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A recent deal may herald the return of unbridled enthusiasm.

By Erin Flynn

When Google purchased YouTube, the video sharing site, for $1.65 billion in stock last year, the transaction raised eyebrows. YouTube was started by two guys in their 20s after a dinner party; the Web site's sale turned dozens of its employees into paper millionaires.

"This all smells of 1999 when Silicon Valley companies used their stock to buy companies at inflated prices, driving a feeding frenzy that ultimately proved damaging to markets and investors alike," says James McQuivey, professor at Boston University's College of Communication. "Gratefully, Google's the only one who can spend its stock like Monopoly money at the current time or we might see another shopping spree like that."

Other major companies like Yahoo! and Microsoft are seeking to expand their online video capabilities. This deal clearly raises the stakes for Metacafe, Bolt.com and iFilm; it gives Facebook more negotiating leverage in its acquisition discussions with Yahoo!.

But is YouTube worth a $1.6 billion price tag? Bill Wise, CEO of Did-it Search Marketing, a company that manages search campaigns, doesn't think so.

According to Wise, Google and the other engines have only two options for ad inventory: lease the eyeballs with a revenue share deal (like the Google/MySpace deal) or own the eyeballs through acquisition. Google's YouTube purchase was, in a sense, a failure of Google Video. "They are admitting that even with the mighty resources of the number-one search destination, they can't invest a few hundred million dollars to compete with a company that currently can't turn a profit," Wise says.

YouTube has an insufficient traffic history to prove that it's a long-term player worthy of such a purchase price. Their current trend looks amazing, Wise adds, but there isn't much of a barrier to entry— especially if you don't mind running an unprofitable business.

“The real question is, how big is the future of online video and is it worth it to Google to pay a premium to make sure it’s a top dog in that space?” McQuivey continues. “The answer there is a definite yes. Eventually, the Internet will be the distribution platform for just about every type of moving video—and whoever controls how people access that video will be in the driver’s seat. That’s worth a few billion in stock to a Google with overvalued shares to trade.”

Bob Monroe, associate teaching professor in information technology and computer science at the Tepper School of Business at Carnegie Mellon, believes this purchase highlights the competitive advantage that Google’s massive market capitalization provides.

“For about a 1.7 percent dilution of their stock, Google acquired the clear leader in a nascent but rapidly growing new market, took out a competitor who could grow to be significant, and improved their odds of controlling video distribution on the Web,” Monroe says. “Microsoft or Yahoo! could have ponied up for a comparable bid, but doing so would have amounted to a much larger bet for either of them than it did for Google.”

Doug Brockway, managing director at Innovation Advisors, an investment banking firm that only works with technology companies, agrees. “For any other acquirer except for Google, it would be an outlandish price,” he says. “It’s an all stock transaction; Google’s stock is richly valued by itself. Google is only giving up about 1 percent of their company in order to take on YouTube. The strategic fit between Google and YouTube makes sense.”

Google is essentially in the advertising business, and the YouTube deal raises plenty of questions. “What will happen to the grassroots nature of YouTube as viral advertising takes hold from Google?” asks **Glover Lawrence, managing director of the international investment bank McNamee Lawrence & Co.** “In addition, we could expect interest to intensify in providers of complementary online video technology categories, such as video delivery and editing, rights management, video search technologies, and viral advertising, as Google and its brethren look to improve the user experience and improve revenue streams.”

If people continue to spend less and less time watching television as their primary source of entertainment and shift their personal time and money to an online medium, it makes sense for Google to place a large bet in the online space.

YouTube has been compared to Napster, a music-sharing service that was closed following lawsuits. Could Google be inheriting legal issues? Lawrence doesn’t think so. “Google as an entity has massive negotiating leverage relative to somebody the size of YouTube,” he says.

The talk of eyeballs and visits rather than revenue and profitability reminded some people of the dot-com bubble. Brockway says he is sure Google has run financial models analyzing the two companies together and the revenue and profits this deal will yield.

“It’s a way of Google continuing to broaden out their search advertising platform,” Brockway says. “It’s indicative of strong M&A trends you see in the technology space.”

Erin Flynn is a freelance writer based in New York City.