare the *unique visitor value* of one investment to another and make assumptions in the basis of this data and use to new investments.

Damodaran (2001) points out the misjudgments on this assumptions made prior to the Internet shakeout in year 2000 and claims that the methods have no or minor significance.

The market capitalization represents, by definition the aggregate value of a company or a stock, that is the *markets expectations* of how profitable the firm's operations will event<sup>17</sup>. The forecasts and market expectations made prior to the Internet shakeout contained several errors. Valuing techniques that are based on data from uncertain sources cannot be stated as significant measures. Prior to year 2000 there existed no comparables in the new technology industry, which can explain one of the main reasons for many analysts' misjudgments. The measure of *unique visitor value* had a high degree of incorrectness since it was based on the comparables stocks, that is, the comparables market expectations, which without doubt were overvalued (Damodaran, 2001).



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current price per share (www.investorwords.com, 2006)

<sup>16</sup> The numbers of unique visitors corresponds to E. Demers, & B. Lev. (2001) dimension *reach* of web traffic measures (Chapter 3).

<sup>17</sup> Stock prices contains several multiples of the status of a company, but depends chiefly on the market expectations of how the future of a firm will event.

## 9. MindValue – an Internet Start-up firm

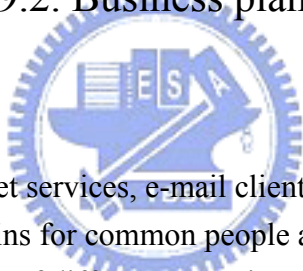
MindValue is a start-up project in Sweden, providing e-business solutions and facilitating e-commerce by user identification. MindValue is in its start-up stage, which means that it has its own services and products in production and legally exists.

### 9.1. History Brief

MindValue started formally as a project at Chalmers School of Entrepreneurship, in 2006, by Robert Bengtsson and Andreas Sigurdsson, who both were Master graduate students of entrepreneurship by then. During the year of 2006, four computer programmers have been recruited who develop the e-business tools of MindValue. Currently, MindValue have a few customers, the company is expanding fast, and are now on its stage to bring in venture capital, in order to grow further.

### 9.2. Business plan brief

#### 9.2.1. The Problem



The increasing supply of Internet services, e-mail clients, web shops, and web portals has led to an increasing amount of log-ins for common people and for professionals. Today authentication and identification of different e-services takes place with a large number of user names and passwords. The trend shows an increase of information on the Internet and login services, and this causes trouble for the users. The phenomena result in the use of easy passwords and log-ins in order to remember them all. Passwords are both good and bad. They are good, since they give the user an integrity protection, but from a commercial point of view, they are bad, because they bring an extra moment when using e-services or e-commercial services on the Internet. This extra moment causes websites up to 70 percent loss of users and potential customers. Passwords are forgotten, and paths to certain websites, are easily forgotten too. This causes hurdles in the *reach* of websites, which is one measure of a website's progress.

#### 9.2.2. The Solution

MindValue's solution to the problem in 9.2.1 is a *personal portal* of every user that collects the users' all login information and passwords in one place. This system makes it possible to customize the portal after all personal preferences, and keeps track on sites that match the

personal preferences. This technique is not unique; many intranets work in a similar way, and the concept is called *Single-Sign-On* (SSO). MindValue differentiates from competitors in their revenue models.

MindValue has identified customer utility in three different segments: *the user, the member portal, and the e-shop*.

Table 9.1. Identified customer utility of three segments

The user	The member portal	The e-shop
<ul style="list-style-type: none"> <li>• One place on Internet where the majority of all actions and events can be managed.</li> <li>• Easier and faster log-in.</li> <li>• Easier navigation on Internet</li> <li>• Better updates thru action reports</li> <li>• Easier new registration on portals and e-services.</li> </ul>	<ul style="list-style-type: none"> <li>• Easier registration for new members.</li> <li>• Easy to log in.</li> <li>• Better possibility to reach the users again thru the action report system.</li> <li>• Opportunity of e-commerce.</li> </ul>	<ul style="list-style-type: none"> <li>• Higher ROI because of direct log-in in the e-shop</li> <li>• Increased commerce when higher reach.</li> <li>• More reliable statistical information because of identified users.</li> <li>• Product offerings can be customized to specific user.</li> </ul>



The benefits from the user standpoint are foremost, referring to figure 9.1, one place on Internet where the majority of all actions and events can be managed, which facilitates simplicity. Simplicity is a property MindValue is striving for in order to facilitate a high number of log-ins (MindValue, Company data, 2006). With easier personal administration, the value added is time saving and comfortable navigation on Internet, still with high-grade security where that is needed.

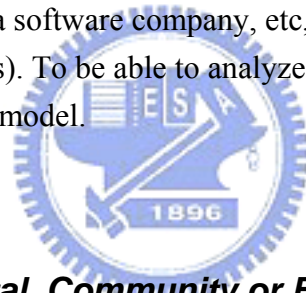
Every portal or community, which requires personal log-ins, is benefiting from an easier log-in. Portals visited, who requires members does not venture to be forgotten, which many portals suffer of today, popular sites included (MindValue, Company data, 2006).

E-shops and other e-commerce operations are benefiting from MindValue's solution, since the rate of *reach* will be maintained. The purchasing procedure is faster and easier, why customers are motivated to purchases.

### 9.3. Strategic group affiliation of MindValue

Analyzing companies and businesses requires systematic techniques in order to come up with adequate comparable data. The use of strategic groups makes it possible to separate different firm's operations in order to compare the essence of every business. Porter's (1980) definition of a strategic group is "*the group of firms in an Industry following the same or similar strategy along the strategic dimensions.*" Strategic groups are defined as sets of firms in an industry who compete with each other on the basis of similar combinations of scope and resource commitments (Cool & Schendel, 1988).

The outline of MindValue's operations is: *MindValue is an e-business company, facilitating e-commerce and providing profitable partnerships with identification and IT-security solutions on Internet* (company information, 2006). The outline puts MindValue clearly in the e-business segment, building systems and facilitating e-commerce. The segment of e-business is enormous though, and has to be divided more, to be able to analyze specific firms within it. Companies that traditionally build systems and providing profitable solutions, are all from giants like *Oracle*, an enterprise software company, *Accenture*, an management and IT-consultant firm, *Microsoft*, a software company, etc, to small and medium sized enterprises like MindValue (company facts). To be able to analyze the right comparables, it is necessary to examine the firm's business model.



#### 9.3.1. Mindvalue – *Portal, Community or E-tailor?*

It is very difficult to define a firm distinct, especially in the world of new economy. Looking at companies as Google and Yahoo, who started as a single search engines and made business out of one single function. Today Google and Yahoo, definitely are the biggest search engines of the world (Cooke, 2006). Both firms have expanded their business rapidly with a wide range of other services as well, but can still be considered as search engines. Search engines are great examples of *portals*, and gateways to Internet. This is also a clear example of the *intermediate* function, helping web users to find special content.

