ALLTOPSTARTUPS.COM

# STARTUPS CASE STUDY

Compiled By Thomas Oppong | Content courtesy of Startup-review.com

# Introduction

You probably have at least a dozen very good reasons why right now is not the right time to start a company. But in another light, it's almost a sure bet that right now is the best possible time for you to go ahead and take the leap. In Paul Graham's own words "You need three things to create a successful startup: to start with good people, to make something customers actually want, and to spend as little money as people." The founders and employees of the companies in this case study share their success stories of how they launched their businesses, strategies adopted to launch the companies, exit strategies and food for thought.

Perseverance is important because, in a startup, nothing goes according to plan. Founders live day to day with a sense of uncertainty, isolation, and sometimes lack of progress. Successful startup founders typically get rich from the process if they provide solutions to problems that need attention the most. Thanks to Web technology, anyone can start a business from anywhere at any time. Collaborate with thousands of other people all over the globe, get instantaneous feedback on new business ideas, and spread your marketing message around the world. With the right support a simple idea could be nurtured to become a multi-billion business.

Alltopstartups aims to cover top startups that are winning awards at various startup competitions and all startups and will provide you with the news, features and advice that will help guide you as you strike out on your own.

Thomas Oppong -Founding Editor, Alltopstartups.com

# Facebook.com

**written by Nisan Gabbay,**

Facebook was launched in February 2004 by Harvard undergrad students as an alternative to the traditional student directory. Its popularity quickly spread to other colleges in the US by word of mouth, and the site now registers close to 15M monthly UVs and over 6B page views per month. Facebook has completed two rounds of venture financing at very high valuations, the first at a valuation of ~$100M and the second at ~$550M (valuations are unconfirmed). These valuations were driven by the multiple acquisition offers that Facebook has reportedly turned down (the latest was a rumored $750M offer). Facebook is already generating significant revenue, so despite all the valuation and web traffic metric hype, it has also established a very real business.

Interviews conducted: Noah Kagan, early product manager for Facebook. Noah will soon release an e-book on Facebook, with good insight on the social networking space. You will be able to download the book at Noah's blog, okdork.com. I have had plenty of informal conversations with people close to Facebook over the last two years, while not formal interviews, I would regard these as quality sources – employees, investors, and competitors.

I would also like to thank Nick Macey, a student at the University of Utah for helping in the research and writing of this case study, and providing the ever valuable user perspective as a current college student. Nick will be helping with some of the writing on Startup Review in the future.

## Key success factors

*Provide pre-existing offline community with a complementary online service*

Facebook had its initial success with college students by providing an information service that was not available offline – an interactive student directory containing each student's class schedule and social network. Before Facebook added the feature sets it has today, it was simply a more complete student directory. Facebook did not create a community where one never existed before; rather they provided an important information and communication service to a pre-existing offline community.

While students already had a loose affiliation with all fellow students at a college, they didn't have an easy way to learn more about their fellow students outside their direct social network. Given the large class sizes at most universities today, students don't have the opportunity to interact with very many of their fellow classmates during class. I remember the days I spent at Berkeley in 200+ student lecture halls scanning the crowd for attractive girls or previous acquaintances. Facebook organized students by class schedule for the first time, making it possible to learn more about that classmate you might have a crush on. Although I am highlighting one particular use case, initial Facebook usage was indeed driven by dating type activity – checking people out, learning more about crushes, light stalking type of activity, etc.

The larger picture here is that Facebook created a high utility online service for enabling pre-existing social behaviors within an offline community. This makes for an interesting lesson learned: it's easier to piggyback off a pre-existing community with offline behaviors that drive online service usage.

*Restrict user registration (and other behaviors) to build desired online service*

Facebook made important product decisions that ensured harmony and trust between the offline community and the online service created. Facebook originally limited membership to those users who could verify they had a ".edu" e-mail address for the college they attend. Facebook also placed limits on the ability to search or browse users to the college that the user attends. These measures aim to make users feel that the site is exclusive and limited to members in their offline community (colleges and universities). In the early days of Facebook, something like 30% of users actually posted their cell phone number on their profile. I'm not sure whether this statistic is still valid, but it supports the notion that users trust who is viewing their profile.

Facebook has recently opened its doors to users outside the .edu networks. To accomplish this, they have created "networks". High schools, employers and geographic areas are, essentially, what colleges were to the original Facebook. When you join one of these "networks," you can only view others in the self-designated network. Additionally, Facebook has implemented a number of privacy controls that allow users to control exactly who gets to see the information they provide.

*Aggregation of a series of deeply penetrated micro communities*

Facebook is a more compelling advertising opportunity than other social networking sites because of deep penetration within a series of micro communities (college campuses). If a local advertiser wants to target a particular college campus, Facebook is the best way to get the advertiser's message to that audience. CPM rates for local advertising command a significant premium from advertisers because of their more targeted nature. With 65% of users logging in daily and 85% weekly, advertisers can run time-oriented campaigns very effectively. The large, branded advertisers, who value reach, can advertise to nearly every student in the 18-22 demographic in the US with one campaign.

Facebook will have ample opportunity to diversify its revenue streams beyond traditional banner advertising due to its deep penetration in these micro communities. Having the attention of 90% of students attending a university lends itself to online classifieds, event listings, e-commerce, and lead generation. Facebook should be well-positioned to be a major player in online classifieds given the usage patterns of its user base.

*Built strong brand recognition amongst user base and advertisers*

The key to an online advertising business targeting branded advertisers (advertisers looking for branding, not just clicks) is having a strong brand that advertisers want to be associated with. A perceived hot brand is what drives premium CPM rates. Two sites having similar demographics and user usage patterns may have drastically different CPM rates based solely on the perceived brand recognition and image factor. While some people I spoke with disagreed, I believe that Facebook did a masterful PR job - highlighting the impact that Facebook has made on the lives of college students and their online media consumption in nearly every story written. How often do you hear that 90% of Facebook users login to the site once per week? Clearly the PR coverage came as a result of the tremendous viral growth, but capitalizing on that PR to help build brand was a key success factor.

*Founder(s) credibility with college audience*

The “face” of Facebook is Mark Zuckerberg. Back in February 2004, when Facebook was founded, he was a student at Harvard. Two other students, Dustin Moskovitz and Chris Hughes were the second and third employees of the company. This added a level of credibility to the site in the minds of the student users. It was something one of them had created, not something fed to them by a “company” in the traditional sense. It was a place that they could trust because one of their own had made it.

Adding to the underground feel of Facebook was the viral spread of the site. It fanned out throughout Boston, and then the Ivy League. Students at other schools had to wait in line until Mark and friends could find time to add their school. This created even more buzz around the product.

# Launch strategy

Prior to launching Facebook, Mark Zuckerberg had experimented with a number of different web products. In fact, his first attempt targeted at the Harvard student body was called FaceMash, which drew criticism from the University and some students, prompting Mark to drop the service.

Mark launched Facebook (at the time called thefacebook.com) in February 2004. Once the site was ready for users, the Facebook founders blasted e-mails to Harvard students to let people know about the site. The team had access to the e-mail addresses of Harvard students at each dorm. Thus e-mail marketing, viral feature sets, and word of mouth was how Facebook was launched. Given the immediate positive reaction that Facebook received at Harvard, Facebook began rolling out the service to other universities. Facebook did not use a targeted geographic roll-out strategy in the early days, they received registration requests from students at other schools, and then prioritized which schools to open based on the number of these requests. Interesting to note that this is how Craigslist rolls out to new cities – based on user requests.

From what I understood, Facebook did not receive any help from the schools themselves to promote the Facebook site to the student body. If anyone has evidence to the contrary, please leave a comment below.

# Exit analysis

There has been much speculation in the blogosphere and mainstream press regarding who will buy Facebook and for what acquisition price. I have heard from reliable sources that Facebook did indeed turn down acquisition offers for ~$750M earlier this year. Recent reports have claimed Facebook is in acquisition talks with both Yahoo and Microsoft for ~$1B. Is such a lofty valuation for Facebook justified? It all depends on an evaluation of future growth prospects, but I think that there is a misconception in the blogosphere that Facebook is not generating much revenue. On the contrary, Facebook was generating almost $1M per week in advertising revenue in Q1 2006. It is likely that Facebook will generate ~$50M in revenue in 2006, up from ~$10M in 2005. Some reliable sources believe that Facebook will do ~$200M in revenue in 2007. Given that Facebook has been guaranteed $200M in revenue over three years by the Microsoft advertising deal, the 2006 and 2007 revenue numbers seem attainable. If the 2007 revenue goal of $200M is reasonable, a 5X forward revenue multiple does not seem to be an excessive valuation multiple.

Many people also point to the fact that Facebook is considerably smaller than MySpace from a site traffic perspective and hence should have a lower valuation than the ~$500M that MySpace was purchased for. This type of comparison based on unique visitors and page views is clearly flawed because not all page views are created equal. There are several good reasons why Facebook's page views are more valuable than those of MySpace:

1) Facebook's core user base (college students) is more desirable than MySpace's core user base (teenagers). Because college students have more disposable income and are more likely to have credit cards than teenagers, they are more desirable from an advertiser perspective.
2) Facebook represents a more compelling local advertising opportunity than MySpace because Facebook can guarantee deep penetration of college campuses, whereas MySpace cannot show the same types of local market usage patterns. The CPM rates for local advertising campaigns are typically substantially higher than national campaigns because of their more targeted nature.
3) Facebook is viewed as a safer option than MySpace for branded advertisers, as Facebook has

a less racy image than MySpace. In a market where advertisers are still hesitant regarding user generated content sites, Facebook has done a better job of brand positioning.

Another noteworthy part of the Facebook story is how they masterfully handled the VC financing process, limiting the amount of equity dilution to the founders. When Facebook raised its first VC round of financing in April 2005, they negotiated a pre-money valuation of ~$85M at a time when they were generating less than $500K per month in revenue. Facebook was able to command such a high valuation by courting both VCs and potential acquirers simultaneously. With term sheets in hand to be acquired for $85M, Facebook was able to drive up the pricing on the VC round. I remember discussing with VCs who participated in the bidding for that first round how the price, which originally started at a $20M pre-money valuation, just kept climbing week after week until Accel Partners finally won the deal at ~$100M post-money. Hats off to Accel Partners for accurately assessing the potential of Facebook in those early days. The prevailing wisdom from other VCs was that Facebook would probably be capped at a $200-300M exit, and hence a 2-3X return was not high enough to justify the risk, given the youth and inexperience of the Facebook founders. Accel is likely to make a 8-10X return on its initial $13M investment in just 2 years. Facebook's most recent $25M round was rumored to have taken place at a $550M valuation after turning downing a $750M acquisition offer. Once again, the Facebook management did a great job of creating a competitive environment for their second VC round. The one piece of information I would be curious to know is how Facebook's $500K seed round of financing was structured. That investment was done at the end of 2004 by ex-PayPal exec Peter Thiel (when Facebook was available on ~30 campuses). I'm guessing that $500K bought 5-10% if it was structured as equity, but would have bought considerably less if it was structured as convertible debt. If anyone can shed some light on the seed round, please leave a comment below.

## Food for thought

The Facebook success story is most interesting to me because of how daily offline social behavior drove usage of the site. There are plenty of activities in our daily life that could benefit from a complementary online product. However, if that offline behavior only occurs once every few months, you have the challenge of user recall. Namely, will users remember your service and know how to find it to fill their need. Facebook demonstrates you have a great Internet service if offline behaviors can drive nearly daily usage online. In the life of a college student, you are meeting or interacting with new people nearly every day. It is human nature to be curious to learn more about that person, hence you jump on Facebook. Facebook fills a high value need for college users on a nearly daily or weekly basis, consistently reinforcing the utility of the service, and building goodwill with users. The issue of user recall is an import one for a web entrepreneur to understand, particularly if the need they are addressing occurs infrequently in the lives of their target users.

Another lesson that Facebook reinforces is the importance of brand and PR buzz to advertising rates. The amount branded advertisers are willing to pay for online advertising is hugely subjective – it's still more art than science. To get premium CPM rates, entrepreneurs must establish a brand – not only with users, but also with advertisers. Many social services do not have high click thru rates on ads because people are not in the mind frame of looking for information when they are using a social service. All social networking sites suffer from this "lack of click thru" problem. While immersive advertising opportunities will eventually displace banner advertising on most social services over time, for the time being, traditional banner advertising is still a critical revenue stream.

Finally, we can learn a lot from Facebook by how they built initial trust between users and their service. While these days it is easy to build a consumer Internet product, establishing trust with users is not. As an entrepreneur, how quickly you can establish trust with your users can be a critical success factor. Facebook built immediate trust via the home page by showing only a select few colleges as being open to registration. Coupled with the registration process, users immediately understood that the site was exclusively for use by college students. This made them feel comfortable disclosing information that people normally wouldn't post on the Internet. Simple, but very powerful. Facebook does give users control over the information displayed on their profile and to whom it is displayed, but only a small percentage of users actually change the default settings. Thus, the key part of the trust equation is not features, but branding and messaging about the service and who uses it.

## Advertising.com

**written by Nisan Gabbay**

Advertising.com was acquired by Time Warner AOL in June 2004 for $435 million, making it one of the most successful exits in the online advertising market. Prior to being acquired by AOL, Ad.com had filed to go public with 2003 revenue of $123M and $12M of operating income. Ad.com posted $46M of revenue in Q1 2004, making its yearly revenue run rate ~$250M. Founded in 1998, Ad.com's revenue growth rate was impressive: 2001 $38M, 2002 $74M, 2003 $123M, 2004 >=$250M. Perhaps even more impressive was the competitive environment in which Ad.com achieved these results. There were the larger, established incumbents like DoubleClick, as well as a plethora of smaller ad networks which never came close to the scale that Ad.com achieved.

Key Contributor: Mike Woosley, ex-CFO Ad.com 1999-2004

# Key success factors

*Emphasis on ad targeting technology from the start*

Ad.com built the most advanced ad targeting platform in the industry, perfecting its targeting algorithms well before the rest of the industry recognized the value of some of the techniques it employed (combination of behavioral and contextual). Ad.com placed significant effort in its optimization technology, enlisting the help of well-known academics.

*Enabled effective, performance-based ad campaigns for advertisers*

Ad.com was one of the first to offer highly targeted price per action campaigns, whether in the form of cost per lead, cost per click, or cost per action. The back-end ad targeting technology enabled Ad.com to buy inventory from website publishers on a CPM basis and monetize them on a more lucrative CPA basis.

Offering effective performance-based campaigns was essential to attracting direct marketers, the only advertisers whose spending continued to grow through the downturn. Ad.com made it easy for direct marketers to track the effectiveness of their campaigns. The background of the Ad.com team was an important factor here, as they had previously made heavy use of performance based marketing analytics at companies like P&G and Capital One.

*Stayed true to ad network business model*

During the downturn, many companies (most notably Double Click) shied away from the ad network business model, choosing instead to license their ad serving technology directly to web publishers. The pure ad serving industry has trended towards a commodity business with prices falling from $0.25 per thousand impressions served down to below $0.04. Ad.com did not license its technology to others, enabling it to build the largest third party ad network on the internet, reaching 110M UVs per month, or 70% of the total US online audience (note: these numbers are already out of date, but the scale is what is important to note). Having this reach was one of the significant factors in attracting both advertisers and potential acquirers.

*Management discipline on operational metrics*

Ad networks, perhaps more than other online businesses, are very much execution-oriented businesses. The management team ran disciplined, analytics driven daily meetings to ensure that top campaigns were performing up to expectations and that Ad.com was capturing as much of an advertiser's campaign budget as possible.

*Well-run back office critical to deal closing*

In getting the company sold, having an entity with public company standards for back office systems, system integration, financial controls, audit, and legal made an enormous difference. Ad.com was too large to attract a slew of bidders - there were a handful of logical buyers. For Time Warner / AOL, this was the first large acquisition made since the abrupt write-down of the AOL-Time Warner marriage, and it was being made by the AOL division which - in the shadow of Enron and MCI scandals - was just emerging from its own set of SEC investigations and accounting problems. Ad.com was descended upon by a team of at least 50 lawyers, accountants and consultants looking for a reason not to do the deal. The lesson learned: if you want to maximize the probability for a smooth exit in an acquisition, act like a (well-managed) public company at all times in terms of control and formality, whatever your size or state of growth. Be easy to buy.

## Launch strategy

Ad networks have a chicken-and-egg problem when they get started, as without web publisher inventory they cannot sell to advertisers, and without advertisers it is difficult to attract publishers. Ad.com did a good job of initially focusing on some of the smaller publishers, and securing inventory on their sites, rather than going after the Yahoo/AOL/MSN type of publishers. When Ad.com was able to prove successful campaigns using somewhat second tier ad inventory, it became easier to attract the larger publishers who were surprised that Ad.com was able to effectively monetize previously thought of junk inventory. With the larger publishers as part of the Ad.com network, it then became easier for Ad.com to attract the marquee advertisers.

## Exit analysis

Ad.com produced a successful return for both its founders and investors. According to the SEC filings, the Ferber brothers owned close to 40% of the company at the time of sale. The price paid for Ad.com was a healthy premium to the EBIT multiples of most online ad network businesses at the time. Taking the Q1 2004 financials of $5.6M in net income ($22M annualized) would be a 19X trailing EBIT multiple. I have not gotten a perspective on how Ad.com has performed within AOL since the acquisition, but given the heightened interest in the online ad market through 2006, it is likely that Ad.com's value would have continued to grow above the $435M acquisition price from 2004 (Note: closer to $500M was distributed to shareholders due to cash on the balance sheet).

## Food for thought

My biggest takeaway from writing this case study was that premium exits in the ad network business are hard to come by without a substantial technology asset. Advertising.com was a successful example mainly because of their technology asset. There doesn't seem to be much loyalty for web publishers to an ad network, so it all comes down to who can make the publisher more money.

This is not to say that an ad network is a bad business for entrepreneurs. There are plenty of ad networks out there in the sub $50M run rate range that are quite profitable and generating good cash flow. However, the trick to achieving a premium exit multiple will be solid technology that addresses a sizeable market. That will be the difference between a 5X EBITDA multiple and a 15-20X EBITDA multiple exit valuation.

Entrepreneurs should think about what drives valuation multiples within the industry that they are targeting and what asset the most likely acquirers will value in an M&A scenario. While the focus should always be on creating a fundamentally sound business, understanding exit scenarios will help in guiding equity and private financing decisions and thus should not be ignored.

## Betfair.com

**written by Nisan Gabbay,**

Betfair is one of the largest Internet success stories that few of us in the US know much about. This is because Betfair is a UK-based company that operates the world's largest online betting exchange and does not accept bets from US consumers. Betfair completed a financing in April 2006 that set the company's valuation at slightly over $3B! The financing should be considered a partial buyout, as Softbank bought a 23% interest in the company for ~$600M. That money was used to provide partial liquidity for the company's early investors, founders, and employees. That lofty valuation is grounded in spectacular financial performance over the last 4 years, as the company grew from ~$10M in revenue in fiscal 2002 to ~$280M in fiscal 2006. Betfair generated ~$70M in operating profit in fiscal 2006, for a healthy 24% operating margin.

As an avid horseracing fan and semi-professional gambler during my college days, I have been aware of Betfair's success for several years now. While the company operates in a gambling market that most US entrepreneurs wouldn't touch, there are many lessons learned from the company's success that can be applied to more general Internet businesses, particularly those with a marketplace component.

Interviews conducted: Adam Platti, early engineer at Flutter, a company that merged with Betfair in December 2001. Adam is now an engineer at Bebo, and has a nice blog that points to many useful tips and articles. I also had two other very good sources who preferred not to be named.

## Key success factors

*Initial product designed for niche (sophisticated gamblers), not mainstream consumer*

In the early days of what would become the online betting exchange market, there were two major players: Betfair and Flutter. Flutter could be considered first to market, as they raised ~$44M in VC funding in two rounds, one before product launch and one just after product launch in May 2000. Given the large amount of capital Flutter raised, Betfair was unable to raise VC funding itself, and instead raised a $1-2M seed round from angels. While both were targeted broadly in the person to person sports betting market, each took an initially different product approach. As it turned out, the Betfair approach was the right one for several reasons.

Flutter was initially envisioned as an online betting community, where users could place bets against their friends and other members of the community. It could almost be thought of as the eBay for betting – users would list the types of bets they'd like to make and other users would choose whether to accept the bet. The concept was inspired by the use case of friends placing bets against one another via email.

Betfair on the other hand was built like a stock market exchange, where odds functioned as the share prices. Betfair was built on the concept that a bettor didn't really care who was booking the bet, as long as they got the best deal possible. The concept of community didn't have much value, but the concept of liquidity in any one betting market was paramount. This would enable players to trade in and out of positions on horses, much like trading in and out of positions on stocks. Betfair's product brought about some profound innovations to the UK horse and sports betting markets, enabling people to "lay" or bet against horses for the first time, while also creating a new type of gambler that took advantage of market trading dynamics without actually having an opinion on the sporting event itself.

Several months after launching in May 2000, Flutter management came to realize that the Betfair approach to the market was the correct one and altered its product accordingly. Although the Betfair approach was thought to only appeal to a small niche of the population (sophisticated gamblers), it turned out that this niche was driving tremendous amounts of volume. After about a year of competing head-on with Betfair, Flutter management decided that it would be most prudent to merge with Betfair. This occurred in December 2001, allowing the combined entity to draw upon the $20M+ in financing that Flutter still possessed, and focus the company on growing the overall market rather than competing for market share.

*Tremendous cost advantage over traditional methods*

Although Betfair covers many betting markets, the majority of the wagering volume is still from UK horseracing, Betfair's initial target market. Betfair's system created an inherent cost advantage relative to the traditional bookmaker model in the UK. Bookmakers would offer odds on horses to the public, with the hopes of balancing the number of bets such that any outcome of a horse race would still result in a net profit for the bookmaker. Because the bookmaker was taking a risk on the outcome of the race, this cost was built into the odds the bookmaker would offer the public. Because Betfair does not function as a traditional bookmaker, it does not have any risk exposure on a race. Thus, the odds that the public sees on Betfair are more reflective of true market, resulting in higher odds in most cases. Thus, a gambler might have found odds of 4-1 on a horse through traditional bookmakers, and would find odds of 5-1 for that same horse on Betfair. In addition to the lack of risk exposure, Betfair also benefited from UK tax laws on Internet gambling that did not require them to pay a tax on gross profit, the way that offline bookmakers did. The net result was a cost advantage for Betfair that traditional bookmakers could not match. This cost advantage translated into a significant value proposition for the bettor – higher odds.

*Took steps to develop high liquidity marketplaces*

Betfair recognized that the key to creating a successful betting marketplace was to improve the chances that any reasonable bet placed, would be matched. In essence, Betfair needed to provide the platform to balance supply and demand the same way that a stock exchange does. As with any marketplace, Betfair needed to solve a chicken and egg problem.

They solved this problem by utilizing three strategies: limiting the number of markets in play at any one time, implementing a business model that encouraged volume betting, and marketing to high volume players. Betfair limited the number of events that could be wagered upon to ensure enough liquidity in that event. Betfair's business model of charging a commission on net profit, rather than gross profit, enabled a new type of bettor – people looking for arbitrage opportunities. These bettors moved large volumes of bets to lock-in a very small profit regardless of the outcome on the race, providing liquidity to the market. Finally, Betfair offered a myriad of incentives and discounts to the heavy bettors responsible for moving large volumes.

# Exit analysis

Betfair's recent valuation of $3.2B indicates healthy trailing valuation multiples of 11X sales and 47X operating profit. Unlike most online gambling companies, Betfair's valuation is more inline with Internet stalwarts like Google, eBay, and Yahoo. There are several reasons as to why one can justify such a lofty valuation for Betfair. For starters, the large majority of Betfair's revenue has come from the UK. There is enormous financial upside if Betfair can successfully expand into new geographies like Asia, US, and Australia. Secondly, a highly liquid marketplace for bettors is a difficult barrier to entry to overcome. Unlike an online poker or casino site that has very few barriers to entry, creating the critical mass to have an effective betting exchange is difficult and costly. An analogy to eBay comes to mind here.

The financing history of Betfair is an interesting one as well. As stated above, Flutter was the first company to raise money, beating Betfair founders Andrew Black and Ed Wray to the punch. Once Flutter raised $44M in VC funding, the Betfair founders found that other VCs were unwilling to back a second competitor. Betfair instead raised ~$2M in angel financing in small increments from friends and family. Despite significantly less capital, the Betfair team built the right product and got quicker user adoption than Flutter. The two companies merged about a year and a half after launch, combining user bases and bringing ~$20M of unused Flutter capital into Betfair. As a result of Betfair's successful start on limited capital raised, both Betfair founders still own significant stakes (10-15%) in the company today. This makes for an inspiring story of how a non-VC funded Internet start-up can win against a better-funded, VC-backed start-up in the same market. The Flutter investors and founders also made healthy returns. In a press release issued by the UK office of Benchmark Capital, it states that Benchmark still owns ~7% of Betfair despite a partial cash-out of its shares in the Softbank transaction. This would mean that Benchmark still has a stake in Betfair worth north of $200M on less than $25M total invested. The press release also states that the original Betfair investors made a return of 130X times their initial capital. I assume this refers to the angel investors in Betfair.

## Launch strategy and marketing

Overall, Betfair was able to effectively launch and market its service because it could target a very tight demographic – horseracing and sports gamblers. Reaching gamblers through traditional media is relatively easy because they tend to congregate in the same places. Betfair launched with an offline PR gimmick that brought it high visibility. Betfair staged a mock "bookmaker" funeral procession through Russell Square in central London on Oaks Day, a major horseracing event in the UK. This garnered press coverage and effectively got bettors to try the system upon launch. Mainstream press would continue to play a large part in Betfair's success over the first few years.

Betfair did a great job of securing partnerships, sponsorships, grassroots marketing and advertising targeted at horseracing gamblers. First, they partnered with the Racing Post, a publication that delivers news and data on races. The Racing Post is equivalent to the Daily Racing Form in the US. Betfair built a co-branded version of the exchange (really just an API to the Betfair exchange) that enabled Racing Post customers to place bets via the Racing Post website; this was a revenue share partnership. Not only did Betfair advertise in the Racing Post, they also sponsored races at the racetracks. Betfair also used some guerilla marketing tactics, approaching bookmakers that operated on-track and making it easy for them to utilize Betfair to hedge their bets. To jumpstart some of the sports betting markets, Betfair sponsored an English Premier League football team.

The merger with Flutter also helped to propel Betfair by combining user bases. It is interesting that Flutter offered users 10 pounds free to wager on Flutter, and while this offer attracted users, it did not result in the desired behavior. Smarter bettors preyed on the new bettors, resulting in a poor experience.

## Food for thought

Betfair's success, particularly relative to their better-funded competitor, Flutter, spurs one topic worthy of further discussion. I find it interesting that Flutter's initial product was geared towards a mainstream audience, while Betfair was serving a smaller niche of sophisticated gamblers. The VC money bet on the mainstream play (Flutter), but as it turned out, starting with the niche of sophisticated gamblers was the right way to approach the market. In hindsight this makes sense, as targeting the early adopters who are more likely to understand the value proposition feels like a tighter go-to-market strategy. Flutter spent a lot of money acquiring mainstream consumers that didn't adopt the product the same way that Betfair users did. Is the Betfair approach the right way to launch a consumer Internet service, i.e. build the product to early adopters rather than the mainstream consumer?

As I have been thinking about the common themes across successful Internet companies, Betfair encompasses many of them. First, they offered a low cost alternative to a previously high cost service (bookmakers). Second, they empowered some users to supplement or make a living using their service. Third, they targeted a niche that turned out to be much larger than most people expected. Fourth, they were able to jumpstart user acquisition through a distribution partnership. Fifth, they had a story that lent itself well to mainstream PR. Lots of ingredients at play!

# Craigslist.org

**written by Nisan Gabbay,**

Craigslist.org is not like other companies profiled on this site, mainly because it is not really run like a typical company. Craigslist fashions itself more of a public service than a for-profit entity, eschewing many opportunities to monetize its user base. However, Craigslist has clearly established itself as one of the leading online brands and the dominant presence in the US online classifieds market. According to Alexa, Craigslist's traffic is up greater than 5X in 2006 over 2005, as it has expanded its geographic presence to ~200 cities. At over 10M monthly unique visitors and 3B pages views per month, Craigslist is the number 7 ranked site in the US (and 25th globally) according to Alexa. Craigslist is also one of the earliest examples of a site built through word of mouth marketing.

Interviews conducted: Craig Newmark, Founder

# Key success factors

Craigslist became successful largely by following certain guiding principles, rather than by following an explicit strategy. I believe that Craigslist's success can be boiled down to three key points, which I did more or less confirm with Craig himself.

