

Markets: are we hearing the sound of bubbles popping?



Are the days of mega-deals numbered in the tech sector? e-Bay has signalled that the Skype internet telephone company is under a cloud and that the hyped-up price paid for the company was an error of judgment.

In a December 2004 SEC filing, e-Bay admitted that it believed that the company's shares were over-valued. Two years earlier it has purchased PayPal for USD1.5 milliard. PayPal was not making much money but it was the payment provider most easily integrated into the e-Bay auction system and was dominant in the US, e-Bay's most important market.

When e-Bay bought Skype in 2006, the deal made sense in only one way: Skype could deliver huge amounts of visitors to e-Bay's advertisers and they would buy using PayPal - by then the most profitable part of e-Bay.

Conspiracy theorists opined that the massive price of USD2.6 milliard may have been subsidised by the US State Department so as to make sure it could monitor calls across the world's largest internet voice comms service for security reasons.

The deal paved the way for huge deals to purchase loss making - or even non-revenue generating - internet businesses such as YouTube, MySpace and - pending - FaceBook.

Skype had almost no revenue but it had enormous numbers of users, and a business plan to generate revenue by mutating its service and the sale of hardware. The principle income, it planned, would come from charging users to call PSTN (ordinary phone) lines using the internet in a scheme called Voice over IP or VoIP. And the VoIP business is dominated by players that have been in the market for a decade - and a host of upstarts, most of whom claim their service costs less than Skype for calls to real phones. Also, they have all overcome a significant fear for many potential Skype users: Skype uses peer to peer technology which means that all users become part of a global network with their processing power and bandwidth being used to support the system. Whilst this overcomes the dreadful latency problems that have afflicted Microsoft Net Meeting and many other VoIP providers, it has led to a backlash against Skype in the workplace as both bandwidth and desktop processing power have been sucked away, even if

the system was apparently idle. And business users were where the anticipated revenue was due to come from.

Worse, for a system that is supposed to be the most reliable in the world and operating without a hitch, there was near panic when Skype went down in mid-August this year. The company had a simple explanation - the nature of peer-to-peer networking means that there are exposures in both ways. Skype works on the basis of nodes, super-nodes and centralised servers. When you log onto Skype, your computer becomes a node and is connected via the internet to a super-node. The problem arose because Microsoft issued a routine update to its Windows operating system. Vast numbers of people installed it (some automatically) and their systems rebooted. The sheer number of simultaneous or near simultaneous reboots - each of which involved automatic re-login to Skype - overwhelmed the super-nodes. That in turn generated massive traffic between the super-nodes and the servers. The effect was as if there has been a massive, so called, denial of service attack on Skype - which was, in fact, what some wrongly believed had happened. So far as users were concerned, what happened was simple: their online chat system which includes text, voice and video didn't work for two days. For business users, that was another reason to look for an alternative.

Historically, given that visitors generate no revenue for the sites they visit, internet companies have claimed that their value depends on "eyeballs." This raises the attraction of the site for advertisers. But in recent years, as the number of sites has exploded from 250,000 in 1995 to more than 60 million today (according to figures from a variety of sources) and as Google has come to dominate search engines and Google's algorithm has failed to filter out sites that exist for the sole purpose of providing advertising links, the primary focus of web publishers has been to either create or at least to fit into a niche, and to define the quality of their visitors rather than the number.

Skype's users are from right across the geographical, linguistic, cultural and economic spectra. It has no demographic focus. Although it has a rudimentary profile for users, completing it is not only optional but faking the details is almost de rigeur for Skype users. Indeed, it is the very anonymity of the system that is so appealing to so many - hence the conspiracy theory mentioned above.

Since Facebook broke out of the university-focus that launched it, it has come to rival MySpace and YouTube for widespread appeal.

e-Bay has decided it paid almost 20% too much for Skype and is down-valuing the company in its books by USD900 million. The problem is the same as faced YouTube: providing a free service is great - but businesses are supposed to make money and if one is free-wheeling life gets very tough when the wheels fall off.

The wheels fell off for YouTube: it was sinking fast into debt as its bandwidth costs skyrocketed but there was no revenue generating model in the horizon. Rescued by Google, someone forgot to ask one fundamental question - what is there to stop copyright owners attacking the new deep-pockets owners? Google is now embroiled in a series of attacks from various directions and using various means in relation to copyright material on YouTube. And Google needs to at least delay those actions if it is to find a way to recover its USD1.65 milliard investment - which it paid in handcuffed stock. Google needs to find a revenue generating model that does not involve the publishing of copyright material. Yet, for many users, the copyright material is the only reason (except for pornography) for visiting. And YouTube has some fascinating material: we found a copy of an extract from a 1973 Oprah Winfrey show, rebroadcast and recorded in Japan, showing Dutch rock band Focus. The number of copyright infringements in that one item is ridiculous - but as a social document, it has considerable interest, if not historical significance.

The price of FaceBook is expected to bear no relation to its revenue generating capabilities. A social networking site is one of the things missing from the Microsoft on-line stable. A link-up between a social networking site, Microsoft's long established NetMeeting and its MSN news and search services would provide MS with a come-back against Google's sudden appearance in the market since Google launched its own phone service.

The aim, then, it seems is to built a network of sites meeting all the social needs of users, and to keep them "in the family." By insisting that at least one of those services has an effective registration including verifiable identification, then information exchange within the network will facilitate accurately targeted advertising.

The current Holy Grail, then, is the grabbing of eyeballs, and converting them into targets, so that highly targetted advertising can be sold.

It all sounds remarkably sensible. Except, so far, no one is close to making it work and the amounts of money that have so far been thrown at it are mind-boggling.

And, as e-Bay yesterday admitted, largely wasted.