MindValue have a portal function, which would place the company in the group of *portals*. However, MindValue also provides *e-tailing* and *community* services in order to attract users, which is superficially close to those strategic groups as well. MindValue is also software developers, which makes it even harder to be distinct in the group affiliation of MindValue.

## 10. Synergies from main activities

The specialists interviewed for this report, emphasize one benefit of the non-financial measures at a point where they work as indicators within a specific business and have relevance to internal benchmarking (Interview, 2006). They emphasize the importance to be specific of how the data is used though. Instead of talking about non-financial measures the specialists rather emphasize the synergies that non-financial data originates from.

Synergies or beneficial resources can be compared to corporate synergies which originates from a scientific term, and “*refers to the phenomenon in which two or more discrete influences or agents acting together create an effect greater than that predicted by knowing only the separate effects of the individual agents*” (Wikipedia, 2006). In business and the corporate industries synergies focus on adding value to the organization and maximizing return on investment. The corporate synergies occur, according to the definitions of Wikipedia (2006), when corporations interact congruently. A corporate synergy refers to the financial benefit a company enjoys when it merges or acquires another company. According to Wikipedia’s (2006) definition of corporate synergy there are two distinct types of corporate synergies:

- **Revenue:** a revenue synergy refers to the opportunity of a combined corporate entity to generate more revenue than its two predecessor standalone companies would be able to generate. For example, if a company A sells product X through its sales force, company B sells product Y, and company A decides to buy company B then the new company could use each sales person to sell products X and Y thereby increasing the revenue that each sales person generates for the company.
- **Cost:** a cost synergy refers to the opportunity of a combined corporate entity to reduce or eliminate expenses associated with running a business. Cost synergies are realized by eliminating positions that are viewed as duplicate within the merged entity. Examples include the head quarter’s office of one of the predecessor companies, certain executives, the human resources department, or other employees of the predecessor companies. This is related to the economic concept of Economies of Scale.

The beneficial resources do not entirely count to the concept of synergies, although both concepts have similarities.



## 10.1. Synergies associated with an exit

Referring to the interview held with two valuation specialists (Interview, 2006), the view of valuing benefits than raw non-financial information, I will clarify the concept of *synergies* or *corporate beneficial resources* that are interesting for MindValue's prospected buyers.

In MindValue's case the most interesting *exit strategy* would to be acquired by a larger corporation. Referring to the theory of *exit strategies* in this report, acquisition is by most the usual way to exit for a start-up company. The other exit strategies are not applicable enough for start-up firms, in order to be successful, since start-ups normally do not have the historical track record of annual profits and the possibility to heavily invest money, which normally is required.

In the design of a strategy that pinpoints possible targets for future acquisition, already in a start-up phase, it is important to highlight the *beneficial resources* that are likely to be taken into future consideration. The *resources* identified to future deliberation are: *Distribution Channels, Strategic Alliances, New Technology, and New Competence*. This selection is based on MindValue's most powerful advantages and from literature, describing synergies (MindValue, Company data, 2006; Kotler *et al*, 2003; Sevenius, 2003).

The resources are valued differently depending on how valuable each synergy is to the firm of interest – the acquisition firm. If the start-up firm succeeds in attracting many customers to an e-tailor website, then the valuable synergy for an acquisition firm might be the reach to the same audience, in order to increase the offerings and increase the product park. This, in comparison to how much effort the same acquisition firm has to make, in order to attract the same amount of customers to its market. If the start-up firm manage to attract a lot of viewers, who passes through the web-site, but are no actual customers, the value of the viewers might not be the same, since no transactions are clearly present. Same philosophy is present when analyzing Strategic Alliances, New Technology, and New Competence – How much effort must the acquiring firm make in order to mach the same amount of utility?

The concept of valuing synergies is closed connected to Porter's (1980) *Five Force Model*. The *Five Force Model* is often used to assess industry structure and attractiveness. The model is a helpful tool when deciding whether to enter a new market or industry.

The synergies might also be valuable advantages that are impossible to acquire in other ways, like *first mover advantage*. The start-up firm might have produced a unique product or service that is closed connected to the firm. Some products and services might be very hard to imitate,

since they belong a unique property. This is the case of many Internet start-ups, acquired by other firms. Communities are almost impossible to copy, since many of them are created of a special group of interests (DI, 2007). To attract the same group of interest will require a huge amount of resources. The opportunity of buying the whole firm of the services, or products of origin is many times a less resource bound operation.

## 10.2. Distribution and Marketing Channels

Distribution is one of four aspects of marketing. The other three in the *marketing mix*<sup>18</sup> are product management, promotion, and pricing (Kotler, 1991).

Before a product reaches the final customer or end-user, there will be a chain of intermediates, each passing the product down the chain to the next organization. This process is called *distribution channels* or *distribution chain* (Kotler, 1991). *Distribution channels* are used to display, sell or deliver physical products or services to the end-user or customer. The channel includes distributors, wholesalers, retailers, and agents (Kotler *et al*, 2003).

To reach a target market, a company can use three kinds of *marketing channels*, were distribution channels is one of them. The other two marketing channels are *Communication channels* that deliver and receive messages from target buyers, and include newspapers, magazines, radio, television, mail, telephone, billboards, posters, fliers, CDs, audiotapes, and the Internet. The third marketing channel is *service channels* which are used to carry out transactions with potential buyers. Service channels include banks, transportation companies, warehouses, and insurance companies that facilitate transactions (Kotler, 2003).

### 10.2.1. Relevance to MindValue

Due to MindValue's structural nature, *distribution* and *marketing channels* plays a significant role in a future exit for MindValue. On par with its business plan, MindValue is seeking to play an intermediate role on Internet together with portal activities. *Distribution* and *marketing channels* are synergies that are relative easy for MindValue to develop. On par with the specialists (Interviews, 2006), channels are synergies that have value-relevance concerning a future exit. In an early stage though, the issue of forecasting the value is still unanswered. According to the specialists (interview, 2006), they are not positive of valuing synergies in early phases, more than admitting that parameters taking into concern are not

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<sup>18</sup> The marketing mix is the set of marketing tools the firm uses to pursue its marketing objectives in the target market (Kotler, 2003)

non-financial information, described in chapter 11, but the future outlook of synergies.

Potential firm's willing to acquire MindValue might look at successful *distribution* and *marketing channels* as important value-drivers.

### 10.3. Strategic Alliances

In order to achieve leadership, companies are discovering that they need strategic partners in order to be effective. Both small and large firms often cannot achieve leadership without forming alliances with domestic or multinational companies that are complement or leverage their capabilities and resources. Entering a new market or new country often requires local partners or suppliers. Joint ventures with local firms or buying from local suppliers are common ways to meet “domestic content” requirements (Kotler, 2003).

Kotler (2003) states that many strategic alliances take the form of marketing alliances, and these fall into four major categories:

1. *Product or service alliances*. One company licenses another to produce its products, or two companies jointly market their complementary products or a new product.
2. *Promotional alliances*. One company agrees to carry a promotion for another company's products or service.
3. *Logistics alliances*. One company offers logistical services for another company's products.
4. *Pricing collaborations*. One or more companies join in a special pricing collaboration.