*Culture of trust*

Craigslist creates a culture of trust around the site in many ways:

- Craig and the Craigslist staff actively respond to user e-mails.
- Craigslist does not make any major changes to the site without first announcing and testing response from users.
- Craigslist actively incorporates user feedback into the product. Craig told me that there has not been any popular suggestion that they have not incorporated into the site.
- No banner advertising on the site contributes to the perception that Craigslist is "not in it for the money"
- Users are the primary mechanism for filtering inappropriate/miscategorized content. Craigslist has some mechanisms for preventing the posting of inappropriate content, but for the most part, it is up to the users to flag content.
- Lastly, the .org domain name contributes to a non-profit perception (Note: Craig did not feel that many users care or think about this)

*Social aspects of site are key to driving the commercial aspects*

To characterize Craigslist as just a classifieds site is a big understatement. I would argue that the entertainment value of the site to users is a key aspect to the Craigslist consumer experience. I often peruse the site to read the outlandish posts in the "Casual Encounters", "Rants and Raves", and "Missed Connections" sections. My friends also e-mail me entertaining Craigslist posts from time to time. These non-commercial sections of the site are important for several reasons. While I rarely post or respond to these sections, they keep me coming back to the site even when I am not looking for an apartment or job. Others find it fulfilling to have a forum to air their thoughts, thereby giving users a voice in their community. This creates a pattern of usage that is more frequent than buying or selling an item. Secondly, these posts foster the sense of community and trust that give consumers greater confidence in the commercial-oriented classifieds.

*Site ease of use*

Craigslist has done a terrific job of removing barriers for users to post and browse the site. Perhaps the key product decision was not requiring user registration, thereby allowing anonymous posting and browsing. A simple, text-based format was also important in the age of dial-up connections to keep site performance fast. The user self-service site publishing tools are also intuitive and core to the site.

# Launch strategy

Given that Craigslist initially started as an e-mail distribution list, it was indeed marketed solely through word of mouth – if you can even call it "marketed". Craig originally started Craiglsist to tell friends about upcoming tech or art events in SF. Once the number of people on the list grew too large, Craigslist became a formal website. Craig originally thought to call the site "SF Events", but friends encouraged him to use "Craig's list", since that was how it was already being referred to. The content expanded from events to classifieds, to the full range of categories offered on the site today. Craigslist will add a new city to Craigslist when there are enough requests from users to add that particular city. Craigslist does not (nor did not) specifically target "social influencers" or conduct any pre-launch marketing in a new market that they enter.

Much of Craigslist's recent growth has to be attributed to an amazing amount of positive mainstream PR, in addition to word of mouth.

# Exit analysis

Craigslist stands by the self-proclaimed "nerd values" of its founder, happy to make a good living for the employees of Craigslist without the need to make an extravagant profit. Craigslist is generating anywhere from $10-20M per year in revenue and employs just 19 people. Craigslist makes money by charging for job listings in a few major cities (San Francisco, LA, NY).

Craig has turned down many acquisition offers for Craigslist that would by any measure make him a very rich man. Craigslist's CEO Jim Buckmaster has stated that Craigslist could probably make 10 times the revenue it makes today if they tried. So what is Craigslist worth? Assuming they could make $200M in revenue at a 40% net margin, and applying an Ebay-type EBITDA multiple, that would place the value of the company at ~$2.4B. I have no doubt that if Craigslist were to sell, it could command more than a $1B purchase price as is today, and probably significantly more (Note: Craig is a better man than I!)

eBay would be the most logical acquirer, given that they already own a 25% stake through a rather dubious stock sale by a former trusted employee of Craig's. FYI – I did not ask Craig to comment on the history of that transaction. Assuming that those were common stock shares, it seems unlikely that eBay as a minority shareholder has any real influence over the strategic direction of the company.

## Discussion Starter

It will be interesting to see what type of impact new competitors will make on the popularity of Craigslist. Everyone from the big boys (eBay, Google, MSN) to start-ups (LiveDeal, Edgeio, Oodle) has an online classifieds offering. Many of these new offerings are employing Web 2.0 technologies and strategies, while Craigslist has continued to maintain its relatively simple philosophy and design.

I do not believe that these other companies will be successful in dethroning Craigslist for the simple reason that the community element around Craigslist is a difficult one to replicate. It is not just a more robust classified post or search feature that makes for a more compelling user experience. The consumer loyalty that Craigslist has developed over the last 10 years is highly defensible. How many people out there owe finding the place they live or work to Craigslist?

There seems to be four main ways that the competition is trying to differentiate itself from Craigslist: 1) incorporate user reputation and feedback into the classifieds, 2) make it easier for users to submit classified listings (especially power users), 3) adjust the business model away from a straight listing fee per classified, and 4) offer a larger selection of items/postings. Of the four strategies listed above, I think that incorporating user reputation into a classifieds site might be a possible winning strategy. Is reputation/feedback of higher value than user anonymity? For some categories I think it will be, and that's where Craigslist might be vulnerable to a competitor.

In addition to commentating on what made Craigslist successful, anyone care to comment on where the weaknesses might be? How will a new entrant make an impact? Let's start the discussion!

# Digg.com

**written by Nisan Gabbay**

Digg has become one of the poster children for Web 2.0 success since its launch in December 2004. Digg is a news and content website that employs non-hierarchical editorial control. With Digg, users submit stories for review, but rather than allowing an editor to decide which stories go on the homepage, the users do. While Digg does not fit the Startup Review criteria for success perfectly (i.e. they have neither successfully exited nor generated large revenue) they have amassed some impressive site traffic in less than two years: 600,000 registered users, 10M daily page views, 1.5M daily unique visitors (UVs), and 10M monthly UVs. Digg has also had a profound effect on the online news business, with many established industry players taking note of their success.

Interviews Conducted: Jay Adelson, CEO and co-Founder, Digg.com. Mike Maser, VP of Marketing, Digg.com. Two interviews with people at large news media sites that chose not to be disclosed.

## Key success factors

*Attracted story submitters by providing transparency*

When Digg was launched, it was critical to attract the power users who devoted the time to submit stories to Digg. Today, attracting submitters is not a critical success factor, but in the early days it was. Now that Digg has an audience of 1.5M daily unique visitors, authors of stories are motivated to submit directly to Digg for the traffic benefits. Plus, with close to 600,000 registered users and 5,000+ daily stories submitted, it is unlikely that Digg will miss out on finding interesting stories. In fact, the challenge for Digg has now shifted from fostering story submission to figuring out how to ensure that relevant stories are matched to each Digg reader and the entire community.

However, one of the biggest challenges in starting any user generated content site is incentivizing users to contribute content before the network effects provide users with the appropriate motivation. Digg solved this problem using three techniques: transparency, recognition, and competition.

One of the great insights that Kevin and Jay made with Digg was that users of other services were frustrated by the fact that those services operated as a black box. People submitted stories to the editor, the editor reviewed the submissions, and somehow a decision was made as to what was newsworthy material. The submitters were unable to decipher why their stories weren’t selected or how close they might have come. Digg made this process completely transparent for people. Submitters could now see what was popular and fine-tune their submitting accordingly. This is what got people to start submitting to Digg, in addition to or in lieu of Slashdot (and other content sites). Transparency also made the process fun for users, providing another incentive to submit. When I submitted my first story to Digg it was a thrill to see how my story was competing with other submissions.

After leading with transparency, Digg evolved the community features to foster recognition for submitters and a sense of competition amongst top submitters. People could see how they compared to other users in terms of number of submissions, hit rate of submissions, etc. This helped to build an active and loyal community of submitters.

*Created an innovative online news product appealing to readers*

For all the theoretical discussions of how Digg has democratized news discovery and promotion, I think that their success can be boiled down to a more fundamental factor: people like going to Digg to read news stories. Sites like Yahoo News and Slashdot were established incumbents with seemingly well-satisfied audiences, but Digg creates a more engaging product for readers in the following ways:

1. Taps into human desire to know how one’s views compare with others. It is somewhat amazing just how much we as humans seek the validation of others. We are constantly trying to know how we compare to the crowd and what the crowd thinks is “cool”. Digg taps into this desire by providing a transparent means to compare what you think is interesting to what the crowd thinks is interesting. (Side note: I was an engineer by training, but I wish I would have taken some psychology and sociology courses in school, because I am finding that understanding basic human desires and how they manifest themselves is critical to creating consumer Internet products.)

2. Element of surprise. Readers enjoy browsing Digg because of the element of surprise - you never know what quirky story you will discover. Many of the popular stories are helpful technology tips or humorous in nature; stories that traditional news editors wouldn’t consider newsworthy.

3. Reader comments / discussion improve the original story. Digg makes the news participatory by providing an inviting forum for readers to express their thoughts and opinions. This improves the original story by providing different perspectives and reactions to the original story.

4. Provides a constant stream of fresh news content. Readers can see what the most popular news stories are for any time increment. Do they want to know what the story of the day is, story of the week, or what’s newsworthy in the last 10 minutes or last hour?

*The Kevin Rose persona*

I believe that Kevin Rose's personality and public persona played a big part in Digg's success. Initial users wanted to see Digg succeed because they wanted to see Kevin succeed. When Digg was raising its first VC round, some well-respected Internet investors felt that better products were about to be launched that would unseat Digg. However, we have learned that having a superior technical product is not necessarily the determining factor for success. Consumer Internet services are both an art and a science. The Kevin Rose persona was a big contributor to the "art" side of Digg that is impossible to replicate by competitors.

I also believe that the Diggnation podcast has been a big contributor to the success of Digg. While both Jay and Kevin do not believe that the podcast was one of the key success factors, I respectfully disagree. Jay's rationale was that the Diggnation podcast was only started once Digg was a success, already having 100,000+ users. Furthermore, the podcasts get 250,000 unique downloads per month versus 10M UVs per month to the Digg site, thus only 2.5% of Digg visitors listen to the podcast. However, the podcasts are a showcase for Kevin's personality and help to build a loyal community around Digg. Furthermore, Kevin's previous position as host of ScreenSavers was another key success factor for Digg, as you will read in the "Launch strategy" section below.

# Launch strategy

One of the first key decisions that Digg made was to focus its initial product on technology news. The Digg team considered applying the Digg concept to product reviews or other types of news, but recognized that the tech audience made the most sense. For one, tech enthusiasts tend to be early adopters. More importantly, this was an audience that Kevin Rose knew well and had access to. Prior to starting Digg, Kevin was the host of a technology cable TV show called Screensavers that aired on the TechTV cable channel. Digg got its initial site traffic by having Kevin Rose announce the Digg launch during a broadcast of Screensavers. This gave Digg immediate exposure to ~100,000 target users – a nice initial distribution impulse function to get started.

As it turned out, the tech enthusiast community was ideal to launch Digg for another reason: natural search ranking, i.e. SEO (search engine optimization) benefits. Because tech enthusiasts tend to be an audience that does a lot of web linking – either via blogs or websites – Digg received a lot of inbound links in a very short period of time. As I noted in the Flickr case study, developing viral features was a key to Flickr's success. Digg also benefited tremendously from releasing its "blog this" feature early. The "blog this" feature made it easy for bloggers to blog, and hence link, to stories they see on Digg. By collecting lots of inbound links, Digg stories naturally began to rise in the natural search rankings on Google and Yahoo. This set the stage for a key exposure point in Digg's history: the Paris Hilton cell phone hack story.

One of the first bloggers to break the Paris Hilton cell phone hack story submitted the story to Digg. Because Digg was ranking highly in natural search results, when people searched for this story on Google and Yahoo, the Digg landing page was one of the top ranked results. This sent a massive surge of traffic to Digg, and serves as a good example of what continues to fuel Digg's growth. Of Digg's 1.5 million daily unique visitors, a large percentage come from people searching for news via search engines. Given that people search for news in short-lived time windows around when a story breaks, Digg is perfectly positioned to capitalize on this traffic. Digg is able to capture this traffic because of what I will call its blogger linking network, coupled with it's story submittal process that quickly discovers newsworthy stories.

# Exit analysis

Digg's valuation has been in the spotlight recently due to the August 14 Business Week cover story that claimed Kevin Rose made $60M in 18 months. Given that Digg has not been acquired or gone public, the $60M number is not grounded in any confirmed fact. I was also reassured by Digg CEO Jay Adelson that there has not been an additional equity financing since Digg's $2.8M Series A investment in October 2005. Thus, Digg's true current market value is anybody's guess.
Digg's market value cannot be assessed based on current revenues, as Digg has not placed much effort into optimizing its revenue streams. Digg is relying on FM Publishing (in essence an outsourced sales force) and Google AdSense to monetize its current 300M monthly page views. There is a lot that Digg could do to improve the type of ad formats and site sponsorships it offers to advertisers, and hence increase its effective CPM rates. Furthermore, Digg has larger potential revenue streams down the road if it can effectively extend the Digg brand into new product categories like product reviews that could be monetized via affiliate marketing fees. So what is a reasonable estimate of Digg's current market value?

My back of the envelope math says $120M feels about right. The best market comp is the New York Times Company. The New York Times Company is expected to generate roughly $270M in revenue this year from its online properties, which include NYTimes.com (500M monthly page views), About.com (450M monthly page views), and Boston.com (150M monthly page views). To make the math easy, $250M in annual revenue for properties generating 1B monthly pages views, means each monthly page view is worth $0.02 ($250M/(1B*12)). Applying this $0.02 per page view revenue comp to Digg would indicate a yearly revenue potential of $75M at Digg's current traffic levels. However, The New York Times properties are much more valuable than Digg because they have a more respected and better well-known brand with advertisers, have premium pay products, and reach a broader audience. It is anyone's guess as to how Digg will stack up from a monetization standpoint, but I think 25% as valuable is a reasonable guess. That would mean Digg probably should be at a ~$20M revenue run rate. Assuming 30% EBITDA margins and a 20X EBITDA multiple, Digg would be worth $120M. Given the current hot market for fast growing Internet properties, Digg could probably fetch that number or more, a reasonable range is $120M - $360M. While speculation about market value might be a fun exercise, the more important question is whether Digg has created a valuable, sustainable asset for a potential acquirer? I think the answer to that question is yes.

Digg has created a number of valuable assets. As mentioned in the launch strategy section, a loyal following of techies with a penchant for blogging assures high natural search rankings – this is critical for any content-oriented site. Secondly, a community of engaged story submitters and comment contributors is a difficult thing to replicate, even for sites with a large audience. While competing sites will get better at fostering community, getting the formula correct is not an easy process. Third, Digg has begun to establish a mainstream brand. They have done a great job of fostering PR, and the longer they keep the PR machine humming, the more defensible their brand will become. Brand is defensible.

## Food for thought

I have made most of these points above, but I'd like to summarize here for emphasis. There was some healthy debate in the blogosphere awhile back about not designing Web 2.0 products around the 100,000+ TechCrunch RSS reader audience, sparke by Josh Kopelman's post. The idea being that Web 2.0 entrepreneurs should build products that solve products for a mainstream audience rather than a feature for a tech geek. I agree with that point. However, I believe that Digg showcased the true value of targeting the tech geek audience and why they matter. They matter because they blog and they link. Digg reaped the SEO benefits of having this group in their favor, enabling them to reach the mainstream audience with no marketing expenditure as a result of high natural search rankings.

My second point is that once again we see the value of an initial distribution channel to jumpstart an Internet service. Kevin Rose was able to publicize the launch of Digg to an audience of 100,000 target users on his cable TV show. I've now seen MySpace, Skype, eHarmony, and Digg have an initial impulse function on launch. However, companies without this initial impulse have also been successful, for example Craigslist and Flickr. While it is possible to be a success without large initial distribution, it certainly seems to improve the likelihood of success. Without this distribution, the keys are to be either: a) extremely viral, social products, b) SEO friendly, and/or c) have enough margin and search volume such that SEM works.

Finally, and this may seem simple on the surface, but is actually quite hard in practice – understand the initial problem you are trying to solve and build the product around that. The recognition by the team at Digg that submitters lacked transparency to editorial review processes at other sites (that seemed arbitrary and unfair) was enough to get the initial contributors over to Digg. Without a critical mass of early submitters, Digg could not have successfully gotten off the ground. Understanding what motivated those submitters and solving their frustrations was a key stepping stone for Digg.

## eCrush.com

**written by Nisan Gabbay,**

The eCrush network is comprised of several major sites (ecrush.com, espinthebottle.com, and highschoolstyleboard.com) that offer flirting, matchmaking, quizzes, romantic content and social networking type features to teenagers (age 13-19). The sites receive over 1 million unique visitors per month, and rank as the 10th largest dating site in the US according to NetRatings. The company has been profitable since 2002, and generated $1.4M in profit in 2006. The eCrush network was acquired by Hearst Media in December 2006 for an undisclosed sum, rumored to be in the $8-12M range based on my sources.

Interviews conducted: Clark Benson, co-founder and seed investor of eCrush

# Key success factors

*Effectively transitioned user base from one service to another*

The original eCRUSH site launched on Valentine’s Day, 1999 as an anonymous matching service. People with a crush on someone could use the eCRUSH service to anonymously discover whether their crush also had an interest in them. eCRUSH was the middleman, connecting the two parties anonymously via e-mail to see whether a crush was mutual. Over the lifetime of the service, eCRUSH has successfully matched over 900,000 people through 2.4 million registered users.

As an e-mail based service, eCRUSH had strong viral characteristics, peaking at over 3,000 registrations per day in 2000/2001. However, the site’s success led to the launch of over 30 copycat sites that replicated the eCRUSH functionality. Even more damaging was the use of the “crush” concept by spammers looking to collect e-mail addresses from unsuspecting consumers. eCRUSH became a victim of its own success, as spammers tarnished the reputation of the service with consumers.

In the face of these challenges, eCRUSH management recognized that they would need additional products to distance themselves from competing services and spammers. Over time, eCRUSH added additional content like quizzes, romance articles, rating games, astrology, etc. to keep its users engaged. eCRUSH launched a site called eSPIN (or eSPIN-the-Bottle) as a new type of flirting application for its teen user base.

eCRUSH would not have had a successful exit if not for the transition to the eSPIN product and subsequent user generated content strategy. The original service provided a nice user base and e-mail marketing database from which to launch the eSPIN service, and over time, the original eCRUSH service became a feeder service for eSPIN.

*Established profitable lead generation model*

eCRUSH found a clever way to monetize its traffic by offering users access to premium site features in exchange for filling out lead generation forms. eCRUSH management, led by Karen DeMars Pillsbury and Amy Gibby, were able to solve a problem inherent to most teen sites in the post-bubble era – a user base largely unwilling to pay for services and a cold banner advertising market. The solution was to hook users on the free service, and ask them to fill out surveys and co-registration forms to unlock premium feature sets. For example, if a user would like to know whether another user had read their message, they would need to fill out a 2-minute survey from a market research firm that eCRUSH had partnered with. During the downturn, market research surveys proved to be the most viable way to monetize teen site traffic. Although teens are unwilling to spend money, they do have time to spend. This lead generation model turned out to be both a blessing and a curse for eCRUSH, as it enabled the company to survive during the downturn and build a nice cash flow business, but ultimately did stunt its growth potential. More discussion on this topic in the "Food for Thought" section below.

*Efficiently managed capital over company lifetime*

As a previously successful entrepreneur with offline businesses, eCRUSH co-founder Clark Benson did not buy into the Internet bubble hype of the times. Mr. Benson resisted the temptation to raise a large amount of capital, opting instead to raise a total of $900,000 over two financing rounds in late 1999 and mid-2000 from angels. The focus was always to build a real business with actual profits. The company kept an extremely low burn rate from 1999 – 2001, and became consistently profitable in 2002. This capital efficiency enabled eCRUSH to wait until the Internet M&A market returned in full force in 2005/2006, as opposed to selling in a much less favorable climate.

## Launch strategy and marketing

eCRUSH launched it's anonymous e-mail based matching service in February 1999 and saw slow, but steady growth over the next six months. The service really began to take off once it got press coverage by some of the teen-focused print magazines. This PR coverage helped kicked the daily registrations to 500 per day, and enabled the viral attributes of the service to take hold. After 18 months, the site had 650,000 unique visitors and 12 million page views. The service peaked at about 3,000 registrations per day in 2000/2001. eCRUSH spent very little on advertising throughout its first 5 years, sometimes experimenting with online advertising and some ads in teen-focused print magazines.

As the effectiveness of the original service began to diminish somewhat, eSPIN was launched leveraging the site traffic and registered user list from the eCRUSH property. This effectively launched the user generated content site (eSPIN-the-Bottle) which today is the centerpiece of the eCRUSH network. With compelling user content and an established lead generation business model, eCRUSH began to advertise heavily (albeit with great emphasis on ROI), spurring its profit growth from 2004 to 2006.

## Exit analysis

eCRUSH was acquired by Hearst Digital in December 2006 for an undisclosed sum. Hearst publishes a number of the leading teen girl magazines, like CosmoGirl, Seventeen, and Teen, thus there was a clear overlap between the user bases of both company's sites. eCRUSH engaged investment bank Montgomery & Co. to aid the acquisition process, and was rumored to be shopping the company in the $12-15M range. In my interview with Clark Benson he mentioned they were happy with the sales price, but fell short of the target. Thus, I can only guesstimate that the price fell somewhere in the $8-12M range. Clark mentioned that at various points in time the company could have been sold for "noticeably less than half" what they eventually got, so they did well to weather the storm from 2001 to 2005. eCRUSH announced that they did $1.4M in profit in 2006, which would represent a ~7X EBITDA multiple at the middle of the acquisition range. Given that eCRUSH only raised $1M in funding, this represented a solid return for its investors – somewhere in the 3X range, according to Clark.

Why does this acquisition make sense for Hearst Magazines Digital? More broadly, why are traditional media companies buying user generated content sites at multiples that many people consider to be excessive? To understand the math behind such acquisitions requires exposing some little known facts about how online branded advertising is sold. Hearst Digital has well established teen brands (Seventeen, Teen, CosmoGirl) that I'm guessing typically don't have a problem selling out their ad inventory at reasonably high ad rates – in the $10-12 CPM range. This is because they have an established sales force with deep relationships to ad agencies and brand advertisers. Hearst can leverage these relationships to include ad inventory from eCRUSH into larger ad deals that go across its network. Hearst can reasonably sell eCRUSH ad inventory in the $3-10 CPM range (the value of page views on sites with social networking is determined loosely by click-thru rates and placement, and there is a big difference from some types of pages to others – i.e. pages deep in a user profile are much less valuable than "jumping off" pages). This brings up the concept of what I'll call "drag along". Say an advertiser wants primary ad inventory on the home page. At the same time, there might be five other advertisers who want this same ad spot. As a result, the publisher will require the advertiser to buy ad inventory on its sister sites to get the ad inventory that they really want. Hence, sites like eCRUSH might get "dragged along" into the deal at high CPMs just to secure an ad spot on the home page of Seventeen for example. Another example of "drag along" is when an advertiser might have a large (for example $500K) ad campaign to fill. They might spend $200K on Yahoo, $100K on MySpace, $100K on Alloy, and $100K on Hearst. Part of that $100K will go towards eCRUSH ad inventory on the recommendation of the Hearst salesperson, inflating the CPM rate that eCRUSH could command on a standalone basis. The advertiser is typically happy because they get more unique eyeballs at reasonable CPMs, while still ensuring that they get their prime branded placement.

eCRUSH, as a start-up and standalone brand, had been using mainly 3rd party ad networks to fill their inventory, with typical CPMs in the range of $0.50. To increase that CPM they'd have to build a small sales force that would have difficulty competing with the larger sales forces of more established sites anyway. Even if eCRUSH could build a competent sales force, eCRUSH still couldn't put together the type of package deals that a large advertiser is looking for. Hearst, selling that very same eCRUSH ad inventory can get minimally $3 CPMs. Hence, the eCRUSH property is 6X more valuable as a part of Hearst than it is as a standalone company. This does not include more strategic factors like cross promotion opportunities, technology, management expertise, etc. With an understanding of this math, it is easy to see how with proper execution Hearst can make a good ROI on its purchase of eCRUSH.

# Food for thought

While eCRUSH was a solid win for its founders and investors, it missed the opportunity to become a home run exit for a few reasons, including some conscious decisions made by the executive team. For one, the eCRUSH management team was very concerned with building a safe online environment for teens. As such, the site only allows communication and flirting between members through pre-drafted phrases and responses. eSPIN screens all photos before they are uploaded to the site too. This is a much more controlled environment than the teen social networking sites that launched well after eSPIN. Second, and perhaps more importantly, eCRUSH was focused on building profit growth rather than maximizing site traffic. Its lead generation business model clearly stunted viral growth by placing obstacles between the user and actions that the users' wished to take, reducing user engagement. In 2004, eSPIN had 800,000 monthly US unique visitors, and as of this writing has over 1M UVs. That represents solid, but not spectacular growth. Had they removed some of these restrictions, it is likely that the site could have grown to 3-4M UVs or greater.

The eCRUSH management team faced some tough decisions in the 2004 timeframe. The online ad market for branded advertising was starting to come around, yet they had a profitable lead generation model in place. They could have removed some of the eSPIN site restrictions to increase traffic growth, but at the expense of profits. It was unclear in 2004/2005 that the Internet M&A market would be driven by traffic metrics. Having lived through the first bubble, the eCRUSH management decided to stay the course of growing profits rather than traffic, and did achieve that goal. It was difficult to predict in 2004 that user traffic growth would be valued more highly than profits.

The irony is, if eCRUSH had played for massive site growth in 2000-2002, they would have likely become another dotbomb. Had they done so in 2004/05, they would have likely increased their exit valuation tremendously. The point being that it is nearly impossible to time the M&A market. The best advice Clark had for entrepreneurs is to understand what your objectives are for the business. Building a slower growth profitable business is a much safer way to ensure that you can hit a double, but at the same time decreasing the likelihood of a home run.

## eHarmony.com

**written by Nisan Gabbay,**

eHarmony established a new category within an online market that many considered to be dominated by two well-established Internet brands in Match.com and Yahoo. eHarmony was launched in August 2000 with $3M in funding and grew into a rumored $100M+ revenue, highly profitable company in less than 5 years (note: revenue currently estimated at $165M per year). By the time Sequoia Capital and TCV invested $110M into the company in November 2004, it was rumored that almost $80M of the round was used to buy out founders shares. Not bad results for a company in a market that not many VCs would have invested in during 2000/2001.

Interviews conducted: Greg Waldorf, eHarmony's current CEO and the company's founding investor. Several conversations with product management people at competing online dating services. I also spoke with online dating industry analyst Mark Brooks, who publishes a great blog called OnlinePersonalsWatch, and who I look to for all news/analysis in the online dating world.

# Key success factors

*Designed and marketed product for large, underserved market segment (serious relationship and marriage seekers, particularly women)*

eHarmony made its mark in the online dating landscape by establishing its brand as the site for the serious relationship seeker, particularly women. In some ways this is classic market segmentation – targeting your product, brand, and marketing to a particular market segment. However, to say that eHarmony had this explicit strategy as the result of an MBA-type marketing analysis is incorrect. Dr. Neil Clark Warren, eHarmony's founder and a 35-year clinical psychologist, believed that his years of research could be applied online to better matching people for successful marriages. His research pointed to the fact that some people just aren't compatible for each other, and this is something that could be screened for with psychological testing.

The result was a dating site that at the time went against all the standard practices and conventional wisdom in the industry. eHarmony didn't allow users to search and browse the database for potential mates. Instead, eHarmony had users complete an exhaustive questionnaire and based on the results fed users an allotted amount of potential mates. This process made for a much better user experience for eHarmony's target demographic in several ways. One, women didn't feel like they were being judged mainly on their photograph and that potential suitors were being matched to them on criteria other than looks.

Second, the entire eHarmony process is very time consuming. It takes 40+ minutes to fill-out the initial questionnaire, users must court potential mates through a series of essay questions, and users must review every potential mate. By making the process so time consuming, eHarmony has the natural effect of weeding out non-serious users. This makes the product much better for the serious female relationship seeker who doesn't have to spend as much time determining whether a male suitor is just seeking a casual relationship.

Third, eHarmony did a good job of leveling the playing field for its users. On traditional dating sites, over 80% of e-mails go unanswered. This is due to what is called the "lightning rod" effect – a few attractive users getting the majority of inquiries. This leads to frustration for both parties. Those sending the e-mails (mainly guys) never hear back after investing time to write, and those receiving either get too many inquiries or not enough inquiries. eHarmony forced users to consider and respond to a set of potential matches before providing that user with the next set of potential matches. eHarmony was the first site to moderate the flow of introductions between users, thereby leveling the playing field for all users.

The result of creating a product suited to women seeking marriage or serious relationships had two huge financial benefits for eHarmony. One, they could charge much more and enjoy much better margins than competitors. Because the perception of finding a soul mate provides more value to the user than just finding a date, eHarmony was able to charge more (~$50/month versus ~$20/month). Second, eHarmony was able to monetize women much more effectively than other sites. Many dating sites make most of their money on men. eHarmony makes more money on women – almost 60% of their paying users are women. For almost any other dating site the reverse is true.

*First dating site that actually succeeded in providing good matches*

Greg Waldorf, early investor and current CEO of eHarmony believes that the main key to eHarmony's success was that quite simply, the service works. eHarmony produced a large number of success stories (marriages) for its users, which fueled the positive word of mouth amongst consumers. The company's obsessive focus around its matching algorithms and true desire to help its users find marriage differentiated it from all other dating sites. There are a large number of extremely loyal former customers who believe that they never would have met their soul mate if it weren't for eHarmony. These very vocal customers were central to establishing the eHarmony brand and providing word of mouth and PR.