To form successful alliances and collaborations companies need to pursue creative thoughts to finding partners that might complete their strengths and offset their weaknesses.

#### 10.3.1. Relevance to MindValue

MindValue started from a joint venture with a software provider already in an early phase in order to strengthen its technical platform, a joint venture that finally ended with an acquisition by MindValue. The synergy of strategic alliances has already been displayed in the case of MindValue, but is most likely to develop further. On par with its business model a key success factor for MindValue is to develop several partnership with strategic partners in order to strengthen its own business model.

Potential firm's willing to acquire MindValue might look at successful its *strategic alliances*

as important value-drivers.

## 10.4. New technology

Acquiring new technologies is a key element in the strategic development of many companies. New technology enables organizations to achieve strategic objectives both within their institutions, as well as in their external environments, such as enhanced community image and competitive positioning. In technologically fast-moving environments, established and matured firms often use acquisitions as means of acquiring specific technical capabilities (Grant, 2005). Microsoft is an example of a company that has benefited substantial technology from such acquisitions. Microsoft's adaptation to the Internet era was based on acquired technology capabilities through acquisitions (Grant, 2005). The risk associated of the new technology acquisition, a firm faces is the way of successfully integrating the acquiree's capabilities with its own.

### 10.4.1. Relevance to MindValue

The technology MindValue currently is using is not unique enough to make it competitive as a valuable synergy. Others can imitate the technical platform the solution is based upon, without any acquisition, and it is therefore difficult for MindValue to benefit from synergies of new technology. The synergies of new technology have therefore no value relevance in MindValue's start-up phase, and the focus of value drivers should be other synergies.

## 10.5. New competence

Acquired *new competence* is very close related to new technology in high technology firms. The *new economy* is also reckoned as the *knowledge economy* (Kotler *et al*, 2003). The growth of the new economy is based on service related industries, and the entire amount of the growth came from high technology industries. This means that right knowledge and high technology skills have become really competitive advantages. A company like Microsoft is dependent on its intellectual brainpower in order to compete with other competitors on its state of the art software development.

### 10.5.1. Relevance to MindValue

The competence MindValue possess might be a competitive advantage and a synergy with significant value relevance. The longer the team of MindValue is progressing the more value in competence, the firm got. Dividing the firm's competence in two disciplines, one can indicate the technical skills as one part and the entrepreneurial and management skills of a start-up company into another part. Both disciplines individually might not have significant

value, competitive enough to be a single reason for an acquisition. But both together, after a time of progress and success, they might be a key competitive advantage for the specific operations of the firm, and is a prerequisite for the operations to maintain success. This is often the case after acquisitions of new technology, since the crew that made the start-up company valuable in many cases is best suited to run the operations until a others have been educated enough (FT, 2006). In many cases is it a prerequisite of keeping the key persons of the origin staff a period of time, to guarantee the acquired firm's constant success until others have learned the key competence.

New competence might be a specific reason, attractive enough for an acquisition, especially in the new technology industry, where the state of the art competence is hard currency in the competitive environment of the Internet industry.



## 11. Structure analysis

When looking at MindValue's competitor analysis, MindValue only identifies one (1) out of fourteen (14) potential competitors that might compete in exactly the same business area (MindValue, Company data, 2007). Many potential competitors have similar solutions but they do not focus their business with the *single sign-on* function in centre, as MindValue does. However, these potential competitors will be classified as *Direct Competitors*. From MindValue's view of an exit perspective, these competitors might be targets of an acquisition, since they might find MindValue as a threat at the market.

From an exit approach, there are other interested parties to take notice of as well. The biggest new technology acquisitions of year 2006 were conducted of media groups, holding companies, and investment firms, mostly of them with some experience of Internet business, but not all.

A display of the most recent acquisitions of new technology companies in Sweden and the Nordic countries will follow in order to get a picture of potential buyers and exit partners.



### 11.1. Strategic groups

The strategic groups of interests are firms that primarily operate at Internet or have interests of new technology firms in their portfolio. The strategic groups are: *Investment firms*, *Media Groups*, *Technology firms*, and *Direct Competitors*, and they are chosen because of their potential incitement of an Internet acquisition. Each player of the strategic groups have relevance to the Internet industry, since they have shown interest in similar investments recently (Company data, Corporate Websites, 2007).