I agree with Greg's perspective on this point to some extent, but I wouldn't list it as one of the most important success factors. I do believe that producing marriages and taking a scientific approach to matching did help eHarmony significantly in generating positive PR. However, it is my belief that the majority of dating site users (including eHarmony users) will not be entirely happy with the service because dating by its nature is a frustrating process. This is because by definition the chances of meeting that special someone is always low probability. I think that eHarmony created the right service and branding to successfully target serious relationship seekers – selling the hope of finding marriage and delivering a service that mirrors that hope is more important than actually delivering the result (marriage). I believe that the success is most attributable to how different the product was from a traditional dating site, as described in the first key success factor above.

*Made heavy use of offline advertising (TV and radio)*

One of the biggest challenges for any start-up is graduating from traction stage to achieving scale. eHarmony gained scale by making use of TV and radio advertising, growing from a ~$10M per year business to a ~$100M+ per year business. These TV ad campaigns were not just about building brand with a long-term investment outlook; they were a vehicle for profitable customer acquisition. eHarmony got immediate returns on its TV commercial campaigns and re-invested these profits into more TV commercials. eHarmony spent 2000, 2001, and 2002 proving the success of the product and the user operating metrics to justify increased spend on marketing. By fall of 2002 it was clear that the eHarmony service was working and that aggressive radio and TV advertising made sense. All of this was offline advertising was paid for through cash generated from operations (cash flow) - the company reached profitability on the initial $3M investment it received in June 2000 from investment firm Fayez Sarofim. By the time eHarmony took in its $110M investment round it was already a $100M per year business and hugely profitable. Other online dating companies like Match.com had largely failed at TV advertising.

*Leveraged the brand image and network of the founder, Dr. Neil Clark Warren*

As described in the “Launch Strategy” section below, eHarmony’s founder Dr.Neil Clark Warren was critical to the company’s success for the sheer determination he put into marketing the service and the credibility he had with consumers as a clinical psychologist. In the world of permission based marketing, doctors have the highest level of ‘permission’. You see the doctor, he/she tells you what drug you need, you trust him/her, and you go buy it. What better person for evangelizing a dating site than a doctor? Not just any doctor, but a white haired doctor with a religious background. This persona inspired more confidence and trust in eHarmony than the typical dating site. It is interesting to see that Match.com recently followed suit by having Dr. Phil be their brand persona.

*Faced minimal competition in early years*

eHarmony faced very little competition in the market segment it pioneered until the end of 2004. This was somewhat counter intuitive to me, as the dating market was already well established once they entered in 2001. However, Mr. Waldorf made the point that most of the established competitors viewed eHarmony as a niche site well into 2004. Even with the radio and TV commercials, not many people believed that eHarmony was generating significant revenue in 2003 and 2004. This goes to show how out of touch some of the leading players in the online dating industry were to the needs of a particular, but large sub-segment of users. eHarmony was able to exploit the success of their model with little competition for a time period much longer than they initially anticipated. It will be interesting to see whether eHarmony can sustain its growth in the face of competition from the likes of new VC-backed entrants like PerfectMatch.com and Engage.com, and the premium offerings from Match.com and Yahoo.

# Launch strategy and marketing

Dr. Neil Clark Warren’s 30+ year career and brand in psychology and marriage counseling were a good starting point for launching eHarmony. eHarmony did everything it could from 2000 to 2002 to generate awareness for its service using Dr.Warren as the face behind the brand. eHarmony’s first launch strategy was a 90-day grassroots campaign, going door to door to church groups in Texas. This grassroots campaign had limited success. Mr.Warren did everything he could to generate publicity for eHarmony, including several guest appearances on Bill Maher’s HBO show and other radio and TV appearances. eHarmony took 18 months to gain its first 100,000 users and these came mainly through Internet marketing. eHarmony got its first major growth spurt by being featured on a Christian radio program, Focus on the Family hosted by James Dobson, resulting in over 100,000 registrations in just a few weeks. It is interesting that the eHarmony message resonated so well within faith communities, a market segment largely untapped by traditional dating sites.

In its first full year of operation (2001) eHarmony struggled somewhat to acquire users. However, by the summer of 2002 the success of the service in producing marriages began to generate real PR. The feature on Focus on the Family was the result of the success stories achieved by several couples. As these types of success stories started to make their way into mainstream press and media, it became clear that the growth rate was accelerating. By January 2003, eHarmony had its first $1M revenue month. The positive PR fueled eHarmony's ability to graduate into radio and TV advertising, the key to its success in taking revenues to the next level.

# Exit analysis

eHarmony has delayed IPO plans for the time being and it remains to be seen whether the $110M investment (rumored at a $350M pre-money valuation) by Sequoia Capital and TCV will result in a good late stage return for its investors. The overall revenue in the US online dating market has slowed significantly in the last two years, facing market saturation issues and competitive pressures from social networking and free sites. Luckily, eHarmony's positioning in the higher end of the dating market shields it somewhat from these concerns. eHarmony's CEO believes that there is still room for innovation and significant growth in the online dating industry. In his words there are close to 100M singles in the US, with only 2M or so subscribed at any one time to a dating site. Nonetheless, perception of slowing growth in the dating market makes it unclear as to whether there is a compelling story for a successful public offering. I would be inclined to think that eHarmony's strong brand recognition and huge profit margins will likely make it a very valuable property for years to come.

Given that eHarmony reached profitability on the initial $3M in funding it received in 2000, what was the need for the $110M investment in November 2004? The majority of this round was used to purchase shares of the founders and initial investors and provide partial liquidity for their efforts. The extra capital ensures that eHarmony can continue to build itself into a long-standing company and approach the IPO market at the right time and from a position of strength.

# Food for thought

One of the themes that I see recurring in the Startup Review case studies is the importance of mainstream, offline PR to scaling an Internet business. eHarmony generated a good amount of PR once it began producing real success stories for consumers. This was not PR manufactured by putting out a press release and targeting media outlets. These were real people that wanted to tell their stories on TV, radio, and print. eHarmony made for a great human interest story. Thus, the key lesson that can be applied to other Internet start-ups is that the entrepreneur needs to generate initial buzz for a service by offering a superior or innovative product, and then fueling the fire with as much mainstream, offline media coverage as possible. Those companies that have a consumer service that naturally lend themselves to a good story are likely to see the greatest success.

# Flektor.com

**written by Nisan Gabbay**

Flektor is a unified suite of tools that enables users to create, manage, and share personal media across a variety of Internet sites. The service can best be compared to Slide and RockYou, but with a more powerful toolset for content creation, like video and photo editing tools. Users create "fleks" - photobooks, polls, quizzes, postcards, etc. - primarily for sharing in social networking sites. Flektor was acquired in May 2007 by Fox Interactive (parent company of MySpace). While the acquisition price was undisclosed, TechCrunch reported a $15-20M figure, while Red Herring is reporting a much higher figure due to potential earn-outs. Flektor's history is rather short, as they began developing the product in June 2006 and exited less than a year later in May 2007, prior to public launch.

I had the opportunity to discuss the company's successful exit with co-founder and COO, Jason Kay. While the company's history is too short to write a full case study, there were still some interesting lessons to be shared.

## Key success factors

*Video game development approach to web app development*

Flektor was acquired by Fox Interactive primarily for the great product that they built for personal media sharing. Unlike the more en vogue approach to Web 2.0 development of releasing early (and often times buggy), Flektor took an approach that is more common in the video game development business. Flektor invested time and focus up-front on building a platform (or toolkit) that would enable rapid iteration of the service in the future. The Flektor team wanted designers and product specialists to be able to edit and extend the product line without needing to go back to the development team to make improvements. This parallels the approach to game development where the game engine is built to make graphics adaptations easy. The Flektor team also placed a great emphasis on product quality, as witnessed by a staff of five full-time quality assurance employees.

The Flektor team spent eight months from June 2006 to February 2007 before releasing the product to closed beta. The result was a platform that provides two distinct advantages: the ability to go quickly both broad and deep with its products. For example, when a Flektor designer had the idea to add post cards to the product offering, it only took a few hours for the development team to add support for this new application and Flektor had a new product to offer its users. In terms of breadth, the platform approach enables Flektor to create a multitude of backgrounds, templates, and transitions for consumers to customize their content. These design changes can be implemented directly by graphic designers without need for iteration with developers.

*Open dialogue with MySpace*

The prevailing wisdom in Web 2.0 circles when building a service that integrates with MySpace is to fly under MySpace's radar for as long as possible. Many Internet start-ups fear that MySpace will haphazardly block off their service with little warning, and hence the only defense is to get big quick and hope enough MySpace users will be vocal supporters if MySpace decides to block you.

Flektor took the opposite approach, engaging in open dialogues with MySpace about the service as early as November 2006 before the product was ready for beta. This was a potentially risky strategy, as some of the techniques that Flektor uses on its site are in violation of MySpace terms of use as they are documented. Furthermore, many entrepreneurs would be fearful of MySpace replicating the product on their own. However, the Flektor team was confident that they possessed differentiable technology and the ability to execute against their vision. This opening of communication channels paid dividends, as the Flektor team was able to build a strong relationship with MySpace management and demonstrate the progress being made with their product over time.

# Exit analysis

Flektor co-founders, Jason Rubin and Andy Gavin had previously co-founded Naughty Dog, a studio responsible for games such as Crash Bandicoot and Jak and Daxter that yielded ~$1B in retail sales. Despite such impressive credentials that could have afforded them relatively easy access to seed capital, the founding team (Jason, Jason, and Andy) opted to primarily self-fund the company, although they did take some investment from a personal friend, Skip Paul.

The decision to self-fund was a good one, as the team had a successful exit in less than a year. When I asked Jason why they decided to sell the company so soon, he made the point that many entrepreneurs undervalue the time value of money, or the IRR (internal rate of return) in favor of the absolute dollar payoff. A quick exit with no dilution when looked at from an IRR perspective is often a better value than a larger exit in 5-10 years after raising successive rounds of capital.

The Flektor team was also able to preserve some upside by negotiating the inclusion of earn-out clauses into the acquisition price.

## Flickr.com

**written by Nisan Gabbay**

By financial measures, Flickr's sale to Yahoo was not a huge success, at least by VC standards. Rumored to be sold for ~$20M-$30M, the company has certainly made a much larger impact on the Web 2.0 landscape than its valuation would indicate.

Regardless of how one views the size of the exit valuation or whether Flickr will prove to be a large, successful business, I still think Flickr makes for an interesting case study. Flickr got a lot of loyal users in a very short amount of time with no marketing spend, and that's something that many web entrepreneurs are interested in understanding.

Interviews conducted: There is plenty written in the blogosphere about what made Flickr successful, and I have linked to quite a few of these references below. Most of what I have written is based on a public discussion with Caterina Fake at Y Combinator's Startup School on April 28, 2006 and a subsequent follow-up interview. I have also discussed Flickr with a Yahoo executive for a perspective on the motivation behind the acquisition.

# Key Success Factors

*Flickr prioritized the development of viral product features.*

Flickr might not have had a formal product roadmap, but they did explicitly focus their limited development resources on product features that directly helped to grow their user base. Features that have become synonymous with Web 2.0, like easy blog integration / export and post to Flickr badges on people's sites were developed early on. As a result of these efforts, nearly 80% of new users found Flickr through the blogs of other Flickr users. Flickr also gave incentives to its power users to actively promote Flickr to friends by offering premium features (e.g. extra storage) in exchange for user referrals.

*Emphasis on making a user's first interaction with Flickr a positive one.*

The first time I came across Flickr was a friend sending me a link to a picture. Right away I liked Flickr because it didn't make you register just to view *your friend's* photo, unlike the major photo sharing sites at the time. This is just one aspect of the many things Flickr did right to convert visitors into Flickr users, such as a simple user interface with no intrusive advertising. But even beyond the product and UI, Flickr emphasized making new users feel welcome. Caterina mentioned how there would be a member of the Flickr team moderating the Flickr forum 24/7 just to make people feel part of the community. While this might sound a bit exaggerated, you get the idea. Flickr put a tremendous amount of effort into community development and support.

*Flickr makes discovering and accessing quality photos easy.*

When Flickr came on to the scene there were really two kinds of photosharing services out there: those focused on efficiency around creating prints (Shutterfly, Ofoto) and those focused on public sharing of photos (Fotolog, Buzznet, Webshots). Flickr was really competing with that second group. What strikes me about Flickr is how easy it is to find quality photos – the best quality pictures on a certain theme rise to the top. In all of the talk about tagging and open APIs, what do these features really contribute to the service? The APIs and tagging make it easy for professional, semi-professional, or other photo enthusiasts to interact with the service in a way that casual users don't.

The Flickr team targeted these professional and semi-professional photographers as the core of the initial Flickr community. They worked very hard to nurture the development of this community. Catering to the power users raises the quality of the photos, thereby benefiting the entire community. Flickr, unlike the hobbyist sites (Fotolog or Buzznet), emphasized that Flickr was indeed a for profit business. I think this perception of Flickr as a company gave users, particularly the power users, more confidence in the service.

*Rapid development cycles.*

Flickr most definitely falls under the "release early, release often" theory of web software development. Caterina said that Flickr does very little traditional usability testing, instead preferring to get the product out quickly and listen to users. Flickr was able to build a following with the techno-geek crowd because users didn't have to wait long to see their suggestions implemented. On a good day, Flickr would release a new version every half hour!

## Launch Strategy

I have discussed above how Flickr emphasized viral feature development to build its user base. I think that Flickr also benefited from a general market need around photo hosting for use in blogs and social networks – as witnessed by the success of services like PhotoBucket and ImageShack. Flickr made a good decision by enabling this functionality, but they clearly were riding a wave there, not the ones creating it.

Flickr was also the beneficiary of a great amount of mainstream PR, even if they did not instigate it themselves. Flickr did not hire a PR firm to generate publicity early on, only hiring a firm to help manage PR requests after the initial buzz created by viral marketing.

## Exit Analysis

Flickr was acquired by Yahoo in March 2005, when Flickr was just on the border of becoming cash flow breakeven. According to Alexa, Flickr's traffic is up >10X since the acquisition, so the company was able to extend its reach outside of its initial core user community.

So what was Yahoo's motivation to acquire Flickr? Flickr was acquired into the Yahoo search group, thus indicating Yahoo's intention to integrate Flickr photos into the general image search engine. It's interesting that the acquisition was not initiated by the Yahoo Photos group, thus revenue, revenue growth, and profit were not the main motivations for the acquisition. Secondly, Flickr had developed a robust tagging platform that could be applied to other Yahoo products. Third, Yahoo was interested in acquiring the people behind Flickr and absorbing their thinking and DNA into the company. The least important factor in the acquisition was the user community that Yahoo acquired. While Flickr's growth and buzz were important in validating the technologies that Flickr pioneered, the sheer number of Flickr users was not an important factor in the acquisition. Thus, at its heart, the Flickr acquisition should be thought of as a technology and people acquisition.

I did not get a chance to ask Caterina about the decision to sell Flickr to Yahoo rather than take venture financing. The valuations for Internet companies in early 2005 were not nearly as robust as they are today, so perhaps Flickr would have gone the VC route if it were executed in today's environment. Perhaps we can get Caterina (or someone else from the Flickr team) to comment on this below?

# Greenfield.com

**written by Nisan Gabbay**

Greenfield Online pioneered the use of the Internet for conducting market research surveys in the mid-90's. They had their IPO in 2004 with shares trading in the $20 range, but have since seen a decline to $10 per share (see share stock chart). The market cap of the company is ~$270M as of this writing. The financials of the company leading up to the IPO were strong: 2002 ($15M sales), 2003 ($26M sales, 17% EBITDA), 2004 ($44M sales, 23% EBITDA).

Greenfield Online is an interesting case study because they faced some difficult strategic decisions in the post-bubble time period. Greenfield shifted company strategy, helping them to grow revenue more quickly, but may have compromised a larger long-term opportunity. It is difficult to say what the right decision for Greenfield was, but makes for an interesting discussion below.

Interviews conducted: Steve Cook (ex-Sr.VP of Sales '96 – '01, 3rd employee) – Steve is now CEO/President of Target Research Group, a full service marketing research company. Rudy Nadilo, former CEO of Greenfield Online.

# Key success factors

I'd like to first chronicle what Greenfield did between 1994 and 2001 to establish themselves as the leading player in the online quantitative market research industry, and then discuss a turning point in the company's strategy that began in 2001. The change in 2001 propelled Greenfield's revenue growth and path to liquidity. It could be viewed as either a success factor or perhaps a misstep, based on whom you ask.

*Company and management credibility*

Greenfield Online was originally a division of a traditional, successful market research firm, Greenfield Consulting Group. This background was important in establishing the use of internet surveys as a valid methodology in the early days. Being a pioneer in a traditional, established industry is a hard thing to do without credibility and pre-existing business relationships. Greenfield Online had both, an important factor in winning over early adopters to try a new methodology.

*Clear value proposition over existing approaches*

Using the Internet to administer surveys had a greater than 50% cost advantage over traditional methods, with greater flexibility in turnaround time and targeting. While Greenfield was not the only company to have this advantage, I felt that it was important to point out that surveying was an application that clearly made sense for Internet delivery.

*First mover advantage coupled with slow moving incumbents*

Greenfield Online was the first company to build an online survey "panel", i.e. a database of people willing to take surveys over the Internet. Being the first mover enabled Greenfield to establish the largest panel at the lowest cost of customer acquisition. The incumbent market research providers (Harris) were slow to embrace Internet surveying because existing methodologies (both quantitative and qualitative) had higher price points. Greenfield Online was mostly focused on quantitative online research, so didn't have any cannibalization / product conflict issues to deal with.

*Change in product strategy to better leverage channels*

So what happened in 2001?

As Greenfield Online was preparing for an IPO in early 2000, the market collapsed, causing the company's investors to shift the company's strategy. While the focus of the company had been on building a full service market research firm that offered a variety of services, Greenfield instead focused on selling "sample" or access to the panel to other market research firms. Thus, Greenfield Online removed product conflict barriers and chose to embrace other market research firms as channels.

This strategy had several benefits in the near term. It enabled Greenfield to ramp revenues more quickly using a smaller number of less expensive employees. Greenfield had been creating syndicated research products and providing custom services which required more up-front investment. Given the emphasis on profitability and a faster path to liquidity, this part of the business became less appealing when viewed through a shorter investment horizon.

However, one could argue that this focus on selling sample was the wrong long-term strategic decision. Selling Internet survey sampling has become a near commodity business with little differentiation amongst the top players Building a database of survey takers and the technology to administer those surveys is not a highly differentiable product. Greenfield's early management team felt that the sample-focused strategy didn't properly leverage the blue chip brand that Greenfield had built. Had they not shifted strategies they could have become one of the pre-eminent market research firms in the industry. It is difficult to say whether the change in company strategy was the right decision or not, and clearly, many factors were involved. It did help to achieve the objectives of a quicker path to liquidity for investors, whether explicitly intentional or not.

## Launch strategy

Greenfield Online built its panel of survey takers in the early days through pretty basic affiliate relationships. Greenfield contacted the webmasters of high traffic websites and asked them to link to Greenfield, with Greenfield paying a sign-up fee back to the affiliate site. This type of rudimentary affiliate marketing was how Greenfield got off the ground in the very early days of the web.

# Exit analysis

As of October 17, 2006, Greenfield Online had a market cap of $270M (enterprise value of $246M). Trailing twelve month revenues were $93M, thus the EV/sales multiple is 2.63. Operating margin over that time period was 10.4%, and EV/EBITDA multiple was 11.1. For a basis of comparison, the average EV/EBITDA comp for all public Internet companies is ~17X. Considering that the stock is down ~50% since its IPO, it has not been a strong performer. How does this compare to a traditional market research firm? Some of the publicly traded companies (TNS, Gfk, and Aegis) seem to trade in the 10X EBITDA multiple range and have 10%-20% profit margins. Thus, it does not appear that Greenfield would have been more highly valued had they stayed the course of becoming a full service research firm.

So how did the VC investors do? According to my calculations from the SEC filings, the three largest VC investors (Insight Venture Partners, UBS Capital, and MSD Ventures) invested a total of $29M over three rounds and owned ~35% after the IPO. I didn't go through a painstaking effort to check when the VCs sold their shares and how many they might still hold, but a 35% stake of $270M would equate to roughly a 3X return. Both Insight and UBS sold some shares upon IPO at a price of $17 (well above today's price of ~$10), but it appears that these sales only accounted for about $30M of their combined holdings.

# Food for thought

Most venture capitalists will never publicly state that they are looking for an exit with an investment. For the most part, both entrepreneurs and their investors are trying to build successful businesses and usually goals are aligned. However, part of the value that a VC brings is identifying the right paths to liquidity for a company and the appropriate timing for such exits. I believe that understanding exit options in today's M&A environment is more important than ever before. The supply side of tech start-ups outstrips the demand in most markets, i.e. buyers have many options from which to choose. There will always be a few hot companies that can dictate their own future, but most start-ups need to take an active role in navigating towards an exit. Sometimes it's a game of musical chairs and you don't want to be left without a seat. As an entrepreneur or company management, keeping an open line of communication with your investors about exits is important.

At Greenfield Online, the early company management that I spoke with wanted to build a premier brand as a market research firm and create syndicated research services (thereby leveraging their panel of survey takers). Greenfield's investors took the company in another direction, becoming more of a service provider to other research firms. I assume that the investors felt this strategy was more scaleable and capable of providing the growth necessary for a shorter path to liquidity. Most VCs don't want to be in services businesses, preferring to be an infrastructure or software provider as they tend to have better valuation multiples than services firms.

This was a case where there was disagreement between management and investors. It does happen - and probably more often than either party would like. My lesson learned: as an entrepreneur you should be aware of the motivations of your investors and have the hard conversations with them early and often to help prevent misalignment. These conversations should also be re-visited when changes occur in the market – when either a competitor has been acquired or market requirements for exit shift.

Secondly, I believe that it is worth pointing out that the start-up (Greenfield Online) that became the winner in pioneering the use of the Internet for quantitative market research came from management with a strong history and brand within the industry. This is a pattern that I have seen often in industries that are well established and haven't had much innovation in many years. These types of industries are slower to embrace change, and as a result, prefer to buy from companies where there is a high degree of trust in the people behind the product, as much as the product itself. When the value proposition for competing alternatives is similar, customers will opt to buy from people that they have pre-existing relationships with. If you are operating in a traditional industry, hiring management that can establish your credibility as a company is a critical success factor.

# Grouper.com

**written by Jay Parkhill**

Grouper Networks is the developer of a consumer video sharing site, www.grouper.com, and a provider of white label video hosting solutions to other consumer facing websites. Grouper has created a variety of easy to use tools to support online video creation and distribution. Grouper was acquired by Sony in August 2006 for $65M in cash, at which time it claimed approximately 8M unique monthly visitors.

Interviews conducted: Dave Samuel, co-founder and President; JD Heilprin, entrepreneur, technology and media consultant, founder of RioPort.

# Key success factors

*Changed product direction from offering a download-based peer-to-peer sharing network to a web-based platform*

Grouper launched its first product, a P2P network designed to facilitate sharing of media among small groups, in October 2004. The founders, Dave Samuel and Josh Felser, believed strongly that media sharing would be an important phenomenon, but that it should be done without the massive copyright violations of other P2P networks. As such, the product was designed to permit only 30 people to be part of any network.

In April 2005, the company realized that online video was becoming increasingly important and that the closed "darknet" P2P model would likely not generate sufficient business for the company. Grouper retooled its product and re-launched in December 2005 as a destination site for online video. As a result, Grouper's user traffic increased from 100,000 to ~8M (as reported by the company).

The tremendous increase in user adoption is best explained by removal of the barriers to viral adoption inherent in the initial product. Version 1.0 was limited to 30 users per network and required a download. It was therefore difficult for users to share either the content or the platform itself. Version 2.0, by contrast, allowed users to share video simply with just about anyone.

*Provided simple tools to enable sharing*

Almost from the launch of version 2.0, Grouper sought to emphasize ease of use. They took clues from Flickr and other companies by making Grouper's APIs simple, prominent and easy to integrate into other web sites. Grouper was also one of the first, if not the very first, to offer one-click posting of videos to MySpace, Friendster and blog pages. Most sites, including YouTube, generated HTML code for users to drop into their page in order to stream a video. Grouper instead streamlined this process by automatically inserting the HTML code on behalf of users. While seemingly a small difference from what YouTube was doing at the time, it actually enabled a large audience of less tech savvy MySpace users to post videos to their profile pages.

*Pursued twin goals to be a consumer destination site and a technology provider to other sites*

At the same time that it grew the consumer-facing website, www.grouper.com, Grouper also developed co-branded video hosting sites for other online communities, most notably Friendster. These co-branded sites helped to drive more video traffic and positioned Grouper as a player in the video ad network market.

This base of technology for creating distributed video hosting solutions was an important factor in Sony's interest in acquiring the company. The other interesting piece of technology Grouper developed was its P2P application, which does not use the BitTorrent technology common to many other P2P clients.

It is noteworthy that Grouper was able to effectively pursue the consumer-destination and the back-end approaches simultaneously. Most start-ups struggle to achieve one set of goals with the limited resources they possess. It helped that Grouper was reasonably well-funded with a $4M round of financing in March 2005.

*Focus on copyright-legal material*

Providing online content without violating copyright was an important component of Grouper's business from the outset and continues to be a differentiator between Grouper and many of its competitors. It seems likely that this strategy increased the company's appeal to Sony. At the same time, I find this point to be a bit of a double-edged sword. Without trying to suggest that copyright infringement should be condoned, it is nevertheless clear that a major factor in YouTube's runaway success has been the availability of content with little apparent regard for ownership rights. It seems unlikely that another video business will be acquired for anything close to YouTube's valuation, but the line of thinking leads to some fascinating questions. Would Grouper have taken off more quickly if it had been less scrupulous about content? Conversely, would higher traffic tempered by greater litigation risk have affected Sony's purchase valuation?

# Launch strategy and marketing

As described above, Grouper's success came in the second iteration of its product. Dave explained that the 2.0 launch and marketing strategies were focused entirely on viral distribution efforts. The company did not have a formal marketing program, although it did engage in a sustained PR effort in order to get word out about the site. Grouper coupled its emphasis on viral distribution with search engine optimization tactics that also yielded good results. Grouper developed video indexing and search optimization tools that gave a big boost to traffic in the time before every major internet portal, especially Yahoo!, had its own video area.

A major challenge Grouper faced was the difficulty in re-tooling completely and changing from a behind-the-scenes P2P application to a public-facing web business. While I noted above that Grouper's ability to maintain the P2P component probably helped its exit valuation significantly, it is equally important to note that had Grouper re-tooled sooner they may have captured a greater share of the online video market.

Grouper decided to refocus on video in April 2005, but did not launch version 2.0 until December of that year. YouTube launched in June 2005, meaning that it had a six month headstart before Grouper launched its competing product. In our interview, Dave explained to me that it was both practically and emotionally difficult for the company to let go of the previous strategy and restart in a new direction.

The Xfire case study provides a useful contrast here. Xfire also changed direction, requiring about six months to introduce its IM gaming product. The key differentiator, in my opinion, is that Xfire entered a market that competitors had not yet figured out how to effectively serve. Grouper did not have that luxury due to the rapid rise of YouTube and other online video sites.

# Exit analysis

Prior to the sale to Sony, Grouper discussed further rounds of venture investment, and received a term sheet that was rumored to value the company at approximately half of what Sony paid. I asked Dave what caused the decision to sell, and he told me that when management reviewed the increasingly crowded video space and the amount of VC money looking to enter it, they decided that the best way to "win", i.e. increase traffic to the site, was to partner closely with a company that could provide cash as well as a unique set of complementary assets, especially video content. The Board likely reached the conclusion that given the competitive nature of the market, it probably made the most sense to take a solid return rather than to keep swinging for a homerun and risk striking out.

No one factor made the deal compelling to Sony, but the aggregation of several elements added up to a successful exit. Specifically, (i) the site's traffic was in the top 15 among video sites, ahead of at least 200 others but well behind YouTube and several other sites; (ii) the P2P platform is likely useful to Sony, but I find it difficult to believe that Sony could not have bought or developed another distribution platform for less than $65M; (iii) copyright compliance is an important differentiator for Grouper, though again not difficult to replicate; and (iv) the Grouper management team had established its credentials in the online media space. Sony did not acquire Grouper for any one of these attributes more than the others, but all together they added up to a business Sony felt it could use as a launch platform for its online video/media efforts.

# Food for thought

It is rare to find a company in the Web 2.0 landscape that has successfully created a destination site and an OEM service. Grouper executed well on both of these product lines, and having both businesses played a key role in their acquisition by Sony. We asked Dave to comment on the benefits of pursuing this dual model: "at Spinner we had this program called "faceplate" … it was our OEM program for Internet Radio. We built Snap (cnet's) radio. We built Comcast radio. We built Yahoo radio. When AOL came knocking, they purchased us. At Grouper, the OEM partnerships (Friendster, Buy.com, Pure Digital) were all very important for the company. They demonstrated our willingness and ability to integrate and partner with 3rd parties. Which is what happens when you are acquired. I definitely recommend that any entrepreneur examine how they can partner with companies. And many times, these partnerships will help find the acquirers." Thus, OEM partnerships help to validate the likelihood that a start-up can be successfully integrated into an acquirer.