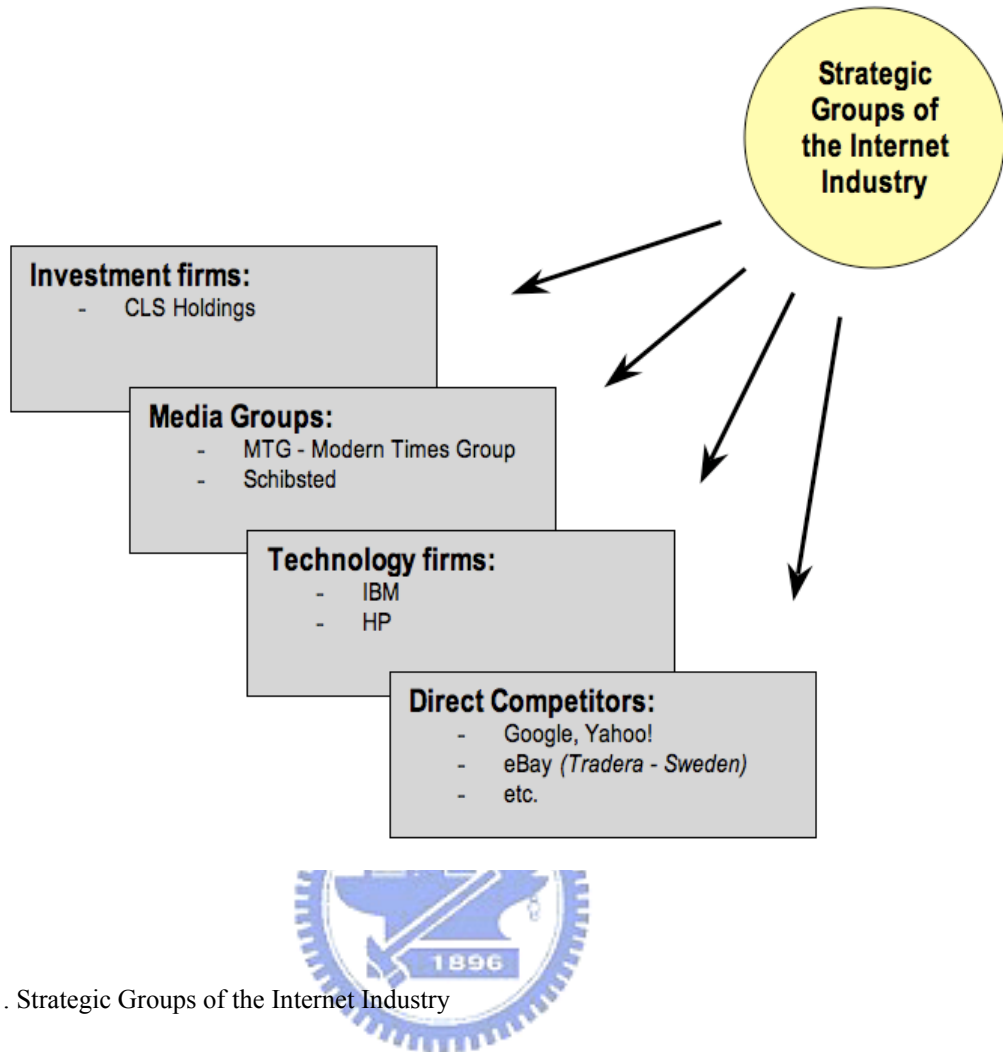


Figure 11.1. Strategic Groups of the Internet Industry

### 11.1.1. Investment firms

An investment firm is financial institution that invests in securities issued by other companies and sell shares to individuals. A definition of investment companies according to investopedia.com, a financial content provider, is “A corporation or trust engaged in the business of investing the pooled capital of shareholders in the financial instruments of other companies.” (www.investopedia.com, 2007). Some successful new technology firms have very good economic developments, and are therefore very interesting targets for investment firms and financial institutions.

New ventures and especially new technology ventures are desirable targets for many investment companies, due to their abnormal growth potentials (Copeland et al, 2000). Commonly for all serious investment firms are diversified portfolios, to spread the risks (Grinblatt & Titman, 2004). This means that the investment company, acquiring Internet firms, is not only interested in new technology ventures, but is also investing in totally different industries.

### **11.1.1.1. CLS Holdings**

CLS Holdings plc (CLS) is a property investment company, which has been listed on the London Stock Exchange since 1994. The company has a property portfolio in London, France, Sweden and Germany valued £1,156.9m (US\$2,142.4m, June 2006, company data). CLS invests in properties and equities to spread the portfolio.

#### **Significant acquisitions:**

At the end of April of 2006 CLS acquired the remaining shares not already under its ownership in the youth community website, *Lunarstorm* (www.lunarstorm.se), of Lunarworks AB. The shares were acquired at a price of SEK 35 per share (£2.59 = US\$ 4.63), valuing Lunarworks at approximately SEK 374 million (£28 million = US\$ 50 million). The cost of the entire investment for CLS is £17.0 million (US\$ 30.4 million, SEK 228.8 million). Lunarworks consistently generates both cash and profits in its home market Sweden. ULS Holdings advocates a significant value creation as the business expands internationally (Company data, website, 2007).

**Lunarworks AB's *Lunarstorm*** is a community targeting youths in Sweden between 12-24 years old. The average age is 18,1 years old, and 71 percent of Sweden's 15-20 year olds' are members of the community. *Lunarstorm* is the busiest Internet site in the Scandinavian (Nordic) countries, with 1.3-1.5 billion site figureions per month and 370,000 unique visitors per day (company facts, Lunarworks AB, 2007). Approximately turnover in 2006 was SEK 90 million (US\$ 12.9 million) (DI, 2007).

#### ***11.1.1.1.1 Synergy relation***

Analyzing why CLS Holdings bought Lunarworks AB, and what they paid for gives that CLS is investing capital in attractive ventures. Since the core business of CLS is property investments, the new technology investment is noteworthy. Obviously, CLS is not buying any new technology or new competence. Neither do they acquire any significant marketing or distribution channels, or strategic alliances. The acquisition of Lunarworks AB seems to be a pure investment, which hopefully will generate a significant return in the future.



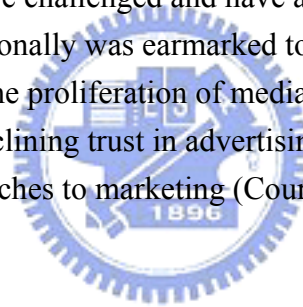
### 11.1.2. Media Groups

Media groups can be described as groups which encompass the production of:<sup>19</sup>

- Books, newspapers, journals, consumer magazines and comics
- Online content
- Recorded music
  - Film and video/DVD/Blue-ray
  - Radio and television broadcast content
  - Theatrical content and operation of theme parks
  - Computer games

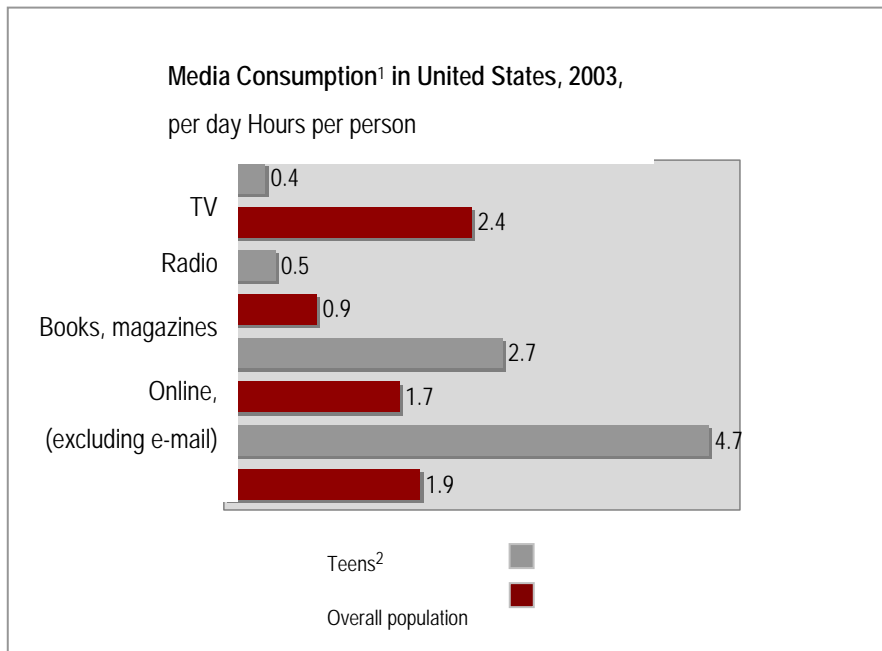
Irrespective of which segments the media companies are working, the main activity is to reach an audience, no matter if it is books readers, television viewers, or web surfers.

New technology firms and Internet sites have become significant targets to control, in order to manage a wider scope of a media audience. According to an article of Court *et al* (2005) traditional marketing models are challenged and have already faced a declining effectiveness of mass advertising, that traditionally was earmarked to media formats like television, newspapers, and magazines. The proliferation of media and distribution channels, multitasking by consumers, declining trust in advertising, and digital technology are all undermining traditional approaches to marketing (Court *et al*, 2005).



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<sup>19</sup> I will disclaim the list as a comprehensive definition of Media Groups. The list's purpose is only to display some Media Groups' operations in order to define the Media industry.



<sup>1</sup>Normalized for selected media only; may include multitasking

<sup>2</sup>13-24 age group

Figure 11.2 Fragmented attention, Court *et al* (2005)



Court *et al* (2005) estimates that television advertising could be only 35 percent as effective as it was in 1990. Recent trends on B2B marketing are likely to be similarly dramatic as sponsorship events and trade magazines become less effective, although the impact is harder to measure.

Because of the proliferation of media channels, the giant Media Groups faces a significant challenge to reach the younger target group. The Internet consumption increases every year, simultaneously as the time spent on television, newspapers, magazines, and books are decreasing (DI, 2007). Internet has become an important distribution channel for younger age groups, which is why an aggressive competition of the new online medias can be witnessed worldwide right now.

### 11.1.2.1. Modern Times Group, MTG

Modern Times Group, MTG AB is an international entertainment-broadcasting group with television as its core business. The headquarter is located in Stockholm, Sweden why its associated as a Swedish media company. MTG was formed out of the holdings of investment

company Kinnevik. The business divisions of MTG are:

- **Viasat Broadcasting** comprises MTG's broadcasting business and is the largest business in the group
- **MTG New Media**, a company that comprises all of Modern Times Group's online and interactive businesses within Viasat.
- **Modern studios** incorporates companies which produce and distribute TV productions and films
- **Home Shopping** contains online retailing and TV-shopping
- **MTG Radio** is largest commercial radio operator in the Nordic region and Baltic countries.

### **Significant acquisitions:**

MTG's acquisitions are mostly related to traditional media as television and radio (company web site, 2007). However, in year 2006 MTG New Media acquired 90 percent of the issued share capital of the *Playahead* online social networking community. The cost of the entire investment for MTG is SEK 102 million (US\$ 14.6 million).

**Playahead** is Sweden's second largest Internet community, after Lunarstorm, with over 530,000 members. Its Swedish operations generated more than 50 percent year on year revenue growth (Company data, company web site, 2007). Approximately turnover in 2006 was SEK 25 million (US\$ 3.6 million) (DI, 2007).

#### ***11.1.2.1.1. Synergy relation***

Analyzing the acquisition of Playahead, gives that MTG is valuing the channels to reach a specific audience, in this case youths between 15-25 years old. MTG is acquiring new marketing channels as well as distribution channels in the acquisition of Playahead. The distribution will foremost comprise in-house media material.

Due to the novelty of strategic *Internet community* acquisitions, many companies like MTG buys *Internet communities* and similar operations, in order to prevent others to acquire them. These actions are strategic, and prevent other companies to reach an audience of hundreds of thousands, many times without having a clear corporate Internet strategy though. Due to the novelty of commercial Internet operations for MTG, the acquisition also indicates the obtaining of new competence as preparation for future operations.

#### **11.1.2.2. Schibsted**

Schibsted is a Scandinavian media group with around 8,500 employees and operations in 20

countries. Its headquarter is located in Oslo, Norway. Schibsted's domestic markets are Norway and Sweden, and have currently presence in newspaper, television, film, online, mobile phone, book and magazine media. Schibsted had a turnover of NOK 9.8 billion in year 2005.



### Significant acquisitions:

Schibsted is one of the heaviest investor of online products and concepts, and has during the recent years acquired a considerable share of the online market in the Scandinavian countries (Company data, company web site, 2007). Schibsted has a clear online focus of the media of tomorrow is controlling the most profitable Internet newspaper, *aftonbladet.se*, which has helped the company to fast pace growth (*schibsted.no*, Interviews, 2007).

**Blocket.se** was acquired in 2003 and is a C2C electronic auction. The cost for Blocket.se was SEK 183 million (US\$ 22.9 million). In year 2006, Schibsted acquired the last 18 percent of the electronic auction, and is now controlling the site to 100 percent. The cost of the past 18 percent was set to SEK 297.2 million (US\$ 40.2 million), and the value of the web site is set to SEK 1.65 billion (US\$ 223.7 million) (*www.aftonbladet.se*, 2007., *www.schibsted.no*). Blocket.se has approximately 2,600,000 unique visits per week (KIA index, 2007).

**Hitta.se** was acquired in 2005 and is a information content provider. The cost of the *hitta.se* acquisition was SEK 200 million (US\$ 26.8 million). The site has approximately 2,000,000 unique visits per week (KIA index, 2007).

#### 11.1.2.1.2. Synergy relation

Schibsted has been noticed because of their heavy Internet investments during the recent years. At the same time, their most successful e-paper, *www.aftonbladet.se* has won awards for their functionality several years in row in Sweden, indicating that Schibsted has a good Internet strategy. The acquired operations quoted above are, after the acquisition, all integrating with each other, thru the main e-paper. Relating this to synergies, it will foremost be *marketing* and *distribution channels*, facilitating marketing and distribution of their own content. Since Schibsted is a Media Group and its core competence would be media content, one can argue that Schibsted also is obtaining new technology and new competence, when acquiring sites that are fully developed like the quoted ones above. Comparing the synergies as new technology and new competence to the marketing and distribution channels, the latter will represent the major part of the acquisition's value.

#### 11.1.3. Technology firms

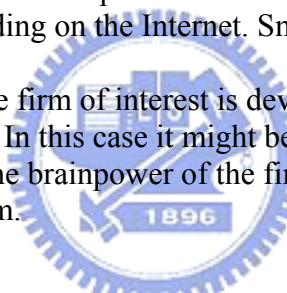
Technology firms, in this context are companies with a special interest in new technology development. Referring to the definition in Chapter 5.2, Damodaran (2001) advocates two groups of firms that are designated as technology firms. The *first group* includes the

companies like Cisco, Microsoft, HP, IBM, and Oracle that *deliver technology-based or technology-oriented products*. Companies like high growth telecommunications, Nokia and Ericsson, can also be classified to the first group. The *second group*, referring to Damodaran (2001), contains firms that use technology to deliver products or/and services that were delivered by more conventional means until a few years ago. In the relative short era of IT-business, Amazon.com has become a symbol of the *second group* of technology firms, and worldwide successful e-commerce.

The group of interest is the first group, companies that deliver technology-based products, specifically software.

From an exit perspective, technology firms might be interested in an acquisition of several reasons:

- *Direct competitors* – The firm of interest, MindValue, are providing a similar solution as the technology firm itself. The interesting part is that small start-ups have serious potential to compete with big corporations, due to ease of spreading on the Internet. Small firms can act big, but remain small.
- *New technology* – The firm of interest is developing something that does not exist anywhere else. In this case it might be software with patent.
- *New competence* – The brainpower of the firm of interest is highly desirable for the acquiring firm.



### **11.1.3.1. IBM – International Business Machines Corporation**

IBM is an information technology (IT) company, creating, developing and manufacturing advanced information technology, computer systems, software, networking systems, storage devices and microelectronics (IBM company website, 2007). IBM also provides business, technology and consulting services. Its major operations encompass a Global Service segment, A Systems and Technology Group, a Software segment, a Global Financing segment and an Enterprise Investment segment.