# Homegain.com

**written by Nisan Gabbay**

Homegain is a leader in online marketing for real estate professionals. In April 2006, ComScore ranked them the 3rd most trafficked real estate site on the Internet with 4.3M unique visitors, topping well known real estate brands like Century21 and RE/MAX by large margins. Homegain was acquired in June 2005 by Classified Ventures, a strategic joint venture owned by 5 large traditional media companies (Gannett, Tribune, Washington Post, McClatchy, and Belo). While terms of the transaction were not disclosed, it was a significant transaction in an online real estate advertising market worth $1.7B in 2005 according to Borell Associates.

Interviews Conducted: One early employee of Homegain and three industry experts: David DePhillips (industry consultant), Mark Yellen (CEO of Appraisal.com), and a third industry insider that preferred not to be disclosed.

# Key success factors

*Great underlying market dynamics – a constant stream of fresh, motivated customers*

Homegain was one of the pioneers in lead generation for real estate professionals and they made some very important strategic decisions to establish their market leadership position (which I will discuss in the next few points). However, through my research I was struck by the fact that neither real estate agents nor consumers seemed to be in love with online real estate products. This is not specific to Homegain - it has been a problem for nearly all online real estate companies. Real estate professionals complain about the quality of leads they get from the Internet and consumers complain about access to real estate information. This seemed somewhat counter intuitive to me. After all, aren't great businesses built on very satisfied customers? My conclusion is - not always. Not in markets where a steady stream of fresh, eager customers are constantly being produced. A fresh stream of customers eager to try your product means that you don't need to have a perfect product to be successful. I've seen this in other industries as well.

The real estate lead generation market is a perfect example. There are currently 1.3 million real estate agents in the US, up from 700,000 in 1999. Most real estate agents have short-lived careers, nearly 60% only last 3 years in the industry before exiting. Fresh crops of real estate agents enter the market every year hoping they can crack into the top 20% of agents that make a good living. This trend was magnified during the recent real estate boom that was driven by decreasing interest rates. These new agents are willing to go to great lengths to establish themselves, especially for opportunities to represent the seller in a home sales transaction. These less tenured agents are much more willing to try new marketing vehicles (like the Internet) and are willing to pay premiums for leads above their more established counterparts. My lesson learned: either have a great product (with a compelling value prop) OR a really motivated customer. A really motivated customer can make life a lot easier for a new business.

*Worked within existing industry structure*

My previous point asserts that Homegain was the beneficiary of favorable market fundamentals. However, there were plenty of companies that could have capitalized on this opportunity, so why was Homegain one of the successes?

One of the reasons for their success was a decision to establish a brand and product strategy that did not attempt to alter the existing industry structure too radically. Other companies tried to enter the online real estate market with a strategy to disinter-mediate the local agent from the buying/selling process or tried to centralize a fragmented market. Homegain simply aimed to drive leads to local agents – much less threatening than other possible approaches.

For its first two or three years Homegain somewhat struggled with an identity challenge, ultimately opting for the approach of being the “Intel Inside” for the Internet real estate market rather than building a known consumer brand. This approach had the effect of easing concerns around business partnerships. It was these partnerships that were a critical element to their success, as described in the next point.

*Strong partnerships for both data and distribution*

Homegain did a great job of forging relationships with established industry players who controlled the underlying real estate market data that was critical to creating the consumer service. This started from the very beginning with Homegain’s first product that relied on home sales transaction data. In real estate, the MLS (multiple listing service) data where homes for sale are listed, is controlled at the local level. Homegain partnered with these associations and other industry organizations to secure data. Thus, Homegain did not need to invest money to re-create this data on its own. Secondly, Homegain secured distribution agreements with Internet portals and other real estate sites, whereby Homegain powered a portion of those sites. Such agreements included Yahoo, AOL, Excite, CNBC, etc. All told, Homegain forged ~300 online partnerships.

*Quickly adapted product lines to changing trends*

For a lead generation company, the business is about generating and selling leads. To be successful, Homegain had to adapt their business to the way that consumers seek real estate information online. Homegain went through three major product changes as it recognized shifts in consumer behavior and fine-tuned its business model accordingly. Homegain started in 1999 with the one of the first online AVM (automated valuation model) to gain traction in the market. This product appealed to consumers seeking home valuation information, presumably as a precursor to putting a home up for sale. By providing home owners with recent comparable home sales, Homegain was then able to upsell these home owners on a service for matching them to local real estate agents. In 2001, Homegain recognized the trend of consumers seeking inventory information about what homes were for sale and launched a new pay for performance service for agents to capitalize on this trend. This service became a success by 2003 driven by a PPC (pay-per-click) revenue model. The PPC model was an important change because of changing MLS guidelines to preserve data ownership, as well as the popularity of PPC driven by Overture and Google. By 2004 Homegain had developed a suite of products, each with different monetization schemes. It was this constant product evolution that drove new revenue generation for Homgain.

## Launch strategy

Homegain was founded in 1999 and raised ~$51M in VC funding and $10M in debt from May 1999 to January 2000, thus it was well-financed at its launch. Homegain got initial mass and consumer attention by employing radio advertising in targeted cities. This was an expensive customer acquisition strategy, but one that was made possible by readily available financing during the bubble. Radio was how Homegain acquired its first million or so registered customers. After that, Homegain relied on SEM (search engine marketing) and SEO (search engine optimization) to acquire users.

## Exit analysis

This is where I am a little lacking in information. I have not heard how much Homegain was acquired for or what its revenues/profits were at time of acquisition. The press releases state that Homegain was profitable since 2002 and employed ~100 employees. If anyone can add some color here, please leave a comment below or e-mail me.

Classified Ventures, Homegain's acquirer, is a joint venture owned by media companies whose core newspaper classifieds business has been hurt by the shift towards online advertising. Their holdings include Cars.com, Apartments.com, Homescape, and Homegain.

## Food for thought

For the most part, the first generation of online real estate companies like Homegain has provided satisfactory, but not exceptional products for consumers. Since the business model is based on collecting contact information from consumers to sell to real estate agents and brokers, companies have erected barriers to information that consumers would like to access without having to register or fill-out forms. A new crop of Web 2.0 companies is emerging that are trying to provide a better consumer experience and steal market share from industry leaders like Homegain. Will these new companies be successful? I think that they have a few big issues that will need to be addressed.

While the new entrants might create a cleaner user interface experience, they will be constrained in providing a significantly better value proposition than the established sites for one simple reason - data. Everyone seems to be working off the same underlying data sets that are controlled by industry players who do not want to cede control. Thus, to create a truly breakaway company in this space, one would need some type of data that is not available to anyone else. Creating such a data asset would require significant investment. I am also skeptical that tweaks to the business model, while possibly superior, would be enough to overcome the SEO/SEM advantages of the current market leaders or the brand equity of the offline players now emerging as strong competitors.

Thus, my broader takeaway from this case study is the importance of understanding the structure and dynamics of any industry you enter above just the product and value proposition that you are attempting to create.

# HotJobs

**written by Rob Finn**

HotJobs is a consumer facing online job search engine and back-end system that provides tools for employers to post, track, and manage job openings. Founded in 1996, the site grew to become the #2 job board when it was acquired by Yahoo! for $460M in 2001. By that time it was generating $120M in revenue per year.

Interviews conducted: Dimitri Boylan, founder and CEO; Rob Jevon, Partner at Boston Millennia Partners and investor in HotJobs.

## Key success factors

*Leveraged network of their prior business*

HotJobs was founded by Dimitri Boylan and Richard Johnson in 1996. The two realized the Internet could provide a direct line of communication between job seeker and employer and this vision morphed into a product while they were working at RBL Agency, an employment agency for technologists. They were in the business of spotting talent and cherry-picked the best programmers they knew for HotJobs product development.

HotJobs initially targeted the high-tech industry since the team had first-hand experience staffing various high-tech companies. HotJobs knew what the customer needed, and they combined this with a customer-first attitude that enabled them to continually innovate on their product. They took a deliberate, tiered approach to building trust with early customers (both job seekers and employers) before they spread themselves too thin by trying to solve everyone's recruiting needs.

*Created superior product and pricing model for job posters*

The initial HotJobs team lacked significant experience building enterprise or mass market product, but this turned out to be an advantage because they approached product development with a customer (job poster) centric mindset obtained from years of working in the recruiting industry.

HotJobs did not simply recreate processes or copy features of its predecessors; it pioneered a new way of doing recruiting online that was differentiated from the competition. Online job boards provided employers benefits over newspaper job listings that had bureaucratic approval processes/intermediaries and tedious formatting that varied per job listing. Before HotJobs even the top online job boards only accepted information by fax, resulting in at least a 48 hour cycle time for posting resumes and jobs to their database. There was no automated or bulk process for employers to list jobs, and it was equally painful for employees to apply to multiple jobs.

Unlike some of its competitors, HotJobs did not re-create traditional and manual processes within the online environment. While competitors suffered from many manual errors due to back office faxing and data re-entry, HotJobs offered instantaneous posting of data through the Internet. They also continuously innovated with other products such as an applicant tracking system, an in-house recruitment tool, and a B2B exchange (with which employers could manage recruiting agency selection).

At its introduction, HotJobs pricing was a first mover advantage. The site priced per corporate seat, per month, providing companies a certain capacity of listings. This was in contrast to the traditional pricing of per listing, and meant jobs filled before 60 days (the industry norm) could be swapped for other listings at no extra charge. This improved economics to the employer and increased visibility for employer’s listings by reducing the clutter created by old job listings. It also offered less stale listings to job seekers.

*Launched with a vertical focus on high-tech jobs to solve chicken and egg problem*

Before the site could expect to get the attention of job seekers, HotJobs needed to build a large database of jobs. The listings were technology-only until 1997, when HotJobs introduced finance and sales/marketing jobs. They focused on the high-tech industry and investment banks, which tend to have more first adopters and technology evangelists than other industries. Additionally, resumes for programming jobs are more suited for online sourcing as they require less screening for soft skills.

Most of HotJobs’s customers were new to the concept of job sourcing online, but were open to new channels as the boom in Internet startups was fueling intense competition for talent. The high demand for programmers played right into HotJobs’s corner, as the site specialized in this type of hire.

Their first customer was SGI, who was equally excited about a new recruiting solution, and the fact that HotJobs was using SGI machines to run the HotJobs site.

*Built consumer awareness by optimizing high advertising spend across multiple channels*

HotJobs had great success using banner advertising in 1997, but significantly decreased their spending in this channel for a few years when advertising prices began to skyrocket in 1998. A year later, they had great success advertising in the Super Bowl. Their ad cost $400K to produce and $1.6M to air – in a year where the company generated $2.5M in revenue. The ad drew a huge number of visitors to the site even during the game, which came as a surprise to the executive team. HotJobs also achieved great press after the Super Bowl as they were the only advertiser to make their creative available to the press, who used it in news stories reviewing Super Bowl advertising.

## Launch strategy and marketing

In order to ensure a sufficiently large supply of listings, HotJobs gave the product away for free to the first 100 corporate customers. Many corporate recruiters would then refer consumers to HotJobs.

Until 1999, HotJobs had a "no headhunter" policy in order to promote the direct communication between employer and job seeker. This was a large part of their marketing message. This helped steal market share from the other job boards where job seekers had become tired of dealing with headhunters. By the time of the acquisition by Yahoo! 85% of spending was in the area of consumer marketing.

## Exit analysis

In May 1999, HotJobs raised $16M from Generation Partners and Boston Millennia Partners. At the time of the investment, the company had $8M in annual revenue run rate. These investors were instrumental in further building the senior management team. Three months later the company completed an IPO of $24M, and raised $121.5M more in November. The initial acquisition interest came from Monster, but Yahoo! outbid them by $80M. It is probable that a Monster acquisition would have been a more considerable threat to the newspaper industries. The company sold for a multiple of ~4x revenue. What is more, the sale was completed during a tough time for the US economy.

The market has continued to grow rapidly and according to Borrell Associates, 2006 was the first year online recruitment advertising ($5.9B) surpassed newspaper job ads ($5.4B). HotJobs has approximately 9% of today's market. Monster is valued at $6.7B, having grown 2001 sales from

$536M to a TTM of $1.1B in revenue. Monster had 60% of the market share in 2001, but fell to approximately 30% in 2007 largely due to the fantastic growth of Careerbuilder.

# Food for thought

HotJobs launched with a vertical market entry strategy, both in terms of industry (high-tech customers) and for type of job (programmers), but after a couple of years expanded horizontally. We are now seeing a number of new sites (and some existing sites) following a similar path of vertical focus. Large job sites offer some efficiencies for recruiters, but the search experience, relevancy of results and data quality can be lacking for both employer and job seeker. These sites can promote an impersonal and less thoughtful process for finding your next job.

According to CareerXroads, 28.4% of Internet hires in 2005 were attributed to three online job listing sites (Monster.com, Careerbuilder and Yahoo) and other web sites accounted for 22.4%. The remaining 50% of hires are attributed to a company website, but this number is questionable as the company web site is usually the destination and not the source. This growth in small web sites is especially impressive given that the large sites can win any type of SEM bidding wars. I believe the decentralization of attention will continue to erode market share for the larger sites as well as for sites that only offer job related content. Yahoo! has obtained additional job seeker audience by converting traffic from its other web properties, and Careerbuilder has gained audience through partnerships with newspapers. I believe the long tail should continue to outpace larger sites due to the increase in blog readership, syndication services (e.g. job networks which are equivalent to the co-op model of blog networks) and community-building tools. These sites are in a better position to screen for chemistry, culture, and validity of information. Additionally, 27% of all external hires are from employee referrals that partly reflect the networking and community aspects of sites such as LinkedIn. Finally, jobs listed as secondary content on sites (e.g. a blog) or solutions catering to getting a job later versus now will attract passive hires. Targeting passive hires versus those out of work leads to a greater audience for the technology vendor and also leads to more desirable candidates for the employer.

HotJobs was/is a leading company evangelizing job sourcing through technology. While online jobs was one of the Internet's first successful industries, technology is still a small portion of the $90B that will be spent on recruiting services in 2007. Continued innovation should lead to further dramatic shifts and improvements in recruiting processes.

# HOTorNOT.com

**written by Nisan Gabbay and Rob Finn**

When HOTorNOT first swept onto the scene a few years ago, not many people thought it would amount to anything more than a short-term fad. Even today, not many people recognize that HOTorNOT has a very profitable casual dating service consisting of 500,000 – 600,000 active users. HOTorNOT is making somewhere between $5M - $10M per year in revenue with very little cost since they don't spend any money on marketing.

I felt HOTorNOT would make for an interesting case study because of how they blend a free, viral service with a premium pay service. This is typically a difficult transition to pull off and HOTorNOT offers some great lessons learned.

Interviews conducted: James Hong, co-founder and CEO

## Key success factors

*Low cost of customer acquisition by tapping into basic human psychological need*

HOTorNOT was probably one of the most viral product launches in Internet history. It seemed to catch everyone's attention during October 2000. I personally remember hearing about it through friends and via e-mail exchanges. You might call ranking people's photos on a one to ten "hotness" scale a gimmick, but I don't think HOTorNOT would have lasted as long as it has if it wasn't serving some basic human psychological needs around social validation, ego, and voyeurism.

For people who post their photo for ranking on Hotonot, they get to find out how they are viewed by the opposite sex and possibly gain validation and ego stroking. There are some girls on HOTorNOT who clearly knew they were attractive before posting to HOTorNOT, but getting 2,000 votes that say you are a 9.5 is a tremendous ego boost. I have to say that I felt pretty good about myself after pulling in an 8.8 ranking. (Note: conspiracy theorists might want to question the validity of the voting algorithms.) HOTorNOT.com was originally launched as "Am I Hot or Not" – a fundamental question that every young person asks themselves at some point. This desire to know how people of the opposite sex view you is what drove people to post their photo. With many photos up on the site available for rating, people can enjoy the voyeuristic aspect of checking people out.

Thus HOTorNOT was able to fill some pretty basic human needs in a way that no other online service had before. This would later translate into financial success once HOTorNOT offered its premium dating service because their cost of customer acquisition was so low - zero. The largest cost associated with operating a traditional online dating site is the cost of customer acquisition, which even for successful sites can be 50% (or more) of revenue. Because HOTorNOT attracted users with its free rating service, it could offer its dating service for the low price point of $6 per month. This is a price that traditional dating sites can't compete with because it generally takes $15-$30 to acquire a subscriber for a traditional dating service.

*Generated mainstream PR to build brand*

HOTorNOT was a dream PR story: two young grad school students wanting to settle an argument, site spreads like wild fire by word of mouth, edgy service with fun and audacious branding, etc. Immediately following its launch and subsequent viral spread, HOTorNOT was featured in a number of mainstream media pieces as a human interest story. The HOTorNOT founders were very cognizant that PR would be very important to their ultimate success and made it a top priority to respond to all PR requests. Given how easy the service would be to imitate by competitors, HOTorNOT needed to establish its brand quickly and PR would play a vital role. HOTorNOT's extensive PR coverage helped to establish its brand in the mind of consumers and drove even more traffic to the site.

*Created a product that perfectly fit the need of its target audience (casual dater)*

HOTorNOT found a way to monetize its enormous amount of unintended traffic by brokering the introduction of two strangers who found each other hot (called a "double-match"). HOTorNOT built a service that caters to the user unwilling to invest a lot of time or money into a dating site. Pay $30 a month to troll through profiles? Hell no! Pay $6 to contact a hot girl who already said she thinks I'm hot too? Probably. Here are some of the product decisions that make HOTorNOT a great service for its target audience:

- No lengthy profiles to fill-out or read. All that a user needs to do to get started is upload a picture – and that's what other users primarily see. No detailed questionnaire that forces you to be witty or introspective. Everyone is on equal footing – your best picture.
- No up-front subscription fee. HOTorNOT has an almost pay for performance business model. It's free to post and browse the site. However, if you'd like to contact someone when a "double-match" has been achieved (a lead if you will) then you are required to pay a reasonable price ($6) for that introduction.
- No e-mail exchange before a connection has been established. Given that casual daters don't want to get bogged down in writing and responding to e-mails, HOTorNOT does not allow e-mail communication between users unless both parties have agreed to begin communication through the double match feature.

*Built user trust and community - generating positive word of mouth*

The HOTorNOT founders (James and Jim) have always treated HOTorNOT as a community and have made many decisions that have traded off financial value for building community and trust with users. James and Jim wanted to build a service that offered good value for users and have made product decisions accordingly. Given that HOTorNOT is so reliant on word of mouth for customer acquisition, they need happy customers more so than traditional dating sites. This focus on customer satisfaction has yielded user satisfaction ratings of 9 out of 10 on internally conducted surveys.

Some specific examples for how HOTorNOT has built user trust and community:

They have not raised the price above the $6 per month subscription fee since the service launched 5 years ago. HOTorNOT has done price elasticity studies that indicate they could chargemore, but have chosen not to.HOTorNOT sends its customers a warning e-mail that their subscription will be renewed for another month before the customer's credit card is charged – making it easy for customers to cancel. It is probably one of the only dating subscription services to do so.

HOTorNOT's double match system ensures that users don't waste time or money contacting someone unless minimal physical attraction has at least been confirmed between the two parties.

HOTorNOT has created a community of 2,000+ volunteer moderators to review pictures and profiles before they are posted to the site. This engages the power users in monitoring and participating in the well being of the community.

# Launch strategy

When HOTorNOT was started in October 2000, the founders never intended to create a business, thus there was no planned launch strategy. They started by e-mailing their friends, 40 friends to be exact, and it just grew from there. HOTorNOT integrated the MeetMe service into the site about 3 months after launch and started charging the $6 subscription fee 2 months later. Thus, HOTorNOT achieved viral customer adoption and proved its business model in 6 months from launch. James credits HOTorNOT's initial traction to the fact it was something new and edgy. It caught people's attention as either a joke or something fun to play with and kill time – sort of like people watching in the real world. The game-type element of quickly rating people's photos and seeing how your scoring matched popular opinion was addicting for users. All in all, it was a site that everyone could understand and gain some amusement from upon initial glance. This was enough motivation for people to want tell friends about it.

Once HOTorNOT generated its initial buzz, mainstream press coverage contributed greatly to driving more traffic to the site. As mentioned above, James placed great emphasis on responding to PR inquiries to create competitive advantage. At no time did HOTorNOT spend any money on marketing.

# Exit analysis

One month after James and Jim launched HOTorNOT they had an acquisition offer to be bought for $3-5M. Not a bad result for a couple months of work. However, they rejected the offer for several reasons. For one, they thought they could launch the premium dating service and make more money that way. Since the dating service had yet to be launched, this was a big gamble. Luckily, it paid off and Jim and James have been paid the $5M several times over. They were also fearful that the acquirer would not run the service the way they intended – as a community.

Jim and James also did not take venture capital money, but for a different reason than most founders. Given the timing of the Internet bust in early 2001, they were skeptical of the intentions of any VC trying to invest in the Internet at that time. Given the nosedive taken by the online advertising market and the lack of exits in the space, they didn't think that HOTorNOT made for a good VC investment. Given market conditions, they felt any VC that would want to invest in HOTorNOT at that point in time was crazy, and they wouldn't want someone like that on their board. As it turned out, HOTorNOT became so successful on its own, that it did not need any outside investment as it became cash flow positive in under one year.

So what is HOTorNOT worth today? By generating $5M worth of profit per year and applying a low 5X EBITDA valuation multiple, HOTorNOT would be valued at $25M. This seems like a fair number to me. According to Comscore, the HOTorNOT Meet Me service has close to 1M UVs per month in the US and James claims it has approximately 500,000 active users. An active, engaged community of this size has potential to be leveraged for launching other Internet services as well. However, given the relative lack of potential acquirers in the US online dating market, its hard to see HOTorNOT being acquired for the 15-20X EBITDA or 5-10X revenue being paid for other online communities and content sites.

# Food for thought

My big lesson learned from HOTorNOT was the clever way in which they created a pay service while still maintaining the viral nature of the free service. One of the toughest transitions for an Internet business is to transition from a free service to a pay service. Adding a pay component to a service will often kill the viral nature of the free service, because users no longer receive value without paying. Compromising the free service is a slippery slope because you may lose the ability to acquire users at low cost.

The key to mixing the free and premium services is to be sure that they are two separate, self-contained processes such that the user receives differentiated benefit from each. In the case of HOTorNOT, they never changed the initial free service of rating photos. Anyone who comes to the site can easily post a photo to be rated or rate photos themselves. A user can benefit from this service without ever being asked for payment. The casual dating service is placed on top of this service, but does not interfere with the original value proposition of the free service. The premium service has a completely different value proposition from the free service, one based on the promise of communicating with someone, as opposed to the entertainment or ego gratification value prop of the free service. Users are willing to pay for the premium service because it is clear that they are getting a different benefit from the free service. Furthermore, by never tampering with the free service, HOTorNOT enjoys the continued benefit of zero marketing cost for its pay dating service. While other dating sites have high customer acquisition costs, HOTorNOT has none, allowing them to charge a much lower price. Up until recently, this created a sustainable competitive advantage as being the low price leader in the casual dating market.

Another lesson learned is how a cash cow business can be a double-edged sword. James pointed out to me that given how successful the business had become in generating cash flow, the founders became more conservative in terms of changing the product or experimenting with new ideas. This is somewhat counter intuitive given that the founders now had the money to invest in the business. However, any product change had the potential to negatively impact the significant cash flow being generated, so it was hard to justify adjustments. Could HOTorNOT have grown much larger or changed directions if it had not been run as a cash cow business? After all, it was one of the most successful user generated content sites with a demographic proven to demonstrate viral behavior. Might it have successfully expanded the scope of its services with a more aggressive growth strategy? Possibly, but it’s hard to say whether they would have been successful. Relying on ad revenue was a hard business model from 2000 – 2004. In any case, it’s hard to argue with maintaining a strategy that earns millions in profits with minimal management overhead. HOTorNOT is currently exploring new services and a change to its business model – expect to see some innovation in the future.

# iStockphoto.com

**written by Kempton Lam and Nisan Gabbay**

iStockphoto is both an online community for photographers and a source of high quality, low-cost stock photos. As of October 2006, iStockphoto's stock photo library contained ~1.1 million images contributed by 23,000+ photographers. In 2006, iStockphoto expects to sell 10 to 12 million photo licenses from this library, at prices ranging from $1 up to $40 per image. iStockphoto's success opened up a new market segment for stock photography, catering to customers who could not afford traditional, high cost stock photos from the likes of Getty Images and Corbis. This success caught the eye of Getty Images, who acquired iStockphoto for $50 million in cash in February 2006.

Interviews conducted: Bruce Livingstone, founder & current CEO of iStockphoto. Patrick Lor, first employee and ex-President of iStockphoto. Paul Connolly, independent consultant specializing in digital media and the stock photography market. Special thanks to Kara Udziela and Yvonne Beyer of iStockphoto for helping to support the creation of this case study.

## Key success factors

*Offered a free alternative for a previously high cost service*

iStockphoto established the market for "microstock" photography by providing high quality stock photos at extremely low price points. iStockphoto's innovation was offering all its photo licenses royalty-free, available via easy download over the Internet. The notion of high quality photos licensed for free was a game changing development in the stock photography market in 2000. iStockphoto enabled the distribution of photos from budding and semi-professional photographers to reach a large market for the first time. iStockphoto also drastically reduced the cost of stock photography for a slew of customers (graphic designers, small businesses, non-profits, etc.) that could not afford traditional sources of stock photography.
As iStockphoto increased in popularity, hosting and bandwidth fees for the site grew proportionally, forcing a decision upon Bruce as to how to pay for bills approaching $10,000 per month. Bruce opened the discussion to the iStockphoto community, ultimately allowing the community to determine an acceptable solution. In February 2002, the community decided to charge $0.25 per photo mainly to cover site maintenance fees, with 20% of charges going back to the photographer.

iStockphoto has since gone through several iterations of its business model, but continues to offer photos at a relatively low price point. The first iteration occurred in 2004, when iStockphoto officially became a for-profit entity. At that point iStockphoto charged 1, 2, or 3 "credits" (priced at $0.50 per credit) for photos of different sizes, offering a 20% commission to the contributing photographer. Today, iStockphoto offers photos at a myriad of price points and has a more robust photographer commission structure. For example, photos are offered at price points of 1, 3, 5, 10, 20, or 40 credits (priced at $1 per credit). Commissions vary from 20% - 40% based on sales milestones reached and whether the photographer grants iStockphoto exclusive use of images.

*Fostered a loyal and active community*

iStockphoto was started as a hobbyist site by founder Bruce Livingstone and it remained so for several years. The fact that iStockphoto wasn't created as a business venture from the start was a big factor in iStockphoto's success. In many ways it parallels the start of another popular online community, Craigslist. Just as Craig Newmark's personality has had an influence on Craigslist, so too has Bruce's personality and passion for photography had an influence on the iStockphoto community. Bruce was always a core user of the site, and as such attempted to nurture the needs of its users.

iStockphoto consciously fostered its community from day one through forums, emails and face-to-face meetings. iStockphoto has many active online forums where new users can post questions and get help from experienced users. These active forums have made the iStockphoto community welcoming to new users and engaging for experienced users. Secondly, iStockphoto makes a point to provide very prompt responses to user questions submitted via e-mail. Even as CEO, Bruce routinely takes the time to send emails to users to offer encouragement or help. Thirdly, iStockphoto hosts a series of trips (called iStockalypses) where users can shoot photographs of interesting places and share knowledge about the stock photography trade.

The iStockphoto site itself has many features that help to get users engaged with the service. For one, it provides transparency around how active certain members are with the site, specifically around number of photos uploaded and number of paid downloads. This enables new users to learn from the success of power users, providing examples of the types of photos that get the most traction. iStockphoto also creates a sense of positive psychological exclusivity amongst users by only approving photos that meet certain quality standards. This process helps users improve their photo taking skills and makes them feel that they have "earned" their place within the community.

*Emergence of low-cost "prosumer" digital SLR cameras*

In the winter of 2003, the Canon Digital Rebel (a 6.3 mega pixel prosumer digital SLR camera) became available at a price under $1,000. Both Bruce and Patrick viewed the availability of these cameras as a turning point for iStockphoto because they created a great influx of high-quality photos. iStockphoto was in a great position to capitalize on this emerging trend through the infrastructure they had developed over the previous years.

*Took measures to ensure that submitted photographs met quality standards*

As the popularity of the iStockphoto service grew, the number of photos submitted exploded. At the same time, customers came to expect a certain level of photo quality from iStockphoto. As such, iStockphoto developed detailed guidelines for what constituted acceptable photo submissions. iStockphoto views this both as a quality control mechanism and a means to provide feedback to photographers. iStockphoto takes time to explain to contributors why their photos are rejected. According to Patrick, sometimes a new user may only start with a 25% acceptance rate but with constant feedback and guidance are able to improve their acceptance rate to 75% - 90% within 6 months.