IBM has three principal segments: Systems and Financing, Software and Services. The majority of its enterprise business, which excludes its original equipment manufacturer technology business, occurs in industries that are grouped into six sectors: financial services, public, industrial, distribution, communications and small and medium business (NYSE, 2007).

### **Significant acquisitions:**

An enterprise sized as large as IBM constantly conduct strategic acquisitions. During the year of 2006 IBM conducted three large acquisitions in software companies, ranging from US\$ 740 million to US\$ 1.6 billion.

One of the recent acquisitions with relevance for this report is IBM's bought of **ISS, Internet Security Systems**. Internet Security Systems develop security products and services, protecting IT-systems. ISS was founded in 1994 and has about 35 offices in 20 countries globally. The cost of the acquisition was set to US\$ 1.3 billion.

Analysts state that the acquisition of ISS announces IBM's desire to raise its profile in fast growing segments of the IT-market (IBM, Company data, 2007).

#### ***11.1.3.1.1. Synergy relation***

From the press release of IBM's acquisition of ISS in 2006, following quotation can be read: *"This acquisition advances IBM's strategy to utilize IT services, software and consulting expertise..."* (IBM corporate information, 2006). Referring to the synergies, the value in this acquisition is clearly the new technology and new competence prior to marketing and distribution channels.



#### **11.1.3.2. HP – Hewlett Packard**

HP (Hewlett Packard) is a provider of technology solutions, products, and services to individual consumers, small and medium-sized business (SMBs), large enterprises and institutions globally. The company's offerings span over a wide specter covering IT structure, global services, business and home computing, and imaging and printing. During the fiscal year 2006, HP's operations were organized into seven business segments: Enterprise Storage and Servers (ESS), HP Services (HPS), Software, the Personal Systems Group, the Imaging and Printing Group, HP Financial Services and Corporate Investments (NYSE, 2007).

### **Significant acquisitions:**

In 2005 HP acquired **Trustgenix Inc.**, a leading provider of software federation solutions that establish secure, privacy-protected exchange of user data among cooperating organizations. Trustgenix offers federated identity management software that supports all open federation protocols and integrates with any identity management system or homegrown **single-sign on**

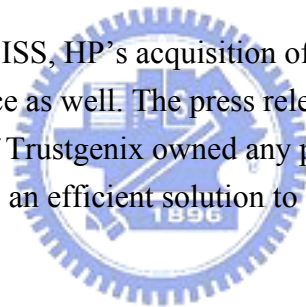
**system**, which has significant similarities with MindValues own solution

*"Identity federation appeals strongly to companies in the telecommunications, financial services, manufacturing and government industries,"* said Todd DeLaughter, vice president and general manager, OpenView Business Unit, HP. *"Adding Trustgenix solutions to OpenView will bolster our efforts to help customers securely and quickly expand their enterprises to include business partners."* (HP company website, 2007).

Trustgenix uses industry-standard federation protocols to link multiple accounts with different providers on the Internet so that secure user authentication occurs only once. When a user navigates to different sites belonging to the same federation, *Select Federation*, a solution of Openview Business Unit, HP, recognizes the user and is able to provide a secure, personalized experience based on the user's preferences and identity (HP company website, 2007). Financial terms of the transaction were not disclosed.

#### ***11.1.3.2.1 Synergy relation***

Similar to the case of IBM and ISS, HP's acquisition of Trustgenix was an acquisition of new technology and new competence as well. The press release did not disclose any technical details of the transaction, but if Trustgenix owned any patents related to the operations, an acquisition of the technology is an efficient solution to strengthen HP's competitive advantage.



#### **11.1.4. Direct Competitors – Pure Internet firms**

The direct competitors in this context are competitors that operate purely on Internet, with a wide range of products and services. Referring to MindValues business plan and competitor analysis, there were only one (1) out of fourteen (14) competitors that could be classified as a direct competitor, providing the same solutions as MindValue does. The direct potential competitor provides an e-payment solution, and has similar ideas of how to grow its business as MindValue. This specific company might be a potential buyer of MindValue or vice versa, since it is also in an early growth phase.

Direct competitors in an angle of an exit, in this report are pure Internet companies, defined as the *second group of new technology firms* (Chapter 5.2, Damodaran, 2001) which operates purely on the Internet.

Similar to large technology and new technology enterprises like IBM, Microsoft, and HP,



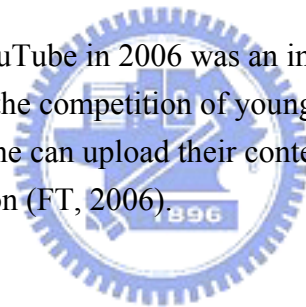
giant Internet firms like Google and Yahoo!, constantly conduct strategic acquisitions, in order to maintain or become market leaders (Grant, 2005., FT, 2006). On par with many other successful Internet firms, these *direct competitors* have expanded their business extremely fast into a wide range of products and services. Because of a fast pace of expansion into new markets, and a widening of the products and services park, these *direct competitor* companies are always important from an exit point of view of newly start-up companies.

#### **11.1.4.1. Google Inc.**

Google Inc. offers advertising and Internet search solutions, as well as Intranet solutions through an enterprise search appliance. Google Inc. offers a wide range of products and services thru Google.com and had a market share of the US search engine market of 49.2 percent in 2006 (Yahoo! Finance, 2007., Nielsen NetRating, 2007).

##### **Significant acquisitions:**

Google Inc's acquisition of YouTube in 2006 was an important strategic action, referring to the outline of chapter 13.1.1 – the competition of young peoples media habits. YouTube is a video-sharing site, where anyone can upload their content and share it. The cost of the acquisition was US\$ 1.65 billion (FT, 2006).



#### **11.1.4.2. Yahoo! Inc.**

Yahoo! Inc. and its subsidiaries provide Internet services to users and business worldwide. Similarly to Google, Yahoo! is a portal, providing primarily search services, but offers also a range of online tools and marketing solutions to business. Yahoo! is number two in the search engine market, with a market share of 23.8 percent in 2006 (Yahoo! Finance, 2007., Nielsen NetRating, 2007).

##### **Significant acquisitions:**

Yahoo! Inc., like Google constantly conduct strategic acquisitions, in order to maintain first mover advantages in new markets. The giant search engine's buying pattern makes it interesting for newly start-up companies in an exit context.

In 2006 Yahoo! Inc. acquired the Swedish based start-up company *Kenet Works*. Kenet Works provides a technology, which enables visitors of an online community to “chat” on

their cell phones, and to use other functions such as push-to-talk. Yahoo acquired the Stockholm-based 13-man company in 2006, for at least US\$ 23 million (www.stockholmbusinessregion.se, 2006).

Kenet Works was founded in 2003 by seven civil engineers (*MSc. in Engineering*), led by CEO, Gustav Söderström from the Royal Institute of Technology in Stockholm (KTH).