## Launch strategy and marketing

iStockphoto was originally started as a hobbyist site in May 2000 by Bruce Livingstone. Bruce created the site as a means to share and publicize his portfolio of photographs. Initially seeded with 1,600 of Bruce's photos available for free download, the popularity of the site prompted Bruce to open the site to other photographers who also wanted to contribute their photo collections. This transformation took place 6 months after initial launch, creating a thriving community of contributing photographers.

Bruce initially marketed the site by word of mouth, telling friends via e-mail. One of Bruce's friends, web design guru Jeffrey Zeldman helped publicize the site from its early days by blogging about it and using iStockphoto images in magazines like Macworld. Mr. Zeldman's influence in the designer and photographer communities was highly instrumental in popularizing the use of iStockphoto for royalty-free stock photos.

As the iStockphoto community evolved, its photographer base served as the main marketing vehicle. By promoting their own iStock photos, these photographers create publicity and word of mouth marketing for the service. iStockphoto provides them with some interesting marketing tools (like free, customizable business cards) to help them self-promote their portfolios. Today iStockphoto has 23,000 photographers that are the cornerstone of the company's marketing efforts.

Later on its lifecycle, iStockphoto began advertising its service on the Internet, in print, and at trade shows. An extension of this advertising strategy was to maintain good long-term relationships with influential book authors within the design community who could provide increased awareness for the iStockphoto service.

## Exit analysis

iStockphoto was able to support its operations for many years from the revenue generated by photo sales. However, during business planning in late 2005, the company realized that they needed about $10 million to meet their future growth expectations, including $3 million for hardware expansion costs. With this new capital requirement, the iStockphoto management team sought venture funding for the first time. After securing a term sheet from a VC, management became hesitant that this was the best option for the company. The team feared that they would not be able to maintain product control or nurture the community in the same fashion that iStockphoto had been built upon. Thus Bruce decided to seek other options, and contacted Jonathan Klein, CEO of Getty Images. After some positive conversations regarding company strategy and cultural fit, iStockphoto was sold to Getty Images in February 2006 for $50 million in cash. This represented a valuation substantially higher than the valuation placed on the company by the proposed VC investment. Hence the sale to Getty Images made both financial and cultural sense for Bruce and the rest of the iStockphoto team.

## Food for thought

I was surprisingly struck by the parallelism between iStockphoto's company history and evolution, and that of another successful online community, Craigslist. Both began as a hobby fueled by the passion of their founders: for Bruce it was photography and for Craig Newmark it was local events. The popularity of both services grew beyond anything the founders had envisioned, largely driven by creating a free service where only high cost options existed before (high end stock photography and print classifieds respectively). Both grew to a point where the services had to be sustained by incorporating small fees into the service, all with the support of the community itself.

Some great lessons can be learned by the examples set by these two successful companies. For one, the needs of the user base will tell you when is the right point in time to add fees, rather than implementing a revenue model prematurely. For iStockphoto, as the level of sophistication of its users grew, so did the necessity for more advanced pricing and commission models. For Craigslist, they began charging for some categories of online classifieds to improve the user experience. In both instances, it was actual user needs that drove the revenue model and timing of the revenue model.

Secondly, you have a sustainable company on your hands when you have created or contributed to the financial livelihood of a segment of your users. One reason that iStockphoto has such an active community is that their power users have personal, financial ties to the overall success of the company. For example, the top iStockphoto photographers have had hundreds of thousands of their photos downloaded – that's real money that iStockphoto is putting into the pocket of its users. eBay and Google are probably the best two examples of Internet companies that have also created significant personal wealth for individual users. iStockphoto has created it as well, albeit on a much smaller scale. Can you create a service that contributes significant personal income to your users? If you can, chances are you'll have a successful service.

On a separate note, both Bruce and Patrick credited much of their success to having great mentors and advisors involved with iStockphoto. Both Bruce and Patrick have been reading, learning, and applying business concepts and ideas from the business guru Guy Kawasaki for years. After meeting Guy in 2003, he became a close personal mentor for the iStockphoto management team. Having great advisors and mentors can be critical to the success of any company, but particularly a start-up. No entrepreneur can possess all the skills and experiences necessary to succeed themselves; it helps immensely to have the right mentors to act as a sounding board..

# Jumpcut.com

**written by Jay Parkhill**

Jumpcut is an online community for video creators. Jumpcut provides free video editing tools that let consumers upload short video segments and edit them online to add music and effects. Its Flash-based tools attracted immediate attention in the blogosphere and from consumers, resulting in the company's acquisition by Yahoo! approximately six months after launch.

Because of its short operating history, Jumpcut makes an interesting study of the launch phase of a business without considering subsequent growth. The company (the business's legal name was MiraVida Media, Inc. prior to the acquisition) worked very quickly to develop its product and build a team, and was then acquired before the product had time to make more than an early dent in the market.

Jumpcut's founders met in June 2005 and agreed to start working together almost immediately. They formed the company in September of that year, raised approximately $1M from a group of angel investors and early-stage VCs and launched an alpha product to a group of 500 users in January 2006. They followed up with the commercial release of the product in April 2006 and built the company to 15 people before selling to Yahoo! at the end of September 2006.

Interview conducted: Mike Folgner, co-founder

## Key success factors

*Team synergy*

The company's two founders had never met before June 2005. On determining that they had complementary skills, they decided to make a one-month trial of working together. Ryan Cunningham did the technical work while Mike Folgner performed market analysis and developed the business plan. Both agreed that if the relationship did not work out, Folgner would take ownership of whatever had been created during the "test phase".

Folgner told me that this period was very useful to both founders in evaluating the business's potential. The two found that they could work together effectively and formalized the business shortly thereafter.

Following this start, Folgner told me that their emphasis in building the team was on finding people with valuable skills, but it was equally important to assemble a group of complementary personalities. To find such people, the founders relied heavily on their existing networks of contacts and had a policy only to hire people they knew personally or came highly recommended both for business skills and personality fit.

I found this a little ironic: the founders had no prior relationship, but only hired people they or others close to them knew well. The founders "got lucky" in finding one another, but realized they could not rely on serendipity for other staffing decisions.

*Targeted niche*

The founders had experience with online media (Cunningham was a veteran of Macromedia and Folgner worked at OpenTV) and saw the emergence of the online video market. They perceived that other nascent businesses had focused on sharing media, but had few or no tools to permit users to easily edit video. At the same time, they saw ever-increasing numbers of digital cameras and phones that could shoot video clips and predicted that the amount of "casual video" footage would continue to grow. Desktop-based video editing tools were (and still are) complex and time-consuming systems not well suited to address this new market. The founders believed that all of these factors pointed to an unfilled niche for an online service to edit and store short video clips.

*Technical merits*

Jumpcut's website and editing tools are impressive and easily demonstrable. I was amazed by how smoothly Jumpcut worked, and how effectively it removed complexity from the user experience. Simplicity comes at the expense of sophistication and fine-tuning of video content, but for many purposes Jumpcut may provide a happier result for casual video authors more interested in sharing than sophisticated editing.

# Launch strategy

*Use of the blogosphere*

Jumpcut illustrates the relative ease of garnering publicity through the blogosphere rather than traditional media. Folgner told me that the company reached out to a broad group of traditional media and blog outlets. Of these, no traditional media companies (including the New York Times and San Jose Mercury News) covered the company's launch, but bloggers (principally Techcrunch) did profile the company and brought Jumpcut its first important boost in traffic.

Folgner attributed Jumpcut's success in reaching out to the blogger community to: (i) articulating well the niche filled by the product, (ii) waiting to release the product until it was well-developed and "showed" well, and (iii) making in-person presentations to influential bloggers.

Interestingly, he also said that the company got a spike in traffic from this publicity, but that it was short-lived. Consumers read about the product and visited the site to check it out, but most did not return. Many of these visitors also never made it past the home page. Thus, launch publicity brought the company a small group of new users, but did not make the business by any stretch. Folgner emphasized that no one factor led to the company's success, but efforts in a number of areas seemed to increase traffic and visibility.

*"Tuning" the home page*

The company has worked continually to improve its clickthrough rate from the home page. Early versions of the home page emphasized sharing of content to a greater extent. The company realized that its greatest differentiator from other video sites was its editing tools, and over time the home page came to feature those more prominently.

*Focus on viral feature development*
Another key factor, and one that has been important to many companies profiled on Startup Review, is the extent to which it was able to promote viral distribution of content. Embedded players on blogs and social network profile pages, and "send to a friend" buttons next to videos both helped to drive traffic and increase the company's visibility.

*Distribution deals*

The third important factor was Jumpcut's ability to partner with established media companies. Jumpcut cut deals with Warner Bros. and Fox Films to use clips from those companies' film libraries in promotions and clip-editing contests. These deals drove traffic to the site, but more important, they improved the company's visibility and standing with other potential partners, including Yahoo!.

## Exit analysis

Jumpcut's initial financing, together with the later distribution deals, gave it enough cash to operate into the fall of 2006. In the middle of 2006, they began to discuss options with a number of venture firms and potential acquirors. The company received offers from several firms regarding a larger investment round, and acquisition interest from multiple companies. In the end, the Board decided that the valuations being offered were not compelling enough to continue as a standalone business. On the other hand, Yahoo!'s model of allowing its acquired businesses to operate with substantial independence (such as with Flickr and del.icio.us) was very attractive. Terms of the deal have not been disclosed but are rumored to be something less than $10M.

## Food for thought

Jumpcut was clearly acquired for its team, technology and its product, rather than for traffic, revenue or any other component of its business. Big internet companies, especially Yahoo!, Google and Fox, have made a number of similar acquisition in the past couple of years and are eager to find talented people and high-quality products that they can scoop up at low valuations. When faced with such an environment, every startup must consider a number of questions, including: (i) whether the product is robust enough to stand on its own, or whether it needs to be augmented significantly before it can generate revenue and support a company; and (ii) whether the company's competitive environment will allow it enough time to find a revenue model (if one isn't clear at the outset).

In addition, the Board needs to conduct an economic analysis to determine whether the return to be generated by an early sale will provide sufficient value to the investors and the team for capital and sweat equity invested. This point can be complicated because an early exit might be a great result for the founders, but less so for professional investors.

# Jumpstart Automotive

**written by Jay Parkhill**

Jumpstart Automotive Media is a vertical advertising network focused on the automotive market. The company represents automotive web publishers for advertising sales and offers a suite of services for advertisers and publishers around that core business. Vertical advertising networks have received significant attention and investment recently, so Jumpstart's story is timely. The company was founded in 2000 and acquired in May, 2007 for $110M in cash and earn-outs.

Interview conducted: Mitch Lowe, CEO & co-founder

## Key success factors

*Became a strategic partner for publishers, not an ad network*

When most people hear the term "ad network" they think "blind" ad network – a company that sits between a network of publishers and advertisers and targets ads based on some unknown algorithm. This is why most major publishers will run several ad networks at the same time, dialing the amount of ad inventory that each ad network receives based on performance (effective CPM rates).

Jumpstart never approached the market as an ad network, but rather took the approach of being a strategic partner for their publishers. Jumpstart is really a "rep firm on steroids", focused on one category - automotive. By consolidating valuable automotive inventory, Jumpstart has substantial strength to negotiate more favorable rates and packages with its advertisers. What Jumpstart brings to publishers includes elements of rep firm, ad agency and ad network. In exchange for investing resources into a publisher relationship, Jumpstart garnered long-term contracts with their publishers. Jumpstart built its relationships slowly, starting with one publisher in 2000, adding one more in both 2001 and 2002, before accelerating publisher acquisition in 2003. Building these deep relationships with publishers enabled Jumpstart to become experts in automotive Internet advertising. They worked with publishers on web site design, advertising products, and marketing initiatives, thereby developing a wealth of expertise on the most successful practices across a range of publishers – making themselves more valuable to both publishers and advertisers.

*Picked great market for Internet advertising – large, valuable, and difficult to reach with traditional media*

Jumpstart picked a great vertical market. The automotive market is very large ($40B) and has a difficult to solve advertising problem. Although most consumers will be car buyers at some point, identifying which consumers are “in-market” to buy a car is difficult to do with traditional media. Given that buying a car is a major expenditure, most people will do some level of Internet research before making a purchase decision, and that is why Internet advertising has been capturing a larger share of automotive advertiser’s ad budgets over time.

Mitch explained that the company continually evaluated whether to expand from its core focus on new car buyers. Even within the automotive segment there are certainly many other types of consumers to target. The company always decided, however, that its core competence was in aggregating new car buyers for advertisers, and the market was large enough to support such a tight focus. Kendall Fargo told me almost exactly the same thing in regard to StepUp Commerce. I’m not sure if the lesson here is to know the market well before you start, or if Jumpstart and StepUp are merely two companies that found value in tightly focused niches. I suspect that the continual re-evaluation process is as important as the answer for any given business.

*Raised no outside capital early in company lifecycle, kept costs low, and grew with a very measured approach*

Jumpstart went six years before raising outside capital from a late stage VC firm (Alta Communications). As mentioned above, Jumpstart only added one publisher per year from 2000 to 2002, before adding three publishers in 2003. Mitch explained that this was important because it gave Jumpstart room to iterate and to grow at its own pace, and at the same time kept the team focused on the bottom line. The company did not have an office for its first year and half, and employee compensation was an amazing 80% variable based on performance.

*Staffing policies*

Jumpstart’s strategy for hiring was to wait for truly exceptional candidates. Although hiring only ideal candidates constrained Jumpstart’s growth in the early years, Mitch felt it was critical to have that foundation because great people only want to work with other great people. Jumpstart looked for three qualities in people: capacity (ability to do the job), drive, and integrity. They were less focused on previous work experience. Mitch stressed that his exceptional team made all the difference in the company’s success.

## Launch strategy

When Jumpstart got started, the founders considered whether they should build a destination site or go with an aggregation model. The challenge of a portal is to provide content that draws public interest, while the aggregation model has a chicken-and-egg problem of needing advertisers to attract publishers and vice-versa.

Jumpstart evaluated the online landscape and decided that the network/aggregation model was a better approach given the many already strong existing brands in the automotive information market. Jumpstart addressed the chicken-and-egg problem by signing long-term, exclusive contracts with automotive website publishers. Having access to sought-after ad inventory attracts advertisers, and once Jumpstart was able to aggregate advertisers they had an easier time signing more publishers. Mitch reported that revenue doubled every year (reaching $24M in 2006) and at the same time the company maintained a lean operational structure that allowed it to gradually build expertise and reputation.

# Exit analysis

Jumpstart was founded in 2000 and the founders made a conscience decision not to raise any outside capital in the early years. Only after six years of successful growth (doubling revenue every year) did they accept VC investment, when they were a ~$20M per year business. The purchase price of $84M in cash and $26M in earn-out is a very good result. Taking only a late stage investment meant that the lion's share of the proceeds went to the founders and team.

Jumpstart's acquirer, Hachette Filipacchi Media is a publisher of properties such as Car and Driver, Road and Track and Cycle World magazines, along with their online counterparts. As a subsidiary of Hachette, Jumpstart also sells advertising for the competitors of these online properties. We asked Mitch whether he worried that the ownership structure would create conflicts for Jumpstart. His response was that it would probably be more difficult to sell advertising without a separate identity (i.e. if Jumpstart had merged into Hachette), but that as a standalone subsidiary Jumpstart is able to leverage Hachette's size, and hence market power to raise ad rates and add new advertisers – a direct benefit for all publishers represented by Jumpstart. The pairing of Hachette Filipacchi Media and Jumpstart is an interesting one, which we discuss in the "Food for Thought" section.

# Food for thought

In the last two years we have seen a substantial rise in the number of vertical-oriented ad networks. Jumpstart, as one of the first and most successful, offers some interesting lessons for entrepreneurs in this area. For one, Mitch believes that to be successful you need to offer a blend of services to publishers and bring real expertise to selling advertising in that industry. Second, not many verticals will support a truly large ($100M+) vertical ad network. There are however good opportunities to create companies with $25-50M in revenue and $5-10M in EBITDA. Entrepreneurs would be best served to limit the amount of outside investment, given that the exit sizes are also likely to be capped. The pairing of Hachette Filipacchi Media and Jumpstart demonstrates the need for large portals/destination/content sites to also have an off-network strategy to spur further growth. We saw AOL to be one of the first to employ this strategy with the purchase of Advertising.com, and we will likely see smaller "portals" (like Hachette Filipacchi in other verticals) pursue this strategy as well.

## Linkshare.com

**written by Nisan Gabbay**

LinkShare is a leading provider of affiliate marketing solutions which enable online merchants to offer commission for sales driven by other websites, called affiliates. LinkShare provides the technology for a merchant like Dell to partner with and track transactions originated by affiliates. The LinkShare network of merchants and affiliates make it easy for both parties to locate and partner with each other.

LinkShare was acquired in September 2005 for $425M in cash by the largest Japanese e-commerce company, Rakuten. The size of the transaction surprised many industry observers given the much smaller multiples paid for other affiliate marketing companies like Commission Junction, BeFree, and Performics. Hopefully this case study can shed some light on what Linkshare did right and the reasons for the premium paid by Rakuten.

Interviews Conducted: I interviewed two early employees of LinkShare who are no longer with the company and one early employee who is still currently at LinkShare. I also interviewed Jeff Molander, who was a co-founder at LinkShare competitor Performics. I also spoke to several LinkShare customers.

# Key success factors

*Focus on attracting top-tier merchants.*

LinkShare's strategy was to target the top-tier merchants: F500 companies like Dell and American Express, and leading online brands like Match.com and Hotwire. LinkShare built a solution that catered to these customers better than competitors did. A key aspect to the LinkShare solution is the service and business process expertise they provide for large merchants. While there were four to ten other competitors who could provide a technology similar to LinkShare's at a lower cost, the top tier merchants valued a solution-oriented approach. LinkShare's first mover advantage helped to build a knowledge base of experience in implementing affiliate programs that could be leveraged for new clients. LinkShare had a more focused sales strategy and product than Commission Junction (CJ) for the F500. CJ's merchant product was built more to help get up and running quickly, perfectly suited to merchants that didn't need much customization. LinkShare would take two weeks to a month to deploy and provide a higher level of customization and service.

Signing the large, brand name merchants was a winning strategy in the early days of the web because they were able to attract the top affiliates. Affiliates preferred to sell these merchants because they got higher conversion rates. Having a large install base of established F500 merchants also lessened the impact of the dotcom crash on LinkShare's revenue base. Other competitors were much more dependent on start-ups for their revenue, which caused many to fold during the downturn.

*Focus on building (and marketing) the size of the LinkShare affiliate network*

Linkshare's main competitor for attracting the large, branded merchants was BeFree, and in 2000, BeFree had more revenue than LinkShare. LinkShare was able to overtake BeFree by focusing on the value that the LinkShare affiliate network brought to merchants, rather than competing on a technology differentiation basis with BeFree. LinkShare was able to establish its position in the market as the only true network-based affiliate model for top branded merchants.

LinkShare was able to attract affiliates by having the branded merchants and a technology solution that appealed to affiliates. LinkShare tracked affiliate transactions using a non-cookie based approach, while other providers used cookie based tracking that affiliates perceived as being less reliable (with the effect of short changing the affiliate). LinkShare's approach, whether more effective or not, built greater trust between the affiliate and merchant so that the affiliate felt they were being fairly compensated.

# Launch strategy

LinkShare had no marketing budget in their first two years of existence as a bootstrapped company. They focused on signing up merchants for the program with the promise that the affiliates would follow suit. Given the early stage of the market, adding a new brand name merchant had the effect of attracting affiliates because there wasn't the saturation that there is today.

# Exit analysis

The LinkShare acquisition price was a surprise to industry observers given the precedent transactions in the affiliate marketing space: CJ bought for $58M by ValueClick in October 2003, BeFree for $128M by ValueClick in March 2002, and Performics for $58M by DoubleClick in May 2004.

Unfortunately I don't have any view into the revenues or profitability of LinkShare at the time of sale, but here are some thoughts on why the premium price. For one, LinkShare signed exclusive 1-year to 3-year contracts with its merchants and enjoyed a strong renewal rate. LinkShare did an excellent job of leveraging its market position to get such strict, exclusive contracts with its customers. These types of contracts provide an acquirer with more confidence in the projected revenues of an acquisition target, as well as confidence in the long term defensibility of the business. Secondly, having Mitsui as an investor in LinkShare was instrumental given Mitsui's relationship with Rakuten. Lastly, market timing was clearly in LinkShare's favor as awareness of the online advertising space has clearly grown since the last affiliate marketing acquisition (Performics in May 2004). CJ sold to ValueClick right before the inflection point in its growth according to those close to the company, as a result, ValueClick probably got a great deal in that transaction.

## LoopNet.com

**written by Rob Finn**

Loopnet is a leading online marketplace for real estate brokers, agents, buyers, and investors to sell and buy property. Founded in 1995, the company IPO'd in 2006 and has grown to feature more than $408 billion in properties for sale and 3.2 billion square feet of space for lease as of March 31, 2007.

Interviews conducted: Rich Boyle, CEO; Patricia Nakache, General Partner at Trinity Ventures and investor in LoopNet.

# Key success factors

*Persistence in slowly developing market*

Dennis Deandre founded the company believing that he could bring people "into the loop" using the Internet to connect the fragmented commercial real estate market. He never stopped believing, although it took 9 months to land the first customer and three years of bootstrapping (selling personal possessions such as cars, homes, etc. as he funded growth) before raising a first institutional round of $3M in September '98. This was not a market with evangelical customers who signed on because they appreciated technology innovation.

The commercial real estate market is comprised of office, industrial, retail, multi-family and land for development. This market is valued at over $5 trillion in the United States and primarily relies on brokers and agents to facilitate sales/leases of property. According to CB Richard Ellis, the industry generated approximately $23 billion in revenue in 2004. This brokerage system is highly fragmented and Ellis states that the top five commercial real estate brokerage firms accounted for less than 15% of the revenue generated by the industry. The market is mostly dependant on local newspaper advertising and dominated by a few big companies who know the buyers and the sellers. As a result, the market is not very transparent to those who are not in the know. Disrupting the market required a slow process of education, as those entrenched are only now becoming technology savvy. LoopNet relied on the early team's connections, most of them from the commercial real estate industry.

LoopNet's slow growth led to a strong appreciation of early customers and a customer service focused philosophy; namely, not to lose them! The commercial real estate market is segmented by property (agricultural, healthcare, industrial, hotel, land, apartments, office, senior housing, industrial space) and geography, each segment requiring a dedicated but not consuming amount of varied customer service and product offering from LoopNet. The industry has two major groups: tenants leasing space from owners or landlords and the investment market for buying and selling properties. LoopNet built a service valuable to both, as today 40% of users are brokers and 45% are owners/investors (10% are service providers and 5% are other).

LoopNet's resolve to grow the business conservatively was tested in the early years, when competitors raced into the market. There were 19 competitors in '99 and $500M-$1B in VC money put into the market from '96-'00.

*Partnership with industry leaders to gain access to data*

Unlike some other B2B exchanges that disintermediate certain sections of a supply chain, LoopNet did not have to worry about alienating a powerful group of professionals who would do everything in their power to kill the exchange. LoopNet is only the starting point for the commercial buyer and does not attempt to displace or own any other part of the sell side's domain.

LoopNet is a classic example of user generated data business. All the property data on the site is generated by LoopNet customers. LoopNet made this process as easy as possible for the large brokerages through several innovative strategies.

LoopNet rolled out a white label service named LoopLink that large brokerage firms could use on their own web sites to allow web visitors to search listings, create full-color brochures, view maps and photos, and contact listing agents. Most importantly, LoopLink inventory would also be auto populated onto LoopNet.com. This strategy has been used by a few other successful startups. StubHub, for example, had a similar product for sport team web sites in their own early years.

LoopNet is based upon a “cooperative and collaborative” relationship with the brokerage community. This relationship was solidified further in funding terms. Marcus & Millichap, Grubb & Ellis Co., Trammell Crow Co. and Insignia/ESG funded a $20 million round. Fine print of the round: each firm agreed to use LoopNet exclusively to market its clients’ properties on the Net.

The resulting large inventory from these relationships attracted the long tail of the listing market which in turn attracted buyers. Today, the 480k listings are split equally between “for sale” and “for lease”. Landlords and owners of property realize the advantage of making data public and fostering competition amongst brokers.

*Continuous business model innovation*

Being the first mover in an industry is not a guarantee or driver of success. LoopNet did not quickly reach critical mass despite the word of mouth benefits of adding new customers, and further innovation was required to attract new segments of the fragmented industry.

LoopNet had plenty of potential concerns to address as they grew. The industry has a high amount of customer churn (3-5% monthly), but this was countered by customer inflow from the strong marketing relationships with large brokerage firms who do not get any revenue split and instead are paying customers. There is also the threat of stale or low quality (poor description, pictures) listings. The LoopLink service partly addresses this problem as brokerages are motivated to maintain quality listings on their own web sites, and these listings are auto submitted to LoopNet.

LoopNet did not start charging subscription fees until ’01; prior to that revenue source was mostly through paid listings. Today, they have 80k premium memberships (70% are brokers and the average monthly fee is $50) which account for 80% of revenues. There is large incentive to sign up for premium subscriptions both for buyers and sellers as free listings are not shown to non-premium members. This is significant as 90% of buyers are non-premium members.

Additional areas of growth have been from M&A such as BizBuySell (LoopNet acquisition in ‘04) which is an exchange for buying and selling businesses and charges a monthly $40 subscription. LoopNet also merged with PropertyFirst (the 2nd largest in the space at that time) in ’01.

Other innovative, new and expanding revenue streams include lead generation for loans, promoting professional profiles on LoopNet, advertising on LoopNet search results, showcasing property among listing results and newsletters, enhanced listing page, email marketing tools, pre-screen buyer and tenant tools, real estate reports such as recent sales data, saving, and alerts.

## Launch strategy and marketing

In the beginning, LoopNet relied a lot on a classic startup success tool, the art of exaggeration. LoopNet was one of the earliest movers in its space, and used this to its advantage by convincing prospects it was larger than it actually was. After a few initial customers signed on, the company pitched itself as the largest commercial real estate site on the net (again, absolutely true at the time, although a look at actual numbers might have brought a chuckle).

LoopNet marketed how it was a dramatically cheaper method of advertising properties compared to running spots in local newspapers. LoopNet also marketed the fact that customers could now more easily expand beyond their local markets. This was great timing for the large firms who wanted diversification along with more control over placing advertising into new markets.

## Exit analysis

LoopNet raised $30M mostly from 13 institutional investors and eventually IPO'd closing their opening day at a market cap of $521M. So how did the VC investors do? According to my rough calculations from the SEC filings, the two largest VC investors (Rustic Canyon and Trinity Ventures) each had unrealized gains of 15x or around ~ $40M on the IPO's closing market value. Today, LoopNet has a market cap of $767M and a revenue multiple of 13.80. Trailing twelve month revenue is $54M and the Price/Sales multiple is 14.5. This is rich compared to the median 5.2 for online real estate companies. Investors are valuing the subscription and network driven nature of the business model. LoopNet is the only online real estate web site with more than 2m members.

## Food for thought

In an industry not known for adopting technology, LoopNet patiently built a business by treating its customers as partners and not trying to shrink the market or compete against any of the players in the market. It is obvious from margin trends that capital efficiency has been ingrained into management execution.

The company innovated along the way to discover and effectively execute the fremium model. Definition of fremium model courtesy of Fred Wilson - Give your service away for free, possibly ad supported but maybe not, acquire a lot of customers very efficiently through word of mouth, referral networks, organic search marketing, etc, then offer premium priced value added services or an enhanced version of your service to your customer base. Premium membership churn is around 50% annually but LoopNet continues to annually grow memberships by converting higher numbers of basic members.

Other companies in online real estate services rely on listing fees or pay for performance, and thus are exposed to market downturns. LoopNet's subscription model is more secure and the commercial sector less volatile than residential. LoopNet is not severely impacted by a weak commercial real estate market because memberships are not tied to listing frequency- All it takes is one listing to make that membership valuable. A member may go three months without listing a property, but most members who are committed to LoopNet do not have the time to manage cancelling and reactivating their memberships. LoopNet also sells membership on quarterly and annual tiers.

LoopNet's success will attract well funded competitors. Today, there are a few small competitors such as CCIMNet, Commercial Real Estate Exchange, CommercialSearch, WebRealEstate.com, CityFeet.com and Property.com. This is probably a market newspapers and portals will eventually pursue with large investments. Barriers to entry are low but barriers to critical mass are a lot higher. LoopNet listings are SEO friendly. Basically, LoopNet increases its SEO status anytime a listing is created because a new page on the LoopNet.com equals a better ranking given by search engines. That adds up and is a snowball that is tough to catch!

# LowerMyBills.com

**written by Nisan Gabbay**

LowerMyBills.com is one of the leading consumer focused lead generation companies. They were acquired by Experian in May 2005 for $330M in cash and were reported to be generating $120M in revenue and $26M in profit for fiscal 2005. LowerMyBills.com provides consumers with shopping comparison and bill payment for a variety of monthly consumer services and consumer finance products. LowerMyBills generates the majority of its revenue by selling mortgage finance and other loan application leads to lenders.

Interviews Conducted: Olivier Chaine, VP Web Operations, 2000 – 2003. Olivier left LowerMyBills to start SalesBuilder. Olivier wanted to offer other companies a similar platform for generating and converting sales leads, as the one he helped develop at LowerMyBills.

## Key success factors

*Built platform for rapid testing and optimization*

LowerMyBills.com invested years and millions of dollars in building a platform that enabled them to rapidly test, iterate, and optimize their website content with their marketing campaigns. The business model is fairly easy to understand: attract consumers to the site (usually through online ad buys), collect lead information from the consumer, and sell the lead to lenders. The complexity arises in the myriad of variables that can be adjusted to improve the return on ad spend. The site layout and content can be adjusted to match the large variety of ad campaigns (different ad formats, different traffic sources, timing of campaigns, etc.). It can best be thought of as a hugely complex A/B test. This technology and business process platform is what enabled LowerMyBills.com to execute on its media campaigns on a daily basis.

*Maintained a broad portfolio of consumer products*

LowerMyBills.com started out by offering 18 different consumer products. This was a key success factor because it enabled them to discover the huge market for mortgage finance leads, even though this wasn't the original intention of the company. The service was started with the intention of helping consumers lower their monthly service bills, and in the early days of the company it was the service for lowering telephone long distance plans that was most popular. As long distance service became commoditized, it was no longer important for consumers to discover competitive plans. Because LowerMyBills was constantly monitoring the performance and profitability of each category they were quick to realize the hot market for mortgage loans. Had they concentrated all their efforts into one category they would have missed this opportunity.

*Team focused on daily execution*

While day-to-day execution is important in any business, for Internet companies whose core business is acquiring and converting traffic, a maniacal focus on daily ad campaign execution is paramount. We saw this in the Advertising.com case study and we also see daily execution as a key success factor for LowerMyBills. LowerMyBills CEO Matt Coffin set the tone for the company by managing the team and resources of the company via a daily dashboard report. Ad campaigns were never let run without constant monitoring. LowerMyBills would do tests in small increments and pull non-performing campaigns every day.

# Launch strategy

When LowerMyBills raised its first $4M of VC funding in December 1999, the plan was to raise another $30M shortly thereafter. This was to be invested in direct marketing campaigns. However, after a single $400K marketing campaign only generated $10K in revenue (and the VC financing option disappeared with the bubble), LowerMyBills went back to the drawing board. LowerMyBills.com spent its next 5-6 months testing site layout, content, and traffic acquisition techniques before scaling its marketing spend. From that point forward they built the company by continually testing small scale ad campaigns. LowerMyBills did not face a chicken and the egg problem because there were established channels for selling leads, thus, they only needed to figure out how to profitably attract and convert traffic into leads.

## Exit analysis

LowerMyBills was acquired by Experian Interactive, a division of publicly traded Experian Group Limited (stock ticker EXPN), in May 2005 for $330M, plus performance incentives that could reach an additional $50M. This acquisition price represents a valuation of 2.8X sales and 12.8X profits. While much of the attention in the Internet M&A market has been placed on Google, Yahoo, and Fox, Experian has been a major, but under recognized player. Perhaps this is because their focus has not been on the sexier consumer Internet start-ups, but those with more of a business to business focus. In addition to LowerMyBills, Experian has acquired Pricegrabber (shopping comparison site for $485M), ClassesUSA (education lead gerneration - rumored $60M), MetaReward (loyalty marketing firm in 2003), and ConsumerInfo.com (in 2002), amongst other, smaller acquisitions.

## Food for thought

LowerMyBills is a good example of a company that adapted from its initial business plan to find success in a different market. Although the company had some initial success helping consumers lower their monthly long distance bills, they eventually found the larger opportunity in one-time consumer financing events like home mortgages. In a previous case study, we saw that Flickr made a radical change from a multiplayer online game to a photo-sharing site. Craigslist evolved from a local events e-mail list into a classifieds site. In an upcoming case study we will see how Xfire adapted from a site where gamers bet against each other into a communication platform. These types of examples illustrate why VCs say that they don’t invest in ideas, they invest in teams. Good teams learn and adapt from what their users, customers, or market is telling them. While commitment to a vision or strategy is important, entrepreneurs cannot afford to be inflexible either.

A second thing I found interesting about LowerMyBills is that they tried a variety of different products, enabling them to discover opportunities in new markets. This is somewhat counter to traditional start-up wisdom that you should maintain laser focus on one product or opportunity. I’m not sure how I feel about this one. I don’t think that most start-ups can afford to experiment with different products. However, if it can be done with minimal investment, it seems like a valuable options strategy. Given the low costs of web development these days, we are seeing more Web 2.0 companies launching a variety of products. For example, the founders of Digg have also started a company called Revision3. The founders of podcast site Odeo have also diversified their product offerings. In addition to these two examples, I have also seen a number of other companies explicitly plan to test multiple products to see what sticks. I'll plan to revisit this topic at a later date once I've developed more of an opinion. Will this become a new theme in the Web 2.0 landscape? If anyone has a perspective to add, please leave a comment below.

# Marchex.com

**written by Nisan Gabbay**

Marchex is an online marketing services firm, offering merchant advertisers a mix of performance-based advertising and search-oriented services. Marchex has emerged as a leader in the direct navigation market with its purchase of Name Development Ltd. in February 2005 for $164M. Marchex was founded about four years ago and went public shortly thereafter. Marchex has a market cap of $490M on trailing twelve month financials of $125M in revenue and $39M in EBITDA.

Interviews conducted: Two early employees who preferred not to be disclosed

## Key success factors

*Previously successful management enabled access to inexpensive capital*

Marchex was founded in January 2003 by Russ Horowitz and four other executives from Go2Net. Go2Net was founded by Russ Horowitz in 1996 and ultimately sold to Infospace in a deal valued at $1.5B in October 2000. Before Go2Net, Russ was twice previously a successful entrepreneur, founding a sports apparel company and a merchant bank. Once Russ and team had left Infospace, they had no problem raising capital based on their previous track record. Marchex raised $20M from its founders and individual investors to acquire two companies that would form the basis for Marchex. Just 15 months after founding, Marchex held an IPO that raised an additional $27M. Marchex had one of the most successful IPOs of 2004, trading up 37% on its first day. Marchex achieved this despite only having ~$20M in revenue and ~$2M in operating profit from its initial two acquisitions.

Maybe the investment bank underwriting the IPO played a key role? Probably not. Marchex used National Securities Corp, who hadn't underwritten an IPO in 6 years. Marchex's success in raising capital can be attributed to Horowitz's previous track record and the competency of the management team. Even more impressive is the fact that the founders accomplished all this and still controlled more than 70% of the equity post-IPO! Marchex's financing strategy is worthy of a case study on its own. Unfortunately, most entrepreneurs aren't usually in the same type of position to raise capital so easily.

*Strategy focused on acquiring and improving undervalued assets*

Marchex was not about product innovation at its start – it was about identifying underperforming assets and acquiring them on the cheap. They looked at acquiring the number 3, 4, or 5 companies in a market as opposed to paying a premium for the top two assets. Interesting to me is that this goes counter to the well-known GE motto of "get out of a market where you are not number 1 or 2". Perhaps this motto doesn't apply on the Internet? If Jack Welch is reading this blog, please leave a comment below. Marchex was about financial engineering – acquire good, but not great performing assets on the cheap. Marchex has made 8 acquisitions in its brief history.

Once the assets were acquired, Marchex brought the necessary investment capital and management oversight to improve performance. The team's experience with Go2Net and Infospace gave them plenty of knowledge and relationships in the search market. As a smaller player, they could move more quickly to exploit emerging markets like local search and direct navigation.

## Launch strategy

As mentioned above, Marchex was launched and built through a series of acquisitions, using them as beachheads into emerging markets. Marchex started in search marketing, but quickly expanded into local search and direct navigation. These two markets were underserved, and perhaps undervalued, by Marchex's larger competitors. Marchex used a simple strategy of building a portfolio of proprietary traffic sources and acquiring unique technology platforms.

Marchex was launched via the acquisition of Enhance Interactive (formerly ah-ha.com) in March 2003. Ah-ha.com was a Provo, Utah-based, profitable company employing 50 people at time of acquisition. Ah-ha specialized in managing paid search placement for clients, listing client web sites in search engines for a fee.

## Exit analysis

Marchex raised $20M of private funding in February and May 2003, with $7M of that contributed by the founding executives themselves. Prior to the IPO in March 2004, the 10 founding executive officers owned 77.5% of Marchex. Thus the $13M raised from outside investors was done at a post-money valuation of $100M. Marchex completed its IPO just one year after its acquisition of ah-ha.com and only 15 months after founding. Marchex raised $27M in its first offering and became the best performing IPO of 2004. The company did this on just $12M of trailing revenue over the nine months from inception to IPO filing, all of which came from the ah-ha.com acquisition. Today, Marchex trades at a market cap of ~$500M. Thus the initial investors have made an ~5X return on their holdings in four years.

## Food for thought

When most of us think about Internet start-ups and entrepreneurship, we generally think about product innovation. But the Marchex story is not one of product innovation; it was about management execution and financial engineering. Marchex manufactured a company from undervalued assets, a relatively simple strategy, and great execution.

Coming up with the next great idea has sex appeal, but Marchex proves that you don't need to invent the next great product or service to be successful. There are plenty of opportunities out there to play a mini-LBO type of role as an entrepreneur. This strategy requires access to capital however, and not all of us have the background and connections of a Russ Horowitz. Nonetheless, there are plenty of smaller scale entrepreneurial opportunities out there to turn around an underperforming asset.

# MyBlogLog.com

**written by Nisan Gabbay**

MyBlogLog was launched as a blog analytics service in March 2005, but became popular by creating online communities around specific blogs. MyBlogLog enables bloggers to connect with their readers on a more personal level by building profiles of readers and connecting them via social networking features. As of February 16, 2007, MyBlogLog had 70,000 registered blogs, approximately 14,000 of which are using its popular "Reader Roll" widget. The company was acquired by Yahoo in January 2007 for a rumored price of $10-$12M. The company was bootstrapped with no outside investors, resulting in a nice payday for its three founders.

Interviews conducted: Scott Rafer, CEO of MyBlogLog

# Key success factors

*Popularity of the reader roll widget*

The popularity of MyBlogLog's reader roll widget, a blog sidebar widget that showcases mini-profiles of the most recent readers, was the driving factor behind MyBlogLog's success. The widget served as free advertising, driving near zero cost user acquisition. MyBlogLog is serving more than 2.5M reader roll widgets per day on 14,000 sites, as of mid February 2007. Fred Wilson has a nice post where he calculates the value of the widget at $300,000 per month in free advertising (using a $10 CPM and 1M impressions per day). I would argue that a $10 CPM is probably on the high side, but even using a $1 CPM at 2.5M impressions per day would still be equivalent to $75,000 per month in free advertising.

Equally important is that the widget communicates very neatly and succinctly what MyBlogLog does, enticing both bloggers and readers to register for the service. The widget also appeals to people on an emotional level. In my previous posts, I have touched upon how successful photos of people's faces are to attracting a user's attention, and this is another great example.

*Team responsibility and authority clearly divided along three lines*

Scott credits a big part of MyBlogLog's success to how the team operated. Each member of the triumvirate had responsibility and ultimate authority over their respective areas of expertise. Eric Marcoullier was responsible for product, Todd Sampson for technology, and Scott for overall business decisions. Interestingly enough, Scott did not think that the reader roll widget would be important to the company, never mind the key driver behind the company's success, when the idea was first proposed by Eric. However, given that Eric had control over product decisions, Scott did not stand in his way. This is not to say that the team does not collaborate on decision making across their respective areas, but making each person the ultimate decision maker over their area paid huge dividends for MyBlogLog.

In our case study on Userplane, CEO Mike Jones gave similar credit for dividing the company along those three lines. Might we have stumbled upon the correct management structure for Internet start-ups – business, product (user champion), and technology equally represented? I think the key insight here is giving product (taking a user-centric view) an equal weight; in most organizations product is usually subordinate to the other two.

*Identify problem area and solve through product marketing*

Scott didn't fully agree with me on this one as a key success factor, but I am going to propose it anyway because I think other entrepreneurs might benefit from this train of thought. MyBlogLog was founded in January 2005 with the intention of helping bloggers to better understand their readers. The initial product started as a way for bloggers to understand what links people were clicking to leave their sites. Scott joined MyBlogLog in March 2006, bringing the simple idea that bloggers would prefer to know who their readers are from a social context rather than have detailed, aggregated analytics on user visits. Scott proposed to simply show bloggers who each and every individual reader actually is, which in retrospect, is sort of an obvious insight. Later on, the reader roll widget idea was proposed by a couple of users and championed by Eric as a great idea.

The lesson here for entrepreneurs is that one should pick a problem worth solving and then rely on product marketing techniques to lead you to the right solution. If you truly understand the problem you are solving, what your users value, listen carefully to feedback, and don't fall too in love with your initial product vision, you will have a much higher probability of success. I think that the MyBlogLog team accurately identified an unsolved pain and did well to pursue it through several iterations before figuring out the right solution.

I think there is a good framework for Internet entrepreneurs to follow when evaluating their opportunity:

1. Are you confident that a problem (or customer pain) exists?
2. Is that problem worth solving, i.e. will there be a lot of people that change their behavior in a small way, or a few people that change their behavior in a big way? Or stated differently, if you solve that problem, do you think there will be a large reward? (for those of us that are greedy)
3. Go try to solve that problem, but don't assume that you know too much about the answer. Rely on users to guide you.
4. Make sure you have enough runway to iterate – probably 18 months is good.

# Launch strategy and marketing

The key to MyBlogLog's success in launching its social networking service was the fact that they had an installed base of thousands of bloggers using their analytics service. MyBlogLog was founded in January 2005 and launched its blog statistics service in March 2005. Thus, when they launched the private beta of the social service in July 2006, they had 14,000 registered bloggers whom they prompted to create social profiles. The product progression here is worth pointing out. MyBlogLog started with a product that delivered value to users without requiring network effects to be in place first. The social product would not have worked as effectively upon launch without it being pre-populated by profiles.

From there, MyBlogLog did well to get influential tech bloggers to use the service, people like Brad Feld and Fred Wilson. They also actively participated in blog conversations regarding their service by placing comments on other people's blogs to drive awareness. The big win in terms of marketing and viral adoption came with the launch of the reader roll widget (please see above).

## Exit analysis

Yahoo acquired MyBlogLog for a rumored $10-12M in January 2007. There is a great discussion on Don Dodge's blog about the exit valuation for MyBlogLog and what Yahoo bought for that sum. While Don's analysis is nice from a textbook-style approach to valuation, what really drives the purchase price is simply the price that the market will bear, and quite frankly valuation metrics don't really come strongly into play. This is more of a three-way game of chicken between VC's, Yahoo (and other suitors), and the entrepreneur. Had MyBlogLog had offers from VCs to invest at a higher valuation, Yahoo would likely have spent more to acquire them.

According to Scott, Yahoo's motivation for the purchase was several fold. One, Yahoo execs really liked the product, plain and simple. It has a nice emotional pull that attracts people. A more rationalized justification for the purchase comes from how MyBlogLog will contribute to two big Yahoo initiatives around off-network distribution and social services. A key part of Yahoo's monetization strategy is to build its capabilities in behavorial targeting of ads. MyBlogLog's user profiles and rich cookies (100+ million to date) can be added to Yahoo's ad targeting engine, thereby yielding increased revenue via higher click-thru rates.

When I asked Scott why they chose to sell rather than take VC funding, he had a nice quote for me: "eat when dinner is served" (a quote Scott had heard from the guys at Topix). The founders had invested about $200,000 in MyBlogLog in terms of hours of coding contributed, and Scott added $24,000 to help cover hosting costs when traffic started accelerating. A 50X return in two years time is hard to argue with. No dilution, no loss of control, and no uncertainty about future acquirers. Eat when dinner is served!

## Food for thought

MyBlogLog is another company whose success in acquiring users came about through widget marketing. Other examples include YouTube, RockYou, and Slide. I think that we will continue to see more companies have success with widgets, although the bar for user attention will continue to climb. So what are some keys to getting widgets to produce results? For one, the widget needs to benefit the end user with a clear value prop. I think that many of the failed widget plays out there don't provide enough value to the end user. Afterall, the user is trading real estate on their site to put up the widget, so as a widget provider you are not only competing with your direct competitors but also with all other widget providers and advertising options vying for that user's attention. Second, the most successful widgets seem to be social in nature rather than informational. Pictures seem to draw people's attention the most. In the case of MyBlogLog it was faces in a social environment starved for them. As Scott said, "something in our forebrain can't remain indifferent to eye contact".

Widget marketing will be an area that I will research more fully and perhaps create a separate post on. If you have any more ideas for how to make a widget successful, please contribute by adding to the comments below.

## MySpace.com

**written by [Nisan Gabbay]**

In less than 3 years time, MySpace has become one of the top 5 most visited sites in the US, racking up 48 million unique visitors and 27.4B page views in June 2006. While it will probably never come close to the profitability of Google, eBay, or Yahoo, it has the potential to be the Internet's next "platform" company. It has made for particularly interesting case study material for leapfrogging early social networking leader, Friendster.

Interviews conducted: I interviewed several people who were close to MySpace in the early days, although no longer with the company. I would consider both of these to be excellent sources. I have also spoken to a number of people in the social networking industry – product managers at competitors, MySpace service providers, etc. I am also a board observer at a company that competes with MySpace.

# Key success factors

*Gave users more control over their MySpace pages, enabling a higher degree of self-expression and communication with friends*

While there were many factors that contributed to the MySpace success, if I could pick just one, this would be it. MySpace had its greatest early success with teenagers, and teenagers use the site for sharing pictures, communicating with friends, and creating their best possible "my space" on the web. Having independent music bands anchored on the site for music discovery is a nice complement, but that's not what is driving the voluminous amount of page views. And yes, people do use MySpace for dating and hooking up, but that type of activity is more popular with 21 – 26 year olds, not the audience that made MySpace what it is today.

I also cannot emphasize enough how important the photo sharing aspect is. The growth in digital cameras and camera phones has been driving the utility of all social networking sites, not just MySpace. MySpace allowed users to add more pictures to their MySpace pages through third party services like PhotoBucket and ImageShack. I strongly believe this was a crucial factor in their success relative to Friendster.

*Rapidly adapted product to desires of user base through rapid development cycles*

So what specifically did MySpace do to enable this great environment for self-expression? It started with a very basic strategy to not have pre-conceived notions about how users wanted to interact with the site. When users started creating group profile pages around interests and associations, MySpace accepted this behavior where Friendster did not. MySpace listened to user feedback and quickly iterated the product with rapid development cycles. MySpace added blogs, comment boards, message boards, IM, long before Friendster was able to upgrade their product given scalability issues. When users began to hack their MySpace pages to embed more photos and graphics from places like PhotoBucket, MySpace did not discourage this behavior. This enabled users to add photos and graphics images into their friends comment boards. The comment boards drive much of the motivation for users to invest time into their MySpace sites.

*Used combination of viral tactics, offline advertising, and online distribution partnerships to seed initial MySpace community with users*

Public perception seems to be that MySpace launched and instantly grew its user base through word of mouth viral marketing. This was not the case. MySpace used a combination of tactics, including traditional, cost per acquisition (CPA) campaigns through established online brands, which yielded successful results. MySpace was hatched by the former ResponseBase team within Intermix, and thus the team had a strong background in direct e-mail marketing and CPA tactics. Once MySpace had acquired its first few million users, it could then rely on pure viral effects. I have more detail on the MySpace launch in the “Launch Strategy” section, but I thought it was worth highlighting here as well.

*Made product and policy decisions to ensure MySpace site performance*

A key turning point in the Friendster versus MySpace battle was the well-documented Friendster site performance issues that drove many initial Friendster users away. While Friendster was its own worst enemy in this regard, MySpace did take several well-thought measures to ensure it did not face similar problems. First, MySpace decided not to display “friend chains” on the site. Friend chains – which show how users are connected to one another – cause a heavy computational load when dynamically calculated. MySpace decided against incorporating this key Friendster feature in hopes of keeping site performance high. Second, MySpace limited user registration in the early days to US-based users. Friendster had great success (and still has success) in the Philippines. Unfortunately, until the branded ad market matures in Asia, this traffic is more of a cost center than a revenue center. It was detrimental to Friendster’s site performance for US users, whom are much more valuable from an advertising standpoint.

MySpace made a good decision to preclude registration from these users until they had critical mass in the US.

## Launch strategy

The idea to develop MySpace from within Intermix came from Chris DeWolfe and Tom Anderson, who came to Intermix through the acquisition of ResponseBase. Much of the ResponseBase team had formerly come from X-drive as well, so they had a background in both online consumer services and direct marketing. After witnessing the initial success of Friendster and having the ResponseBase/Intermix resources at their disposal, they thought they could create a strong competitor. ResponseBase had a database of ~100M e-mail addresses and Intermix had a number of Internet sites heavy with users in the MySpace target demographic.

MySpace took 3 months to build a site with similar features to Friendster, launching at the end of 2003. MySpace did not launch with the strategy that they would target independent music bands and create a social networking site anchored around music. This developed more naturally as a result of who they attracted to the site. Interestingly enough, MySpace did not begin to see user success until 6-9 months after initial launch and promotion. They started promoting MySpace by running a cash prize contest for Intermix employees (~250 of them); asking them to invite friends to use the site. This had some success, but was limited to reaching only a certain size. Next, they made use of the ResponseBase e-mail marketing list, which made some impact, but was largely considered a failure. This was because e-mail marketing does not attract people having loyalties to the site through a pre-existing group of friends or other association. MySpace then began promoting the site offline, sponsoring parties in Los Angeles with clubs, bands, and party promoters. This began to build the buzz around the site, but more importantly attracted micro offline communities (i.e. groups of people) to use the site together. Small community groups of 100 to 1000 people got more of the viral snowball effect going than attracting individual users to the site.

Once this initial audience had been established, MySpace than added fuel to the fire by leveraging Intermix's media buying and channel relationships. Affiliate marketing partnerships with already strong Internet properties is what propelled MySpace from initial traction into runaway success. It is unlikely that MySpace would have grown as fast as it did without employing this more traditional marketing tactic.

# Exit analysis

Intermix was acquired by Fox for $580M in July 2005, with MySpace being the key driver behind the transaction. I estimated the value of MySpace as the difference between what Fox paid ($580M) and the market cap of Intermix (~$100M) as a publicly traded company prior to the success of MySpace. This would ballpark the value of MySpace at time of acquisition at ~$500M. However, another complicating factor at time of acquisition was the outstanding legal liabilities of Intermix for Internet privacy violations. Having Fox assume these liabilities may have also had a significant impact on the acquisition price.

MySpace had a reported $20M revenue plan for 2005, but was on a steep growth curve. Actual revenue in Q2 2005 was ~$6M, meaning that Fox paid a 20X current run rate revenue multiple. At the time, this was considered by most people to be a steep premium valuation, however, within a year of acquisition MySpace was already generating ~$8M in ad revenue per month. Thus, Fox ending up paying about 5X forward revenue at time of acquisition, which was a reasonable price. Given the mainstream brand and cultural impact that MySpace has created in the US since, I think it is fair to say that the purchase price turned out to be a very shrewd move by Fox (especially in light of the recent $900M deal between Fox and Google). It also begs the question as to how Yahoo, MSN, AOL, and Google missed the boat on this one. If anyone could have predicted the growth that MySpace would achieve, shouldn't it have been one of the established Internet powers?

So how did the VCs and founders make out? Bill Burnham has an excellent post on the details here, thus I will only summarize his findings. Redpoint Ventures managed to spinout MySpace from Intermix with an $11.5M investment for a 25% ownership stake in February 2005, equating to a pre-money valuation of ~$35M. MySpace was already a success by that point, firmly established in the Alexa Top 100. (Note: It is interesting to see how dramatically the valuation multiples for Internet properties with traction have changed in the last year and a half. The Redpoint investment valued MySpace at $35M for a top 100 user generated content site. Financings for sites like Facebook, Bebo, YouTube, and Tagged have occurred at much higher valuations since.) Intermix put a smart clause into the Redpoint transaction that allowed Intermix to buyback the MySpace shares if Intermix were to be acquired within one year. Based on the terms, this had the effect of capping Redpoint's return to ~$65M (about a 4X return on $15.5M). A great return for Redpoint and one that shows being a VC isn't necessarily about discovering the next great thing, but rather maneuvering into an investment into the next great thing. The VC firm that most profited from MySpace was VantagePoint Venture Partners, whom had invested in Intermix well before the MySpace success. As a majority shareholder in Intermix, VantagePoint came away with $139M on a $15M investment, for a 9.1X return. VantagePoint did not invest in Intermix because of MySpace, but was a benefactor of MySpace's success.

So how did Chris, Tom, and the rest of the ResponseBase team come away financially from the Fox acquisition? Intermix wholly owned MySpace upon it's conception, thus the capital structure of MySpace was not one of a typical start-up. However, I was told that early in its life, the ResponseBase team was given the option to buy 1/3 of MySpace from Intermix/eUniverse for $50,000. In fact, you can see the actual contract here. Chris and Tom did participate in this "round," and via an assortment of stock option grants and bonuses, it is fair to say that they are both multi-millionaires.

## Food for thought

If the two largest Web 2.0 successes (based on number of registered users) are Skype and MySpace, I think it is interesting to note that each benefited from having a major distribution partnership during launch. As I will highlight in an upcoming Skype case study, Skype got its initial distribution through Kazaa. Since the founders of Skype also founded Kazaa, they had an easy way to jumpstart the Skype service by advertising it through the Kazaa network of desktop clients. While both Skype and MySpace were inherently viral products, they might not have reached such large scale in such a short period of time without that initial impulse function from distribution channels.

Furthermore, Web 2.0 entrepreneurs should recognize that they are not just competing with the large, slow-moving giants, but other nimble start-ups with large distribution at their disposal as a primary weapon. Other examples beyond Skype and MySpace, are lesser known successes born out of ad networks. Take for example, Livedigital.com which was launched by online ad network Oversee.net and has quickly grown into a top 5000 Alexa site in less than 9 months. The ad network Blue Lithium is following a similar strategy, planning to launch online community sites by making use of its excess ad inventory. What about newcomers Tagworld and MyYearbook? Their cost per action (CPA) advertisements have been plastered all over MySpace "ecosystem" sites (sites providing graphics and html code to MySpace users). The results of these campaigns have had mixed results, but worth noting that they do exist. While traditional distribution partnerships might be frowned upon in Web 2.0 thinking, MySpace and Skype are both examples that prove distribution partnerships shouldn't be overlooked in Web 2.0 hype.

If a web entrepreneur chooses to go the route of pure viral distribution, then you really need a product with a simple, compelling value proposition that is easy to understand and use. Otherwise, there are other start-up companies out there with access to distribution that can be formidable competitors.

Please leave any comments on the keys to MySpace's success or launch strategy below.

# Newegg

**written by Nisan Gabbay**

Newegg is a private company that has not yet exited, but has successfully built a strong online brand and shown impressive revenue growth since its founding. The revenue numbers basically speak for themselves: 2005 ~$1.3B, 2004 $980M, 2003 $526M. How does this compare to Amazon? Amazon's trailing twelve months sales were $8.5B, so Newegg is roughly one-sixth the size! Even more impressive was that this growth was achieved without venture capital funding in the early days, only taking outside equity financing in late 2005 from Insight Venture Partners.

Interviews conducted: Howard Tong, Co-Founder and VP; Ryan Hinkle, VC investor at Insight Venture Partners

## Key success factors

*Site (and company) built with needs of core user in mind*

Newegg's success can largely be attributed to understanding and satisfying the needs of its core user demographic: the tech enthusiast that is comfortable with constructing or modifying their computer. When you visit the Newegg site, it is clear that the site was not designed for use by the average consumer. Newegg is a good example of an e-commerce site that has matched its product to the needs of its target demographic.

This customer-centric viewpoint can also be seen in Newegg's approach to customer service. Newegg made the decision early on to make its logistics operations a core differentiator of the company. Internally managing inventory in its own warehouses enabled Newegg to meet the quick turnaround times demanded by its customers.

*Created sense of community amongst customers*

Although much has been made about the strength of online communities like MySpace and Facebook, Newegg has shown that community is also an important element to a pure-play e-commerce retailer. Newegg does a great job of engaging its customers through online discussion forums. If a customer needs help in modifying a computer or selecting a component, they can turn to a trusted resource – other Newegg customers like themselves. Successful offline retailers often create a shopping experience that engages its customers on a personal level; Newegg has been able to replicate such an experience online. In an industry with razor thin margins and intense price competition, customer loyalty and repeat purchasing is critical to financial success. Giving people the sense that they are part of a community - something warm and fuzzy - helps to drive repeat purchases and word of mouth marketing. A nice side benefit is a significant reduction in technical support calls.

*Narrow initial product selection*

In the early days Newegg was able to build a loyal customer base by being the premier provider of VGA (graphics) cards online. Newegg management purposefully started with a narrower product catalog to deliver the best value it could to the customer. Management was careful not to spread themselves too thin by offering too many products, preferring to build upon the successful foundation of VGA cards and expanding from there.