#### ***11.1.4.3. Synergy relation***

The synergies of Google's and Yahoo's acquisitions are the benefits of first mover advantages. In terms of synergy, first mover advantages can be seen as strategic alliances, where both companies benefit from a merge. The big companies like Google and Yahoo benefit from the novelty of content and the smaller acquired firms benefit from a fast expansion and a contribution of venture capital. In some cases, new technology in terms of patents can be a synergy that raises the value as well as marketing and distribution channels. The acquisitions of YouTube and Kenet Works are examples where many synergies occur concurrent. The novelty of YouTube vouches for a first mover advantage, and its content is an important marketing and distribution channel. The technology of Kenet Works may be patented, why the new technology is important to acquire, as well as the new competence connected to the technology. Often the original management team is obligated to stay in its position for a period of time after the acquisition, to ensure that the new competence acquired does not disappear, but also transferred to new manpower.

## 12. Analysis of a potential exit situation of MindValue

The exit possibilities for an Internet start-up company are currently very positive (DI, 2007; MindValue, company data, 2006). There are several examples of successful exits of new technology firms made the past years (Appendix). The aim with this report is to analyze and identify the value drivers, which gives a specific company competitive advantage enough to differentiate from others.

Referring to the chapter of *exit strategies* (3.1) the most likely exit for a new start-up firm will be an acquisition, due to negative fulfillments of the requirements of the other exit situations. The other exit strategies are not suitable enough, because of the requirement of healthy liquidity, which start-ups mostly do not benefit of (www.bizplanit.com, 2006). In order to become attractive enough for a larger firm the value drivers that creates future profit must be accentuated, which also can give answer to the first question of issue of this report:

“What can a start-up firm do in order to become valuable for an acquisition firm?” and  
“What operations are value-related from the approach of an acquisition firm?”

Yet, MindValue is no pure e-commerce firm, nor pure e-business firm, although the firm is heavily inclining to the e-business concept (MindValue, Company data, 2006) From an analyst’s perspective, it is a challenge when firms like MindValue have no comparables, and are designing new business models and structures at the new technology arena (Damodaran, 2001). From an entrepreneur’s perspective, the starting-point of being the first in a segment in an industry vouches for advantages of the kind Porter (1980) designates as *First Mover Advantages*. Though, the valuing of new start-up firms, first of its kind is still a challenge.

Looking at the latest acquisitions of new technology firms all over the world, it is not the main operations of these new technology firms that are of most interest, it is the resources of synergy, like distribution channels, marketing channels, new technology, new competence, etc. (FT, 2006; DI, 2007). The video sharing site *YouTube* as example, it is not the idea of streaming videos all over the world that drives value, it is the possibility to reach billions of people in the age range of 13-24 years old (referring to figure 11.2), providing them with customized and target aimed advertising, etc.

The value drivers of MindValue are currently not their technological expertise, but their ability to attract a large amount of people in different segments. Referring to the latest acquisitions of the companies segmented in chapter 11, which were *video sharing sites, game*

*sites, youth communities*, it is not their main activities that are of importance. More likely is it to have a positive answer to following question

- Does the company of issue have the potential to attract enough of clients (for a vary of value creating operations)
- Does the target group have enough purchasing power
- Does the firm of issue have enough credibility, ambition to last over a long period of time
- Are the company's business and revenue model realistic
- Is the management capable enough to run the business successfully
- Is the management capable to manage growth, or extreme growth

These questions are just some examples of issues that are if importance when acquiring a new technology company.

Elaborating the statement from chapter 2:

*Since the life cycle of a new technology start-up might be very short, the initial operations of the firm will reflect the outcome significantly.*

Looking closer to the acquired companies of chapter 11, surprisingly few of them where having a professional approach from the start (Lunarstorm, Company data, 2007). Many of them were created because of a specific interest from someone, not necessarily with a financial goal. Other key drivers for new inventions on the Internet can also be the lack of specific functions of other applications (YouTube, Company data, 2007). Jointly characteristics for these firms are that they have succeeded to attract a large number of users, which subsequently have attracted investors as well. Although many successful entrepreneurs did not (officially) had the ambition to grow to a global brand or company, it would be beneficial to plan for such a take off already from start, since the new technology industry has a faster growth period than other businesses. One big problem, according to Lindström (2001) is that that many companies that grew fast in the beginning of the 21<sup>st</sup> century, did not have competent management teams enough, capable to run the company. When firms grow to a certain level, the corporate structure look more or less the same in every industry and even the new technology industry requires traditional basic knowledge of how to administer a corporation. Despite great computer knowledge, many companies died in the era of Internet business in late 1990ies and early 2000, because the lack of professional business knowledge (Lindström, 2001). A well formulated business plan, with every growing step meticulously planned would therefore reflect the outcome significantly.

Referring to the second question in chapter 2, *in which way, and how, will MindValue, the specific new technology firm, be valued*, new start-up firms have in general two approaches to take into consideration when estimating value, a *traditional approach* and a *non-financial approach*. There is still no clear or jointly agreement of how to value volatile *new technology start-ups* with high grow potential, so both valuation models have to have significance. Relating this question to the first question above, concerning preparations, good knowledge of what really drives value in new technology industry is clearly an advantage. Knowledge of the pros and cons of specific valuation models, is an advantage in terms of negotiation, which also fall into the category of start-up related preparations.

From the statement of: *Specific transactional activities can be valued more, than activities only counting visits and unique users*,<sup>20</sup> one conclusion is that, after analyzing the chosen firms of chapter 11, new technology firms with more unique visitors are valued higher (DI, 2007). The statement above gives that web sites strictly transactional are valued more than others, which vouch for a support for the statement.<sup>21</sup> *Lunarstorm.se*, which is a youth community, has a value of approximately SEK 374 million (£28 million = US\$ 50 million), and a visitor rate of approximately 1,000,000 unique visitors per week. *Blocket.se*, Schibsted's C2C market web site has a market value of SEK 1.65 billion and a visitor rate of approximately 2.6 million unique visitors per week. These numbers indicates that e-commerce web sites should have a higher value than other member sites.

To the third question in chapter 2: *Which companies are potential buyers for MindValue, the specific new technology firm (who are the players)*, it is difficult to give a strict answer to, since there might be several interested parties not taken into account yet. Chapter 11 in this report gives a brief of what kind of companies that might be interested, according to their earlier purchases resent years.

To the statement of: *The market structure of the potential buyers of a new technology firm is divided, that is, it is not only direct competitors or firms in the same market sector that are interested in acquisitions of new technology firms*, I also find support! Referring to chapter 11, the potential buyers of a new technology firms is divided. Chapter 11 shows that the

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<sup>20</sup> Online gaming like poker and casino related sites are typical examples of activities that are strictly transactional – the site users strictly visits these sites to bet and transact money, which might raise the turnaround of the Internet company more than an Internet companies with different business models.