*Management's industry relationships*

Newegg's fantastic growth would have been hard to achieve from a standing start. Newegg's founder had previous experience in a tangential market, which was important to secure relationships with key suppliers, particularly those based in Asia. Newegg was an offshoot business from the founder's original company, which made custom assembled computers.

# Launch Strategy

Newegg spent no money on external marketing in the early days, instead preferring to focus on the customer experience and relying on word of mouth marketing by its customers. Even as a $1B+ company, Newegg still spends less than 2% of its revenue on marketing. Newegg is a great example of an e-commerce company that was able to build a successful brand without spending money on branding. So how did they get the initial users? Newegg did a good job of SEO (search engine optimization), optimizing natural search rankings as best as possible. Newegg also focused on its rankings with the shopping comparison engines, places where many of its users start their searches for products. Other launch strategies previously mentioned: initial narrow product focus and build strong relationships with key vendors.

# Exit Analysis

The e-commerce market has not seen many substantial exits in recent years relative to the hot online advertising market. Given that e-commerce growth continues to become a larger part of the overall retail market, are exits far behind? Perhaps the recent $477M acquisition of Provide Commerce by Liberty Media is a sign of things to come. The recent influence of Fox, Viacom, and Experian as acquirers in the online advertising market has made a big impact on the M&A

market there, and we have yet to see any traditional retailers make big e-commerce acquisitions. E-commerce now accounts for ~3% of all US retails sales, while online advertising accounts for ~5% of the US ad market. Both markets are growing in the 20-30% range per year. My guess is that the e-commerce M&A market is about 18 months behind the online advertising market. Newegg will no doubt be an attractive acquisition target or IPO candidate when the market heats up.

# Reddit.com

**written by Nisan Gabbay**

Reddit is a social news site that was launched in June 2005. As of April 2007, Reddit is generating ~170,000 unique visitors and 1.9M page views per day. The company was acquired by Conde Nast Publications in October 2006 for an undisclosed sum. Reddit is thus far the most successful graduate of Paul Graham's Y Combinator program, reaching a successful exit with just four employees and $100,000 in total angel funding.

Interviews conducted: Steve Huffman, Reddit co-founder. Aaron Swartz, early employee/co-founder via merger with infogami.com.

## Key success factors

*Easily accessible, interesting content the key to product appeal*

Reddit's success from a product perspective can largely be attributed to the site's interesting content that is made easily accessible right on the home page. The Reddit team stuck with a design philosophy that focused on the content, as opposed to site features. The user submitted links to articles occupy the majority of the real estate on the site, and Reddit did not clutter the content with registration forms, ads, or features. Equally important to the accessibility of the articles, was the quality of the content itself. Reddit articles can best be described as news for tech-oriented people, but not just technology news. The articles tend to be intellectual and witty, largely shaped by the personality of Paul Graham devotees and the Reddit founders' themselves. Because Reddit competitor Digg launched off the basis of Kevin Rose's TechTV audience, one could theorize that the Digg community is more tech gadget oriented and mainstream, while Reddit has the personality of a high-end hacker. Regardless, of the origins, I think it is fair to say that Reddit's success has a lot to do with the articles being interesting. I think you would be hard pressed to visit Reddit and not find at least one article where you learned something pretty cool or did not crack a smile.

*Initial community of Paul Graham devotees*

An important factor to Reddit's success was its affiliation with Paul Graham; this is aside from the seed financing, support, and business advice that Y Combinator provides to it's start-ups. Paul Graham was directly responsible for helping to launch Reddit, by sending traffic from his website over to Reddit. As detailed in the Launch Strategy section below, a link from Paul's site generated a consistent 3,000 – 4,000 visitors per day to Reddit immediately upon site launch. Another event that aided the growth of Reddit was a blog post about Reddit changing the Reddit site from Lisp (correction: created by John McCarthy but was evangelized by Paul Graham) to Python. This stirred a bit of controversy in the blogosphere, and exposed more Lisp fans to the Reddit site.

*Partnership opportunities led to exit*

Reddit's successful exit to Conde Nast was due in large part to an OEM relationship that Reddit had developed with Conde Nast. Reddit adapted its technology to power a site called LipStick.com, launched by Conde Nast and targeted at the celebrity gossip market. The Reddit team and technology impressed Conde Nast during this interaction, ultimately leading to its acquisition. The lesson learned here is perhaps obvious, but successful partnerships do lead to successful exits. Reddit did well to maintain its flexibility in regard to business model choices, making itself available to OEM opportunities, rather than just building Reddit as a destination site.

# Launch strategy and marketing

Reddit was launched on June 22, 2005, and saw fairly steady growth from that point forward. Initial traffic was provided by referring traffic from Paul Graham's website to Reddit, resulting in 3,000 – 4,000 visitors per day upon launch. This provided the initial spark to grow the community.

Reddit seeded the initial content on Reddit almost exclusively through the efforts of the Reddit team in the early days. For the first few months of Reddit's life, Reddit co-founders Alexis Ohanian and Steve Huffman scoured the web to find interesting articles to post to Reddit. They were able to create the illusion of more contributors by submitting articles under different user names. As Reddit developed a loyal readership (due to the content hand-selected by the team) other users began to submit links, although the Reddit team was still responsible for 80% of the submitted links for many months. Reddit was able to spur contributions from the readership by creating a point system around a concept they called karma. By keeping a scoreboard of top contributors, this sparked a healthy competition amongst Reddit users to be a top contributor. Today, the community does provide all of the submissions rather the Reddit team.

Reddit was able to grow its site traffic from 3,000 UVs per day to 170,000 UVs per day in just under 2 years time. The Reddit team did very little traditional advertising. They attribute the majority of the site's growth to positive word of mouth about the product, and good PR coverage. In my interview, Steve explicitly credited Alexis for doing a good job of garnering press coverage. Aaron pointed to re-writing the site in Python from Lisp as a key turning point, roughly 5-6 months after launch. This sparked a bit of controversy in the blogosphere among Lisp (and Paul Graham) devotees, but the net result was a good bit of traffic for Reddit. Up until that point (November 2005), the site experienced slow but steady growth, from 3,000 to 7,000 UVs per day in about 5-6 months time. Growth started accelerating more rapidly after the LISP vs. Python blog post according to Aaron.

# Exit analysis

Reddit was acquired in October 2006 by Conde Nast Publications, which owns approximately 30+ distinct brands between its print magazine and online sites. Conde Nast's more well-known brands include The New Yorker, Wired, Vogue, Vanity Fair, GQ, and Glamour. As mentioned above, Conde Nast approached Reddit to license Reddit technology for use in a Conde Nast site, LipStick.com. Reddit was able to sustain itself (its team of four) on the licensing revenue generated from the LipStick.com deal and $100,000 in angel funding. Thus, at the time of acquisition Reddit was generating very little revenue (sub $50,000 per month). While I have no inside knowledge of the size of the acquisition, the purchase price was likely sub $10M. Still a nice pay day for four people in less than two years time invested. Conde Nast will continue to integrate Reddit technology and approaches to social news into their branded online publications, as well as licensing the technology to other publishers.

# Food for thought

Inevitably, Reddit is compared to the larger social news site Digg.com. I wrote a fairly lengthy case study on Digg here. I believe that one of the main reasons Digg grew much larger than Reddit was because of Digg's advantage in natural search rankings. The Reddit founders acknowledged to me that they invested very little time or effort into SEO (search engine optimization). According to Steve, less than 10% of Reddit traffic today comes from Google. I find it pretty remarkable that Reddit has grown as fast as it has without more referral traffic from other sites.

Speaking with the Reddit founders you get the impression that Reddit's success was not so difficult. Steve credited a few factors: 1) being friendly and likeable to users, investors, and business partners, 2) keeping the website up and running and responding to the community, and 3) garnering positive press coverage. Aaron would claim that persistence was the key. I have read some interviews with Reddit co-founder, Alexis, where he credits being passionate about the product and serving the needs of users as the key. I would say that all these factors were no doubt important, but there are plenty of entrepreneurs who are passionate, hard-working, persistent, and generally “nice guys” that don’t have success.

My explanation gives the Reddit team a little more credit for their personal uniqueness. For one, they did a great job of seeding Reddit with fun and interesting content. It was their own personality that set the tone for the site – the things that they found interesting and fun. Afterall, they did the majority of the submitting in the first few months. They also had a relentless focus on simplicity and ease of use for every aspect and feature of the Reddit site. This combination of personality and product execution, plus initial site traffic courtesy of Paul Graham were the key ingredients in my opinion.

# Rent.com

**written by Nisan Gabbay**

Rent.com was acquired by eBay in February 2005 for $433M in cash. The company was founded in 1999 and became the most visited apartment listings site in the US.

Key Contributors: Two - both from sources who preferred not to be disclosed, but were involved with the company in its early days.

## Key success factors

*Pay for performance business model that fit market need.*

Rent.com was the first and only pay for performance rental listing site, while competitors went with subscription, listing fee, or cost per lead business models. Rent.com matched property managers and tenants, only charging the property manager when a lease was produced through the site. Property managers pay $375 – verified by the consumer through a $100 reward to anyone who signs a lease and acknowledges Rent.com as the referring source.

This type of pay for performance business model was very successful in cities having high vacancy rates, like Houston. The model is less successful in cities like SF or NY where property managers typically don't have a lot of problems filling vacancies and can rely upon Craigslist to publicize a vacancy. Where competition to secure a tenant is more intense, the pay for performance model is ideal since landlords can't be sure what type of results conventional local advertising will produce. They might take out an ad that costs $500 in a local apartment guide without securing a tenant.

Although the pay for performance model was hard to implement early on and took about 18-24 months to show results, Rent.com stayed true to the vision. This was before "pay for performance" business models became en vogue.

*Committed strategic investors.*

Rent.com had some of the country's largest REITs (real estate investment trusts) as strategic investors in Rent.com's $17M round of financing in November 2000. These REITs were important customers because they controlled nearly 20% of the rental apartments in the US. This made it possible for Rent.com to open new local markets by having an immediate source of apartment vacancy listings. Having these important customers as investors helped raised the degree of customer commitment.

*More detailed user registration process.*

Rent.com collected more information from consumers than other apartment listing sites during the user registration process, which resulted in a better ability to target listings to consumers. Thus, Rent.com enjoyed exceptional conversion rates. Rent.com has since refined the user registration process, delaying the collection of certain pieces of information to later in the process. However, it is interesting to note that a lengthy user registration process is justified in cases where collecting such information can improve the value to the user significantly and hence increase conversion rates.

*Cash reward for the end user.*

If consumers find an apartment on Rent.com that they sign a lease for, the end user is entitled to a $100 reward – a nice incentive for driving repeat usage and word of mouth marketing. This is a successful example of a revenue share model with end users, as Rent.com needs the participation of end users to ensure that the pay for performance model is properly administered.

## Launch strategy

Rent.com spent no money on traditional marketing, instead relying solely on search engine marketing. One of the key success factors mentioned above was the role that Rent.com's strategic investors played in the company. By having access to apartment listings from large property managers across the US, Rent.com was able to open many markets without a severe chicken and egg problem. Having some listings to start with in a market enabled Rent.com to target consumers via SEM to those listings. Thus a key differentiator in Rent.com's strategy was to open multiple markets quickly rather than wait to build critical mass in one market before opening another.

## Exit analysis

Rent.com was rumored to have had $40M in 2004 revenue, with healthy profit margins, when acquired by eBay. At a $433M all cash exit, this represents an excellent 10X trailing revenue multiple for a lead generation business. Even if assuming a doubling of 2004 revenue to $80M in 2005 with a 40% net profit margin (note: I believe that Rent.com is close to these numbers today), this would be a 13X forward EBITDA multiple. Thus, the valuation metrics are all strong from any perspective. Why did eBay pay such a premium? I don't have a strong perspective here, but Rent.com does fit well into eBay's push into the classifieds market. Secondly, Rent.com had not only a good consumer brand, but also a stable, loyal install base of property managers providing the supply listings.

## Food for thought

What I found interesting about Rent.com was how they implemented a pay for performance model that really made sense for the target customer (property managers in high vacancy rate cities). Many web companies today are trying to implement pay for performance models assuming that they are superior without truly understanding the value chain and market dynamics in their industry – I think it is important to give the model careful consideration, because in the Rent.com case it took some time and perseverance to prove successful.

Another topic that Rent.com got me thinking about was how much information to collect during the registration process. While no user likes to spend a lot of time registering for a service, in some cases it is actually important to do so if the service needs that information to provide a differentiated benefit to the user. eHarmony is an upcoming case study where this also held true. Counter this to some Web 2.0 services like the photo slideshow companies Rockyou.com and Slide where there collect a very minimal amount of registration data in order to increase the virality of the service. In the case of Rockyou, you don't need to customize the service to each user, so why collect more data if you don't need it? Thus, the registration process should be finely tuned to the goals a company is trying to achieve with their service.

## Rotten Tomatoes.com

**written by Nisan Gabbay**

Rotten Tomatoes is one of the leading movie sites on the web, ranking number 6 according to Nielsen NetRatings for the week of August 20, 2006. Rotten Tomatoes was acquired by IGN in June 2004 for approximately $10M, when it had 5.2M monthly UVs (according to ComScore) and was generating ~$200K per month in revenue.

Rotten Tomatoes is a great story of a company that started out as a hobby, raised a little funding ($1.01M) during the boom, hunkered down during the bust, and managed to make a nice return for its founders and investors. I am personally a big fan of the site and always love to discuss companies started by young entrepreneurs from UC Berkeley (my alma mater).

This is also the first case study I have done based on an interaction I had with a reader of Startup Review. I spoke with Patrick Lee, the ex-CEO of Rotten Tomatoes, because he commented on the Flickr case study. I greatly encourage any reader who was part of the founding team and/or early employee at a successful Internet company to contact me if you'd be willing to speak about your experiences for a few minutes.

Interviews Conducted: Patrick Lee, ex-CEO of Rotten Tomatoes, 2000 - 2005

## Key success factors

*Innovative product*

When Rotten Tomatoes launched in August 1998 it was the first movie review site to aggregate critic reviews and provide consumers with a composite review score of a movie. This feature was called the "Tomatometer", which is the percentage of reviews that are rated "fresh". Coupled with creative branding, it was a winning web product that people "got" immediately. Within a few days of launch, Rotten Tomatoes got great publicity as a cool, new site from web reviewers which drove its initial traffic growth.

Over time, other sites mimicked the Rotten Tomatoes aggregate review score, but they were the only major movie site to provide this feature for almost two years - long enough to capitalize on the initial buzz that the site generated.

*Focus on search engine optimization to increase traffic*

The Rotten Tomatoes team observed that most people searched for movie reviews by searching on the movie name or actors in a film, not for a movie review itself. Furthermore, searches for movies occurred in the greatest quantities around an anticipated release or controversial movie. Therefore Rotten Tomatoes architected the site to give each individual movie its own Rotten Tomatoes mini-site to boost natural search rankings. This was the primary method for how Rotten Tomatoes grew its traffic, as other online advertising and marketing methods could not provide sufficient return to justify the expense. Even as Rotten Tomatoes rolled out more community features like forums, blogs, and friend features, these were not the major drivers of traffic. As primarily an information service/content site, natural search rankings were the key to growth.

** Update to original posting ** Please see comments from the Rotten Tomatoes team in the Comments sections for greater detail on their SEO strategy. Almost 70% of incoming traffic was/is from search traffic, emphasizing the point that a loyal community may not be enough to achieve mass scale for an information service.

*Product and brand dedicated to movie reviews*

Patrick credited the decision to stay focused on movie reviews as one of the key strategic decisions that Rotten Tomatoes made. While many people advised them to branch into other categories early on, the focus on movies helped them build the best possible product for that category and establish their brand. They only launched the game reviews many years later to prove that they could move into other categories. Even within movies, Rotten Tomatoes focused on the reviews, and licensed or partnered with other companies to provide other movie-oriented data (cast/crew, show times, pictures, etc.) or services.

# Launch strategy

Many of the articles I have referenced below provide a great historical context on how Rotten Tomatoes got started. Their initial traffic came as a result of mentions as a cool new site on major Internet sites and mainstream press. As stated above, continued growth was fueled through SEO efforts.

Rotten Tomatoes acquired movie review content through a mix of automated and manual procedures at the start. As the site became more well-known, movie critics began submitting their content directly to Rotten Tomatoes.

# Exit analysis

Rotten Tomatoes was acquired by IGN in June 2004 after being courted for nearly a year. The decision to sell was a difficult one for the Rotten Tomatoes team, as they recognized the improvement in the ad market and continued traffic growth of the site. Had they waited another two years, there is no doubt that the purchase price would have been higher than $10M, given recent precedent transactions for top tier content sites. So why did they decide to sell?

The executive team felt that while Rotten Tomatoes could continue to increase its value, they also identified other potential entrepreneurial opportunities. In particular they saw great opportunity in the China Internet market and thought they could get a higher return on their time by starting a company there, rather than slowly increasing the value of Rotten Tomatoes.

While they recognized the improvement in the online advertising market, in early 2004 it was still hard to predict the boom that we have today. Coming off the ad market downturn due to 9/11 and continued terrorist threats, the team was uncertain how quickly the ad market would grow. After seeing their revenues drop from $50K per month in the boom to $5K per month during the bust, they were all too familiar with how events beyond their control could affect their business.

After devoting approximately five years to Rotten Tomatoes, the team was happy to reap a good, but not phenomenal return for their efforts and move on to the next thing. They also managed to make a return for their investors after some pretty lean years.

# Food for thought

This case study got me thinking about several things.

The team could have sold Rotten Tomatoes earlier than 2004, but they felt an obligation to their investors (mainly angels they had worked with before) to make a return. They turned down many offers that would have netted their investors $0.10 to $0.25 on the dollar, but instead decided to ride out the downturn. Most entrepreneurs face the decision of taking money from friends to get their businesses started, and this does raise the bar in terms of the level of commitment required. Once you take that money, you are signing up to a serious commitment to make a return. If it is only your time and money, you have more flexibility in terms of exit options. I suppose this is rather obvious, but I think many people rush to raise money without fully understanding the consequences of that decision.

Rotten Tomatoes is also a good example of a site that was able to effectively compete with sites having much stronger distribution and resources. While Yahoo Movies still generates more traffic than Rotten Tomatoes, a relatively simple product innovation was able to create a sustainable business and a formidable competitor to the much larger Yahoo and IMDB. Even after the major sites mimicked Rotten Tomatoes, the site continued to grow. The main reason for this was search. Search levels the playing field for smaller sites. If you have a content-oriented / information service site, you are probably best off focusing your time on SEO, because natural search rankings will prove more defensible than having the best feature set. Thus, while it might be more fun to build cool features for a content site, investing time into SEO will likely provide a greater return on your limited resources.

## Userplane.com

**written by Nisan Gabbay**

Userplane provides hosted communications applications for online communities. They offer a suite of easy-to-integrate, flash-based applications like instant messaging and multi-user web chat. Userplane's applications are utilized by over 130,000 websites, ranging in size from sole proprietorships to the largest social networking sites (MySpace, Friendster, etc). Userplane was acquired by AOL in August 2006 for an undisclosed sum, rumored to be in the $30-$40M range. Having never raised any external funding, the exit was a great result for Userplane's three founders.

Interviews conducted: Mike Jones, Userplane CEO and co-founder. Jeff Clavier, advisor to Userplane starting in May 2005. Jeff is also a professional Internet investor and one of the most popular VC bloggers (see Jeff Clavier's Software Only blog).

# Key success factors

*Established initial niche as provider to online dating and social networking sites (i.e. executed a vertical go-to-market strategy)*

When Userplane was founded in 2001, the company was not in a great position to raise external capital. Unlike today, user generated content was not en vogue, the online advertising market was in the dumps, VC's weren't investing in consumer Internet plays, and the founding team was young.

As a result, for the first year and half Userplane operated as a services firm, building custom communications applications for its clients. Perhaps forced into this initial business model out of necessity, it actually contributed to Userplane's success. Having to operate off cash flow forced Userplane to concentrate on building products that served the needs of clients. During this time Userplane developed its expertise in web-design and development, including the IM application that would later become the backbone for its product business.

Userplane successfully transitioned from services to products by taking a vertical go-to-market strategy, concentrating its sales and marketing efforts on becoming the premier provider of communications applications to online dating sites. While the competition took a more horizontal approach to the market, Userplane was very focused on its vertical. Online dating turned out to be a good initial market because even for very small dating sites, the value proposition was clear-cut. As the social networking market emerged, Userplane was in a good position to expand into this related vertical. Having won marquee accounts in online dating like Spark Networks (operators of JDate and American Singles) and Date.com, Userplane was able to land marquee accounts like MySpace and Friendster in the social networking market. These marquee accounts further established Userplane's position in these two verticals, helping to decrease the sales cycles with other online communities.

*Demonstrated ability to scale the business*

While Userplane had established a nice business licensing and selling subscriptions to its products, it had yet to demonstrate the type of growth potential and upside that could command a premium exit valuation.

Userplane did an excellent job of diversifying its business model from custom application development and licensing fees, into advertising supported versions of the product. This created a much larger market opportunity for Userplane to pursue. Userplane CEO Mike Jones believes that there are over 3M sites that could benefit from Userplane products, and they have only penetrated about 100,000 of those to date. It was this larger market opportunity that made Userplane an attractive acquisition candidate.

So how was Userplane able to transform its model from serving a niche like online dating to a broader horizontal play? CEO Mike Jones believes a large part of the success was Userplane's ability to articulate a clear value proposition for each of the verticals it served. They went to great lengths to understand the needs of their customers and become experts in those industries. Second, they did an excellent job of making the products as self-service as possible. Self-service not only from a technical perspective, but from a business process standpoint as well. Userplane makes its pricing plans visible and up-front to potential customers, thereby reducing friction in the sales process. This is one example of how Userplane established appropriate sales interaction models for different customer types. Userplane also did a great job of product tiering – offering different types of products at different price points. The free, ad-supported product had lesser product capabilities around customization than the licensed version. This helped to protect

Userplane's subscription revenue stream while still growing the distribution of the ad-supported product.

*Balanced company decision making across technology, product, and business disciplines*

In my conversation with Userplane CEO Mike Jones, he credits the success of Userplane to the balanced decision making and management across three key areas: business, technology, and product (creative). The three co-founders of Userplane (Mike Jones, Javier Hall, and Nate Thelen) each preside over one of these three areas of the company, and each discipline is well-represented and given equal weight when making company decisions. While we didn't get into any specific details on how this company management model functions, I believe that it makes logical sense for operating an Internet business. Having advocates across these three areas ensures that the business perspective does not outweigh the user perspective, the technical perspective is not outweighed by the user perspective, etc. Perhaps this is a management model other Internet companies would be wise to adopt?

## Launch strategy and marketing

Userplane's customers are not consumers. While Userplane's end users are consumers, the company's sales model more closely mirrors that of a traditional software company, albeit one where all the customers are operators of websites. Userplane employed a number of different marketing tactics to reach these customers. As mentioned in the "Key Success Factors" section above, Userplane started by providing custom development services. As they shifted into a product company, they targeted the online dating market as their first vertical. Userplane went to online dating trade shows, spoke at conferences, and highlighted the success stories of its reference customers. Given the relatively tight nature of this business community, positive word of mouth spread quickly. Userplane also conducted a large amount of direct marketing campaigns from search engine marketing to cold calling of target sales prospects. CEO Mike Jones did a good job as spokesperson for the company, generating trade press and speaking appearances.

## Exit analysis

AOL announced the acquisition of Userplane in August 2006. While the acquisition price was not disclosed, PaidContent.org believes the price was in the $30-$40M range. While I have no first hand knowledge of the transaction, my feeling from some informal conversations is that the price was in this range, or actually a little bit higher, but clearly under the $100M mark. As for the revenue of the company, this is also up for speculation, but I would suspect full year 2006 revenues were under $5M, but above $1.5M. Userplane had about 15 employees and was cash flow positive, so it is probably safe to say they had a revenue run-rate of close to $2M.

Furthermore, if their ad supported model was generating one billion ad impressions a month at a $0.10 CPM yield, then they would be generating $100K per month in ad revenue. Assuming that monthly subscription revenue was at least equivalent to ad revenue, the company was probably targeting a revenue plan of $2-3M for the year. If I am in the right ballpark with all these numbers, the acquisition represents a fantastic revenue multiple of 10-15X current year revenue. Userplane must have done a nice job of selling their future growth prospects.

Userplane was in the process of completing a VC investment when they were approached by AOL with an acquisition offer. After some negotiation, the Userplane team decided to accept the offer rather than remain independent and take VC money. Could Userplane have continued to build the company's value and achieve an even greater exit down the road? Possibly. But given that the Userplane founders each owned a large percentage of the company, it was hard to turn down that much money at the present time. As Userplane was the team's first big entrepreneurial success, it was hard to justify swinging for the fences when you've been living paycheck to paycheck for 5 years. Anytime a first time entrepreneur is offered a payday in the $5-$15M range, that's a tough offer to turn down. Better to take a nice, solid double the first time around, and swing for the fences on the next one.

## Food for thought

Userplane had an interesting business model evolution that went counter to the approach that most Web 2.0 companies are taking today. Userplane started as a services company out of necessity, graduated to selling products, and then offered a free service to gain scale. Most Web 2.0 companies today plan to take the opposite approach: start with a free product to gain mass adoption and evolve into offering premium products and services. What were some of the benefits and drawbacks of the Userplane approach? On the benefits side, Userplane was able to establish at the very start whether customers would pay for their product and hence validate the market opportunity. This also helped them do a better job of product development. Finally, it enabled them to control their own destiny in terms of financing, company direction, and exit options. How about the downside to this approach? For one, it took a long time. Userplane spent the first year and half mainly focused on services rather than selling products. Second, it forced them to prioritize short-term revenue over building long term company value.

Obviously the best approach for any one company will vary based on a myriad of factors. However, since most of the recent case studies on Startup Review have focused on the get big fast viral distribution model, I thought it was important to point out that successes can work in the opposite direction as well. The Userplane strategy, whether it was intentional or not, is another good option to consider when determining business models. Validate market need with a pay product, control the direction of the company, and then decide how to expand for scale.

# Wallstrip.com

**written by Jay Parkhill**

Wallstrip, which produces short online video pieces covering stocks, is a fascinating and unusual business. Born of the blogosphere, founded by a venture capitalist who says he never intended to run it as a long-term business, funded with seed capital and sold less than a year later, the company fairly screams “test project”. The fact that it was sold to CBS for $5M (as reported by Techcrunch) a mere nine months after launch proves that the test was successful.

Investor/advisor Fred Wilson reports that he met founder Howard Lindzon on blogs, and Howard told me that he met the show’s producers Adam Elend and Jeff Marks the same way. Fred, Brad Feld and others invested $600,000 and the production team was sent off with a mandate to produce a short video every business day for less than $1000, and to cover high-flying stocks with humor.

Interviews conducted: Howard Lindzon, founder and Adam Elend, founder/producer

# Key success factors

*Build the distribution mechanism into the content itself*

Adam stressed to us that it is not enough to create content, post it on YouTube and hope that people will like it. From the beginning, Wallstrip was designed around the idea that (flukes and one-hit wonders aside) content should reflect the community it is made for, delivered to the places where the community can already be found, and should encourage viewers to pass it around.

Wallstrip did this in several ways. First, it picked a single subject to cover: high-performing stocks. This was a conscious and careful decision. Focusing on one subject let the company target a specific audience, the online financial community. Their stated goal was to become an “instigator of conversation” about the stocks covered within that community.

Second, it enlisted a group of prominent financial bloggers from day one to comment on Wallstrip, the videos and the companies Wallstrip features. These people were able to deliver the message about Wallstrip with credibility to their own readers.

Third, Wallstrip made its content searchable. The company recognized that video is harder to search than text and compensated by focusing on stocks, where ticker symbols and other key terms can account for a big portion of search requests. Furthermore, the type of content that Wallstrip would produce would not go stale over time, unlike other stock news that is highly time dependent. Wallstrip videos can continue to be relevant for three months or longer.

*Reaching the influencers, and building the content they like to see*

Wallstrip focused on reaching specific groups of people rather than simply going after high viewer/subscriber numbers. In the interactive web's syndication-based environment, traffic reports can show how many people viewed a stream, but very little about who those people are or even whether they watched the whole thing. Feedburner and other tools also help to aggregate the data, but there is no one-stop shop and information needs to be pulled from various sources.

Audience statistics, therefore, are fragmented and short on detail, making them hard for content creators to gather and use meaningfully. Wallstrip figured this out from the start and decided that instead of focusing on total readership, it would concentrate on reaching specific viewers - the "influencers" in marketing terms. To launch Wallstrip the team leveraged Howard Lindzon's personal relationships to engage and involve approximately 10 bloggers (each with 3,000 - 10,000 readers per day) to write about Wallstrip. They not only helped the company reach out to wider audiences, but more importantly served as a sounding board for what the larger financial community would like to see.

As Adam put it - if the influencers (in this case financial bloggers) don't like the content it's a pretty good indicator that either (a) you are targeting the wrong audience, or (b) your content isn't right for the audience you are going after. Bloggers are in need of quality content. If you can provide them with this content, then it is a win-win situation for everyone. Thus, the key is to understand what bloggers will find valuable. Wallstrip did a great job of incorporating feedback from bloggers into its content.