<sup>21</sup> A comparison of Schibsted's C2C market *Blocket.se* and the youth community *Lunarstorm.se* gives that *Blocket.se* both has more unique visitors and has a higher rate of transactions referring to chapter 11.

interested parties of a firm purchase are interested from different point of views, all from speculative investments to strategically competitive purchases.



### 13. Conclusions

The value of a firm is influenced by a number of variables, each with different significance according to who the interested party is (Sevenius, 2003). Synergy effects and control effects that follow for one interested party might not be interested at all for another (Sevenius, 2003). Valuation of new technology firms can be divided into two approaches, a *traditional approach* and a *non-financial approach*. Both approaches have qualities in practice, and theoretically they should end up with the same value of the firm of interest. When elaborating articles and literature of the two valuation paradigms, it is important to clarify what really are value drivers. Both concepts agree for example, that a high rate of *unique visitors* raises value for an Internet company. But the difference is *how* this number of *unique visitors* is used in valuation analysis. The traditional view of valuing companies, in this context states that the *unique visitors* rate *must be translated into business and revenue models*, together with scenarios in order to make robust future predictions possible. The concept of non-financial data is based on research and studies, which states that only *non-financial* data are measures enough for identification of high price companies from low price dittos. Referring to the expert interviews of this report, the experts do agree that non-financial data is important, but they cannot stand for a company's value alone. The non-financial data do have relevance, but what is more important is how a firm's business plan, business models, and revenue models looks like. Analyzing the business model of a firm and using *scenario analysis* to predict the progress, the non-financial data will become a significant tool when judging the possible outcomes.

Looking at possible *exit strategies*, the most likely exit for a new technology start-up firm will be an acquisition, due to lack of historical data and economical resources for the other exits like *merger, IPO, buy-outs*, etc. The value drivers of MindValue, the specific start-up firm of this report, will presumably be the synergies and the resources connected to the synergies that are related to an acquisition of MindValue. Of the synergies: *marketing channels, distribution channels, strategic alliances, new technology, and new competence*, the most significant for MindValue, would be the *synergies of Distribution and Marketing Channels* and the *synergies of Strategic Alliances*. Worth notice, though is that *Distribution Channels* would have as large number of unique visitors as possible in order to become highly attractive as a target firm for an acquisition. The strength MindValue has, compared to other competitors is that its unique visitors are all identified, which vouch for novel business models for purchasers. If MindValue enters strategic partnership with other interested parties, it could strengthen its competitive advantage to other competitors as well, and increase its value.

## 13.1 Recommendations

The topic of valuing Internet or new technology firms is complex. Even if the Internet industry has matured compared to its infancy in late 1990ies, and seem stable in some areas, compared to prior year 2000, the industry is still developing fast. When talking to professionals in firms' valuation, it is still difficult to get clear answers of what valuing approach should be valid, and many seams uncertain, when talking specifically about volatile industries as Internet industries (Interviews, 2006). Further studies on valuation of new technology firms should be more focused on different business models, the power of adequate management, and the likeliness to maintain operations over a long period of time, which also is the trend (DI, 2007; Koller *et al*, 2000). How the valuation of these parameters will be managed is still an issue, but the solution may be found somewhere in between of the two valuation paradigms presented.

Further reading on Merges & Acquisitions are recommended to the interested, as well as further reading on strategies on valuing volatile industries.<sup>22</sup>

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<sup>22</sup> Books recommended on these topics could be: "Företagsförvärv – *en introduction* [English translation: Acquisitions – *an introduction*]," by Robert Sevenius (2003), and "Financial Dynamics – A System for Valuing Technology Companies", by Chris Westland, 2003.





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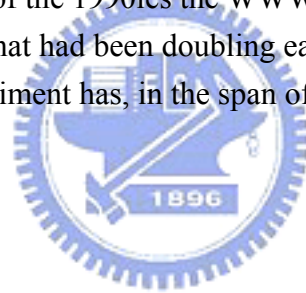
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## Appendix A Internet

### Short history brief

The idea of an interconnected globe was first stated in the beginning of the 1960ies. A wide variety of computer experiments were going on at Massachusetts Institute of Technology (MIT), Boston, USA and the embryo of an interconnected globe begun to take form. The plan and ideas of a global interconnected net developed further, and in the 1970ies the United States Department of Defense Advanced Research Projects Agency (ARPA) officially sponsored the project<sup>23</sup>. The name ARPANET was used already in the 1960ies because of ARPA's interests already by then. During the 1980ies the launch of the personal computer (PC) raise the awareness, and the new PC/technology era is booming. In 1990 the ARPANET has grown from 4 to 300,000 hosts in 20 years, and have connections all over the world. The next year, 1991, the users doubled in numbers and the net's dramatic growth continues with National Science Foundation, NSF lifting any restrictions on commercial use. The Internet becomes such a part of the computing establishment that a professional society forms to guide it on its way. In the beginning of the 1990ies the WWW bursts into the world and the growth of the Internet is booming. "What had been doubling each year, now doubles in three months. What began as an ARPA experiment has, in the span of just 30 years, become a part of the world's popular culture<sup>24,25</sup>.



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<sup>23</sup> The research and computer experiments were already sponsored before the 1970ies, but the Internet and Transmission Control Protocols were initially developed in 1973, by the United States Department of Defense ARPA.

<sup>24</sup> <http://www.computerhistory.org/>, *Internet history 1962 to 1992*.

<sup>25</sup> <http://www.computerhistory.org/>, *Internet history 1962 to 1992*.

## Appendix B

### List of some deals by Swedish IT & Internet companies:

- **Playahead:** □ Founder: Jonas Frost and Leif Carlsson □ Amount: Sold for 102 million Swedish Crowns SEK to MTG in 2007
- **OnGame - Bwin Games AB:** □ Founder: Hörnell Family Oskar & Karl Hörnell with Claes Lidell □ Amount: Sold for 4,5 billion Swedish Crowns SEK to Bwin
- **Tradera:** □ Founder: Jonas Nordlander □ Amount: Sold for 365 million Swedish Crowns SEK to Ebay in 2006
- **Lunarstorm:** □ Founder: Richard Ericsson □ Amount: Sold for 170 Million Swedish Crowns SEK to Sten Mörstedt, CLS Holdings in 2006
- **Skype:** □ Founder: Niklas Zennström & Janus Friis □ Amount: Sold for 30 Billion Swedish Crowns SEK to Ebay in 2005
- **Blocket:** Founder: Pierre Siri □ Amount: Sold for 183 Million SEK to Aftonbladet in 2004
- **Pricerunner;** □ Founder: Kristofer Arwin, Martin Alexandersson and Magnus Wiberg. Amount: sold for 220 million SEK to Valueclick in 2004
- **Lensway;** □ Founder: Daniel Muhlbach □ Amount: sold for 104 Million SEK to Coastal Contacts in 2004
- **Tradedoubler;** Founders: Felix Hagnö, Martin Lorentzon and Magnus Emilson. □ Sold in 2005.

(Source: Dagens Industri, 2007; Company press releases, 2006)