# Exit analysis

It became clear to us that the Wallstrip team showed tremendous savvy and a remarkable ability to articulate Internet marketing strategies - and to carry them out. CBS will no doubt gain tremendously from the team's expertise. CBS told Howard and Adam it liked the team- and especially the fact that they "knew how to get things done on the Internet" as well as the content and the communities Wallstrip built in its short history. The motivation behind the acquisition boiled down to three main things: 1) CBS liked the content the Wallstrip team produced and viewed it as a way to re-enter the financial news arena (CBS previously sold Marketwatch to Dow Jones), 2) they valued the online influencer community that had developed around Wallstrip, and 3) they valued the team's expertise. The Wallstrip team felt that CBS would be a great partner because CBS understands that media distribution has evolved, as witnessed by their efforts to build a distributed content network. Wallstrip plans to leverage these automated systems and partnerships.

The return on investors' capital in under a year is a solid result, noting that the $5M total payout didn't make a home run for any individual. The compressed timeframe almost certainly also produced the "short-term capital gain" effect that Jeff Clavier has also griped about, where the exit comes within one year from investment so that the entire gain is taxed as ordinary income at the maximum rate rather than the lower long-term capital gain rate. Sour grapes for the professional investors, perhaps, but probably more unfortunate for the production team that saw a big bunch of its stake go to the IRS.

## Food for thought

Wallstrip was founded to target a specific community with specific content. The company attracted the attention of top bloggers in that community, worked with them from the outset to develop content that appealed to them, and quickly built its name from there.

This is another way to say that Wallstrip laid out its business plan and then executed on it near-perfectly. They are probably among 5% of companies able to do that without iteration, re-starts and changes in direction. What helped Wallstrip to hit the mark so well?

I believe that foremost was its very tight focus. Wallstrip set out to accomplish a single, narrowly-defined goal: produce and distribute one short, humorous video clip per day on financial news. This let them research the audience carefully and custom-tailor the content to the audience, figuring out what the audience wanted to see and where they wanted to see it.

Many other factors went into the success. Adam talked extensively about the show's intimacy and authenticity, the company worked hard on distribution mechanics, and judging from viewer comments host Lindsey Campbell is a huge draw, but I believe the real key was that Wallstrip knew its audience intimately, developed relationships with key people in that audience to help refine the content, and then gave the audience something it really wanted to see. It sounds simple in hindsight, but Wallstrip accomplished all these things better than most.

# Xfire.com

**written by Nisan Gabbay**

Xfire provides a free instant messaging service designed for online gamers. Xfire enables gamers to detect what games their friends are currently playing and allows unobtrusive IM communication from inside the game. In May, 2006, Xfire was acquired by Viacom's MTV Networks for $102M in cash. Launched in January 2004, Xfire now has 5.6 million registered users, with ~300,000+ joining each month.

Interviews conducted: Early employee who chose not to be disclosed.

## Key success factors

*Successfully changed product direction*

When the founders of Xfire first set out to create a service for online gamers, the IM service which is today Xfire was not their original product. Xfire was actually the second product launched by a company originally called Ultimate Arena, a service that hosted online gaming tournaments. Ultimate Arena users would pay a fee to compete in a tournament or game with other Ultimate Arena users and the winners would collect their prize, while Ultimate Arena collected a "rake" of sorts for facilitating the action. After just 6 months, and despite some initial user success, the Ultimate Arena management recognized that the business would not flourish. Although they were able to attract users to the Ultimate Arena service, not many stuck around because, quite simply, users lost money when playing Ultimate Arena. Users recognized that they couldn't beat players with more advanced skills and hence there was not a strong enough value prop for the vast majority of users. Ultimate Arena appealed to gaming pros, but not mainstream gamers for this reason.
About a year after launching Ultimate Arena, the team re-launched the company as Xfire, with the new IM service as the core product. The speed at which the management team was able identify the weakness in the Ultimate Arena service, commit to a new market opportunity around communication, and successfully develop a new product was a critical success factor for the company.

*Provided a better solution for a large niche (gamers)*

Prior to the Xfire service, there were clearly a number of pre-existing IM services (Yahoo, AOL, MSN). In fact, gamers were already using these services to communicate with each other while playing. So how was Xfire able to attract so many users? Wasn't the Xfire service just another IM service?

Xfire offered just the right combination of features to solve the pain points that gamers had with their existing IM services when playing games. Existing services didn't tell them which of their friends were playing what games and where. Sure gamers could IM a friend directly and ask, but that required a lot of effort on the part of the user. Other IM services detracted from the gaming experience by not having the right form factor. Xfire's IM window was customizable, smaller, and could blend-in with the game being played. Xfire also integrates other features like voice and group voice/text chat and auto-patching of games/maps. They have a growing content site and a P2P digital content delivery system, which helps to address the full range of needs of its user base.

*Proved revenue model using new ad format*

Xfire showed great success in creating a product that users wanted, but equally important in my opinion was proving that they had created an ad product that advertisers valued. Xfire's premium exit valuation can be partially justified by the fact that Xfire had "de-risked" the business model by demonstrating that advertisers would pay a meaningful CPM for a unique ad spot. The majority of Xfire's revenue is generated from a small static image ad that sits within the IM client window while a user has the service running (and presumably playing the game). This ad format was neither of standard size nor had typical banner ad characteristics.

Xfire made a wise decision in hiring an ad sales person early in its lifecycle to help educate advertisers about the Xfire service and value of the ad spot. It is a challenging proposition to sell a non-standard ad format with an unknown brand. Furthermore, Xfire did not have the benefit of a third party service like ComScore or Nielsen to validate the usage metrics on its client. The Xfire sales team did a good job of getting high CPM rates (~$10) for a relatively unknown product. Luckily the Xfire ad spot could be highly targeted and the ad impressions easily tracked.

*Management credibility*

In general I have stayed away from pointing out management as a key success factor in the Startup Review case studies because with any successful company the team should be given credit. However, in Xfire's case I felt it was worth pointing out for a few reasons. CEO and co-founder Mike Cassidy's successful track record made it possible for the company to shift gears from Ultimate Arena to Xfire while maintaining support of its investors. A less experienced CEO would have been unlikely to pull off such a move. As a co-founder of Direct Hit (sold to Ask Jeeves for $532M) Mike was able to attract quality people and maintain employee and investor confidence through a difficult period. Dennis Fong's celebrity status in the gaming world was also important in generating promotional spots for the company and building credibility with users. Xfire's technical team also did a great job in quickly launching and scaling a distributed web service.

## Launch Strategy

Xfire's success in attracting users can largely be attributed to viral marketing and word of mouth. The company had its initial launch by seeding the service with a few thousand of its previously registered Ultimate Arena users. The service spread quickly because for any one user to derive value from the service, their friends had to be on the service too. Xfire took great care to reduce the friction points in the user registration process. For example, they did not even require e-mail validation to register, nor did they ask for any information beyond user name and password.

Xfire also grew its user base through business development deals and PR, but none of these generated immediate, huge spikes in user acquisition. These deals were responsible for adding a few thousand users in a week's time, but no single event made the company. Xfire was able to secure some distribution by being bundled with games, most notably the popular America's Army. During its first year, Xfire got three or four such deals. Xfire also leveraged the gaming celebrity status of one of its co-founders (Dennis Fong) for well-targeted promotion spots. One such promotional spot was an appearance on a German TV show for gamers that resulted in an immediate spike of 2,000+ registrations and kick started the viral growth in Germany. In fact, even today Germany is the second largest user population for Xfire, which can be largely attributed to this initial TV appearance.

## Food for thought

I think that there is a lot that can be learned from Xfire's success. The team did a remarkable job of transforming the company from Ultimate Arena to Xfire in a relatively short time period. The team didn't fall in love with its initial product and strategy and was able to quickly adapt to serve the needs of its users. They scrapped Ultimate Arena as the focus after just 6 months despite having capital in the bank to continue refining that model. Entrepreneurs are given credit for being tenacious in pursuing their vision, but it is equally important to remain flexible and open-minded to what your customers, users, or the market is telling you. The shift in product was also made possible by the fact that the team had adequate funding to continue operating despite a monumental shift in the company's strategy. For all the recent discussion around bootstrapping a Web 2.0 company, having some capital in the bank affords the flexibility for a wrong turn, course correction, or just normal product iteration. Having money in the bank doesn't mean you should spend unwisely, but having some funds for a rainy day is a valuable thing and can greatly improve the likelihood of success.

A second interesting observation is how important the initial user base can be for the success of a company dependent on viral marketing. The fact that Xfire became so successful in Germany because of one TV appearance shows just how unpredictable user acquisition patterns can be with social Internet services. One of the companies I was involved with while at Sierra Ventures was Piczo, a teen-oriented photo sharing and social networking community. Piczo's strength in certain geographies could largely be traced back to the initial users in those geographies. The lesson learned here is that the initial users are critical to defining the characteristics and growth patterns of the community.

## Exit analysis

In May 2006, Viacom closed its acquisition of Xfire for $102M in cash. With some stock considerations, the total size of the deal is probably closer to $110M. Xfire had about 4M registered users at the time of acquisition and has since grown to 5.6M in 6 months. While I don't have exact revenue numbers for the company, the valuation multiple was at a huge premium to revenue – much greater than a 5X revenue multiple. Xfire could have been breakeven 2 years after launch, but is not profitable today given extra investment in resources since the Viacom acquisition. Was such a premium valuation on current financial metrics justified? Xfire is in a good position to expand its offerings into becoming a leading social networking and content site for gamers. Its IM service has an array of interesting data that can be used to further build its online community. Thus, there is a good potential for future growth.

The motivation for the acquisition by Viacom's MTV Networks unit is fairly straightforward. MTV's target demographic is spending more time online and playing games, and less time watching TV. MTV Networks realizes that they need to beef up the digital side of their offerings to both users and advertisers. Given the impressive growth rate of Xfire, did the company perhaps sell too early? To date, Xfire had been faced with little direct competition. However, they are in a market with very large potential competitors like Microsoft, Sony, Yahoo, and AOL. Microsoft has an install base of Xbox 360 users and their 360Live service could be a good platform for launching a competing service to Xfire. Given the competitive risks, Xfire decided it was time to align itself with a larger company. Xfire's investors made a good, but not spectacular return on their investment of ~$10M - $15M. The management team did a good job negotiating strong valuations for the company and minimizing equity dilution, this was in large part due to their previous track record. With a different team, the investors would have captured a much larger portion of the equity.

# Zappos.com

**written by Nisan Gabbay**

Zappos.com is an e-commerce retailer that has successfully built a strong online brand and shown impressive revenue growth since its founding. The gross revenue numbers basically speak for themselves: 2000 $1.6M, 2001 $8.6M, 2002 $32M, 2003 $70M, 2004 $184M, and 2005 $370M.

I think that Zappos.com makes for an interesting case study because they found a winning formula for e-commerce in general: acquire customers cost effectively through search engine marketing (SEM) and make them happy enough with their experience to keep coming back. The Zappos.com details on this formula I think are worth reading.

Interviews conducted: Can't get any better here. Zappos.com founder Nick Swinmurn and Tony Hsieh, early investor and current CEO. Nick left Zappos.com in February to start a cool, new venture called Stagr, an online service for customizing clothes. Special thanks to Startup Review reader Brian Townsend, who provided me with Nick's contact info. Introductions like these is what keeps the quality of the case studies high, so please check the "Contribute" page to see how you can help out.

**Key success factors**

*Shoes turned out to be a great product for e-commerce*

When Nick founded Zappos.com he was turned away by almost all VCs because no one believed that shoes were a good product to sell online. Afterall, who would buy shoes without being able to try them on first? However, Nick stuck to his guns, backed by the fact that shoes are a $40B market in the US with $2B sold via mail order catalogs. So why did Nick turn out to be right?

Most importantly, shoes turned out to be great for SEM for several reasons. For one, people search for shoes by *brand*. Zappos.com didn't need to spend advertising dollars to build the Zappos.com brand; they only needed to get a consumer to click on an ad for Rockport or Vans shoes. Zappos.com also didn't need to educate consumers about their product – people knew shoes. Furthermore, shoes are high ticket items with good margins. The average order on Zappos.com is ~$100 and gross margins on shoes are ~50%. This leaves a lot of wiggle room for SEM campaigns. In addition to SEM, the high ticket price and brand loyalty associated with shoes also lends itself to successful affiliate marketing. Zappos.com has 17,000 affiliates driving traffic and shoe sales to their site.

When Zappos.com was founded in 1999 there was no search engine marketing, hence it was nearly impossible to know this would become such a key factor in their success. Zappos.com was smart to recognize and capitalize on the emerging SEM market. Zappos.com may still have been successful without SEM, but I doubt that it would have grown as quickly without it.

*Repeat customers through superior customer service*

Both Nick and Tony attribute the Zappos.com success to the company's near maniacal focus on customer service. Great customer service is what helped the company build a loyal customer base. Approximately 50% of Zappos.com orders are from existing customers, and an additional 20% are from new customers that were referred by existing customers.

So what did Zappos.com do to keep customers coming back? The key policy was nearly automatic upgraded shipping to next day air. Sounds kind of simple, but it was based on an astute observation. Zappos.com realized that they were competing with offline shoe retailers and not just online shoe retailers. So while the competition was sending shoes 5-7 day ground, Zappos.com decided to do it far better – next day air for free. Zappos.com was also clever in how they rolled out this policy. They didn't just announce free next day shipping on the site, they surprised customers individually. So when a customer thought their shoes would be coming in 3-7 days, they got an e-mail that said they'd been upgraded to overnight air because they were a valued customer - a small gesture that really makes an impression on the consumer. This one shipping policy strongly impacted return purchases.

** Update: Correction to the above paragraph. Tony Hsieh, the CEO of Zappos.com, e-mailed me to clarify the upgraded shipping policy. In Tony's words: "I just wanted to clarify that we don't actually do the surprise upgrade to next day air for all customers. Instead, we semi-randomly upgrade orders for most of our repeat customers. There are a few that get next day air, and many get 2nd day air. Our long term goal is to get to next day air for everyone, but we're not quite there yet." **

The other key policy Zappos.com implemented was their returns policy. Zappos.com helped ease consumer apprehension around buying shoes online by offering free return shipping and a 365-day free return policy. Zappos.com's 2005 net revenue was ~$250M, while the gross was $370M. That's a huge amount of returns. Consumers are clearly taking advantage of the Zappos.com return policies, helping to build trust and satisfaction in the service.

The toughest decision that Zappos.com had to make around customer service was eliminating drop shipping of shoes. Around 2003, Zappos.com reduced the amount of drop shipping of shoes from nearly 25% down to zero, risking a substantial portion of their revenue base. The company went through the extra expense of warehousing all their shoes themselves to better control the fulfillment process, thereby improving customer service.

Other measures that Zappos.com took to create a company culture centered on customer service included:

- 24/7 customer call center in Las Vegas, at the company's headquarters
- 24/7 shoe warehouse operated in Kentucky by the company
- 4 weeks of customer service training for every new employee (2 weeks at the call center and 1 week at the warehouse)

In Tony's words, customer service is all about to what extent you are willing to please the customer. If Zappos has run out of inventory on a particular shoe, the customer service rep is encouraged to provide the customer with links to purchase the shoe from other online retailers. While many customer call centers measure customer call durations, Zappos scores all calls on how helpful the customer service rep was in servicing the customer.

*Management flexibility in re-defining strategy and brand*

Another thing I found interesting about the Zappos.com story was how they adapted their strategy and brand the more they learned about their business. Many times I think people fall in love with their initial strategy and don't properly read the clues the market provides them. When Zappos.com got started they thought they would win based on providing the greatest selection of shoes. The company initially launched as ShoeSite.com – a good name to fit that strategy. However, Nick and Tony found that it was actually really hard to provide a large selection of shoes. Not all shoe manufacturers wanted to work with a small company selling online, so it was going to take years to build a large selection and secure inventory. That is when the team decided to focus their efforts on providing the consumer with the best possible customer service. As such, they focused the company's strategy and culture around service and re-launched as Zappos.com. This was a risky move considering Zappos was a two syllable word with no meaning to people, but one that would allow them to extend their brand into other product categories and build an independent brand around service. This decision would become an important factor in the Zappos.com success.

# Launch strategy

Zappos.com did a fair amount of offline advertising in its early days to help establish its brand with shoe manufacturers. Shoe manufacturers were apprehensive to work with a young company like Zappos.com and were concerned about how their brand would be perceived via the online channel. Thus, Zappos.com's initial marketing investment was only partially aimed at consumers; it was more to impress suppliers. Once Zappos.com had secured some shoes to sell, they could use cost effective online marketing (SEM, affiliates) to attract consumers. Philosophically, Zappos.com chose to invest in superior customer service rather than marketing. Something like 15% of their revenue is spent on customer service and another 15% spent on marketing. For most e-commerce companies, this ratio is skewed significantly towards marketing.

# Exit Analysis

Given that Zappos.com had ~$250M in net revenue in 2005, it is somewhat surprising that they haven't gone public yet. The most plausible explanation is that Zappos.com believes it can significantly increase its value by proving the success of its model in other product verticals (handbags, accessories, apparel). This would make for a much more compelling growth story for the public markets and prove that the Zappos.com brand really does stand for customer service rather than shoes only. An IPO is probably in the horizon, but more likely in 2-3 years.

I would be curious if anyone can offer a perspective on the M&A and IPO market for pure play e-commerce retailers? What are the exit opportunities for e-commerce sites in the $10M - $50M sales range? How are they being valued? Please see my post on NewEgg for more analysis on this specific topic.

In terms of current valuation, I have no personal insight into the value placed on Zappos.com by the late stage Sequoia Capital investments. However, according to Silicon Beat the initial $20M investment was done at a $200M post-money and the next $15M in July 2005 at a $300M post-money. I would take these numbers with a grain of salt, but using some very rough math, that basically translates to one times revenue. Zappos.com's first VC round of $1.1M was provided by current CEO Tony Hsieh (the former founder of LinkExchange and founder of Venture Frog Incubators) in 2000. That initial $1.1M (plus several more million from Tony) and some large credit facilities was enough to build Zappos.com to $100M+ in revenue, at which point Mike Moritz and Sequoia made their initial investment in October 2004. Zappos.com decided to take this late stage funding to invest more in their product inventory (once again, to improve upon their customer service). It's interesting to note that Sequoia was one of the firms that turned Nick down back in 1999.

# Food for thought

As a former consultant, part of my training was to try to put things in simple frameworks, so forgive me if my insight is too obvious. However, it seems to me that a successful formula for starting a retail e-commerce site is to sell a product that is great for SEM and have a sound strategy as to how to garner repeat business. For Zappos.com it was great customer service, but for other sites it might be community features or other enticements to keep people coming back. Are there any other examples of successful e-commerce companies built on this formula?

# YouTube.com

**written by Deepak Thomas and Vineet Buch**

This week's case study was co-authored by guest writers Deepak Thomas and Vineet Buch.

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## Why profiled on Startup Review

YouTube, one of the most successful exits of the Web 2.0 era, needs little introduction. YouTube's single biggest contribution is that it brought into the mainstream the concept of sharing videos online. YouTube shot into limelight when Google acquired it in Oct 2006 for $1.65B (in stock), the largest exit for a consumer Internet company in 2006 and Google's biggest acquisition to date. On a typical day, over 100 million video streams are watched on YouTube.

A few notable statistics on YouTube at the time of the acquisition:

• Fastest growing website in Internet history
• On average 100 million videos streamed per day
• 65,000 new video clips are uploaded every day
• More than 13 million unique visitors per month. An average user spends 30 minutes on YouTube and most uploaders are repeat visitors themselves.
• 58% of Internet videos are watched on Youtube
• 20% to 30% of traffic volume is from the US
• Wide range of user demographics, however the largest segment of users is the 18 to 35 year-olds.
• 30% to 40% of the content is copyrighted. There is a clear correlation between eyeballs and copyrighted content.

Interviews conducted: Interviews and public presentations by YouTube employees were used to compile this report.

# Key success factors

*Created a better user experience around sharing video clips online*

Online video definitely existed before YouTube came into vogue. However, uploading videos, sharing and watching them was quite cumbersome. The primary issues were:

• Lack of a viable storage platform: Video files were too large to be e-mailed. One of the alternatives was to upload them to a generic file-hosting service. This option was fraught with several issues including restrictions on file sizes imposed by storage providers (unless the user had a premium, paid account) and a poor to non-existent interface to share videos with friends and family. The other option was to share videos via peer-to-peer file-sharing software like BitTorrent, which unfortunately shared similar limitations.

• Mediocre watching experience - Viewers would typically need to wait for the entire video to download before they could start watching it. This was a problem not limited to just peer-to-peer video sharing. Most professional websites with video content had the same issue. Downloading the video was just half the battle. Users needed to install the appropriate video player, the free versions of which often behaved like ’spyware’. Even with the right video players and ‘codecs’, there was a fair chance that downloaded video would not play.

• Fragmented viewing experience - Assuming that the user managed to download and play one of these videos, the experience did not go much farther. A video shared on BitTorrent was a standalone unit of content, i.e. there was nothing to connect it to related video clips, say other episodes of a show that the user had just watched. Clearly, any mechanism to group similar content or organize content into catalogs was missing. Also, there was very little by way of content reviews or rating.

YouTube essentially took a problem with a few pre-existing, albeit clumsy solutions, added some engineering ingenuity and lots of creativity to come up with the best working solution. Content suppliers, i.e. those uploading videos could now upload video effortlessly. They could tag uploaded videos with keywords. On the consumption side, by adopting a Macromedia Flash-based video player embedded on a web-page, which played the video almost instantaneously, YouTube eliminated the need for downloads and local media players. Users could now search for videos by keywords, share them by mailing links to the videos, and also rate and comment on these videos. Consequently, popular videos bubbled up to the top in an organic fashion. Notice how, besides the player, other features were essentially attributes of sites sharing pictures, Flicker for example. YouTube was able to adopt what worked in the world of picture-sharing to the world of video-sharing.

*Distribution of popular content (often copyrighted) drove adoption*

Distributing popular and hard-to-find video clips was clearly a success factor. Clips of the popular, long-running television show, Saturday Night Live was a particularly significant example. A free-form platform that allowed users to upload content had to contend with copyright violations. While this is one of the oft-repeated complaints about YouTube, it should be remembered that the founders decided to go ahead with the idea despite the eventual failures of the likes of Napster and Kaaza. While the ethics of such a strategy would require a lengthier discussion in an of itself, the founders clearly took a chance with something that other entrepreneurs might have balked at.

*Viral customer growth due to widget marketing*

YouTube allowed users to easily embed any hosted videos on web pages or blogs. This turned out to be particularly popular with social-networking websites, especially MySpace. The inbound links from these 'widgets' also helped YouTube increase its page rank on Google, thereby driving traffic via natural search..

*Chose the right technology platform for the desired user experience*

While the technology platform used by YouTube was not particularly remarkable, it was designed to solve the problem at hand. The technology concept was to encode videos in the Macromedia Flash format and take advantage of the millions of computers which already had the Flash player installed on it. When Macromedia launched Flash 7 with video playback capability, YouTube was among the first to exploit this feature. Further, based on the team's past experience working for PayPal, they were able to develop a platform that scaled quickly to handle the viral growth in content and traffic.

*Exceptional market timing due to the perfect storm of environmental factors*

Several environmental factors converged leading to YouTube's success:

• Bandwidth became cheaper, faster and ubiquitous. It would have been impossible to gain an audience the size of YouTube's as recent as five years ago due to the lack of broadband penetration.

• Online social networks had attained critical mass. YouTube took off in a big way when MySpace.com users started embedding YouTube content on their pages. Members of these users' networks in turn started adopting YouTube. YouTube was able to leverage an existing social network rather than build one ground up.

• Producer-side technology became more accessible: cheap digital video cameras could now be connected to computers thanks to USB 2.0/Firewire becoming available on most personal computers. Also, use of cell-phones with video cameras became more prevalent.

• A shift in demographics helped: a post dot-com generation was seeking an online experience that placed a lot of emphasis on entertainment.

• Platform-side technology had become cheaper: it became possible to store, manage and serve large repositories of content at a fraction of dot-com era prices.

## Launch strategy and marketing

Like most startups in the consumer Internet space, YouTube did have to survive a couple of missteps before discovering the winning user acquisition strategy. The founders started work on YouTube in Feb. 2005 and a public beta was launched in May 2005. YouTube started out as a video clone of HotOrNot.com targeting the young adult market. However, the initial site was attracting very little traffic. A site revamp in June 2005 focused on:

1. Creating a general-purpose video-sharing platform
2. Increasing number of views by offering 'related' content
3. Encouraging interaction between users
4. Offering an external video player that could be embedded on a site like MySpace.com

The ability to embed the external player on any web page turned the tide for YouTube. Once MySpace.com users started adopting YouTube en masse, MySpace.com blocked video links to YouTube. However, MySpace caved under pressure from MySpace users and reinstated access to YouTube content.

The other key driver to YouTube's user acquisition was the frequency at which popular video content was distributed in a viral manner. According to one YouTube employee: "Once traffic picked up, roughly every two weeks or so a video would become wildly popular. Soon the time between these super-hit videos started shrinking. The site took off at a scorching pace." Video footage of the Southeast Asian tsunami resulted in one of the largest traffic spikes. Other popular clips included Jon Stewart on Crossfire and the infamous Janet Jackson Super Bowl video.

YouTube remains an interesting study in marketing a consumer internet service. While initial responses to the site were tepid, the June 2005 site revamp resulted in viral growth. Some of the initial promotional tactics included posting an advertisement on CraigsList.com, requesting aspiring women models in the Los Angeles area to upload their personal videos. However, this proved ineffective.. After the VC investment, YouTube started giving away an iPod Nano per day for several months. This promotion was actually very successful and helped to further build the user base.

YouTube most likely had both viral and SEO (Search Engine Optimization) factors working for it. Searches for 7 out of 10 of the top-10 popular music albums show up as YouTube hits on the first Google search results page, indicating the SEO factor at play.

## Exit analysis

In Oct 2006, Google acquired YouTube for $1.65B in stock. The working arrangement is that Google will focus on the technology, while the YouTube team will focus on the content. Google has helped to make YouTube videos more searchable, including tighter integration into Google's video search product. As cameras become more and more powerful, YouTube video resolution will need to keep pace by encoding videos at higher and multiple bitrates – this where Google's infrastructure advantages come into play.

The reasons behind Google's acquisition seem quite intuitive. YouTube falls in line with Google's strategy of converting user visits to its properties into contextual advertising revenue. YouTube's huge user-base combined with its own user base gives Google formidable market power and the ability to influence consumer behavior. Also, while the prospect of YouTube being acquired by one of the media giants was slim, the acquisition did serve to deter competitors like Yahoo from making further inroads into the online video-sharing market.

For Sequoia Capital, YouTube's main investor, the investment turned out to be a huge success. Sequoia had initially invested $3.5 million at a pre-money valuation of $15 million and another $8 million in a second round of funding. Sequoia is estimated to have owned approximately 30% of YouTube, for a stake valued at $495M. This represents a 43X return on invested capital in less than 2 years time. Sequoia was chosen by the YouTube founders due to pre-existing relationships and the fact that Sequoia apparently 'got' the concept of YouTube early on. According to YouTube co-founder Jawed Karim, during YouTube's Series A fundraising process Sequoia impressed the YouTube team by having Sequoia's entire staff experiment with the YouTube product.

Was the $1.65B acquisition price justified? Revenue projections for YouTube have not been disclosed, however Fred Wilson has estimated YouTube's revenue figures potential at $400 million annual revenue, $150 million net annual revenue. Another revenue analysis pegs current monthly revenues at $7.5M. The newly announced revenue-sharing model that rewards users who upload content, only serves to muddy the valuation picture even further.

## Food for thought

One of the unique takeaways from the YouTube case is that of using widget marketing to achieve viral user growth. Recently at the CommunityNext conference, Max Levchin remarked that viral marketing on the Internet has been driven in three waves: E-mail, Instant Messaging and Social Networking. YouTube was early to discover and exploit social networking sites as a viral medium. The next venture that discovers a new medium for viral marketing will likely create the next big thing on the Internet.

A few other topics to ponder for start-ups competing in the online video market:

*Time for a change*

As cameras become more and more powerful, video resolution on YouTube will need to keep pace. Google doesn't seem to be addressing this issue so far. Eventually Google may move to encoding at higher and multiple bitrates. However, the next tipping point in online video might be the confluence of high-resolution, widescreen video cameras, with cheaper bandwidth capable of handling the higher-resolution content. This combined with the ability to render online video on TVs and the fact that wireless networking technologies such as WiMax will improve bandwidth to the last mile, the possibilities are endless. WiMax set-top box that connects to open-standard video streams over the Internet anyone?

*Top videos vs. personal videos*

Most visitors go to YouTube to watch a specific video that they have been referred to, and they typically end up watching related content. Videos of family reunions or a day at the beach are not the most popular ones as entertainment content, but such videos remain important to consumers. Youtube's current video size and encoding limitations might offer an opportunity for a start-up.