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# THE WALL STREET TRANSCRIPT

**Questioning Market Leaders For Long Term Investors**

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## **ANALYST INTERVIEW**

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# Online Content Companies

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## SECTOR – INTERNET SERVICES

**(NAT832) TWST: To begin, would you give us an overview of your coverage at Kaufman Brothers?**

**Mr. Kim:** I cover the large entertainment and media names, **AOL Time Warner** (AOL), **Viacom** (VIA), **Disney** (DIS) and **Yahoo!** (YHOO). And I'm going to fill out the rest of my coverage in that sector shortly.

**TWST: How have the online content stocks performed in 2001?**

**Mr. Kim:** Abysmally. In my opinion it's not an economically viable sector. First of all, let's clear up some confusion in semantics. I would argue that **Yahoo** is not a content company, it's a distribution company; it has a wide technological platform. It all depends on how you characterize it, but online companies that just purely focus on content, like perhaps **MarketWatch.com** (MKTW) or those kinds of

names, will have a very tough time in the online space, and that's pretty much been evident in the last couple of years.

**TWST: Have there been any strong performers?**

**Mr. Kim:** I would say the only one that remotely resembles online content that has been relatively successful is probably **CNET** (CNET), but I'd also argue that they too are a distribution platform for technology buyers and sellers. So again it's more of a platform rather than just content. Content is just a means to an end, the end meaning owning the channel. And that's what **CNET** does in the technology vertical.

**TWST: What is causing such weak performance in the group?**

**Mr. Kim:** It's just a flawed business model. I guess the best comparison of the Internet as a medium is probably the magazine business.

### Highlights

*Paul J. Kim says the online content segment is not an economically viable sector at this time because of its flawed business model. It involves not just selling the content, but rather getting a certain critical mass and using the content as a kind of loss leader or as a cost of goods sold, to own an attractive distribution channel that can actually be monetized. Content, he says, is not the end goal; content is just the means to get there. It is not a stand-alone business but more an issue of enhancing a company's core business. He feels the deck is stacked against online content as pure plays and it is not just a cyclical downturn. If you just sell content and don't have an ability to monetize beyond the content, it is difficult to become an ongoing economic business.*

*Companies include: AOL Time Warner (AOL); CNET Networks (CNET); Yahoo! (YHOO).*

That's very fragmented and the Internet is even more so. You can argue that the Internet is infinitely fragmented, so to make any kind of economic value out of this medium, it requires one to amass a certain scale, and that is the only way one can make money on the Internet. It's not necessarily about selling the content, but instead getting a certain critical mass and then using the content as a kind of a loss leader or as a cost of goods sold, to own a particularly attractive distribution channel that you can actually monetize. So content is not the end goal; content is just the means to get there.

**TWST: With the stocks performing so abysmally, how do you approach the group?**

**Mr. Kim:** I would say just structurally it's not a stand-alone business. Maybe it can exist in an **AOL Time Warner** framework, as a sort of ancillary to their core business. It's more of an issue of enhancing your core business, but it is definitely not a core business. Selling content online is just ridiculous, as is also the case in the offline world of media.

**TWST: Who are the core businesses? How have they performed?**

**Mr. Kim:** The most successful business is **AOL**. That to me is a telecom business, it's strictly an ISP at the end of the day. They use content, or their network, or environment, or whatever you want to call it as a way to provide value for the consumer. The only way to monetize that value is through distribution, owning the ISP. That's in essence what they are; they're a telecom company that owns a vertically integrated rela-

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tionship with the consumer. They provide everything, the telecom access, the actual content, the services, commerce, what have you. The way you monetize that relationship is through subscriber fees, because if it didn't have that component, it would be harder to monetize that contact that the company has with the consumer. The content is sort of the bait you use to get people into your environment. That's how you monetize content, just like in the offline world. That's the core business of any entity that is trying to make money on the Internet or on any other medium.

**TWST: Are there any online content companies that you are enthusiastic about?**

**Mr. Kim:** The survivors are there for a reason. It's survival of the fittest, and they have proven their business models. So along those lines, it's **Yahoo**, **eBay** (EBAY), and even **Amazon** (AMZN). To reiterate the investment theme, all the aforementioned companies are platform companies. **eBay** is a dominant provider of auction. It's putting together buyers and sellers; it's just a gigantic scalable platform to enact commerce. Along the same lines, that is sort of what **Yahoo** is doing. It's a massive distribution platform where it has a massive critical mass to monetize its user base. I would argue they haven't done a very good

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job monetizing this; I think they left a lot of money on the table. But with new management and new focus, they're finally pursuing that end much better.

**TWST: Do the surviving online content companies have any similar characteristics?**

**Mr. Kim:** They cornered the distribution channel in whatever they're trying to do. In auctions, **eBay**; following the retail commerce model is **Amazon**; and kind of an **AOL** without the ISP model is **Yahoo**. But I think the commonality that they share is that they've blocked out most of the other competitors and they have a critical mass — they are in essence the purest form of distribution. They are just platforms in which people can interact, communicate, and enact commerce.

**TWST:** You had mentioned **CNET** before as a strong performer in the group. How would they compare?

**Mr. Kim:** I would say that they are a little more narrow in scope, but definitely they are pursuing the same end goal, except that they focus on a vertical which one can argue is relatively lucrative — the technology area. So if you're a **Compaq** or **Dell** and you want to reach consumers, **CNET** can provide access to their distribution platform. So again, it's a platform in which to enact commerce and interaction. Obviously there is a lot of rich content but it's there so they can monetize the marketplace of buyers and sellers that they have amassed. Through the years, they've established a leadership position in the lucrative and sizable technology vertical.

**TWST:** What should investors be avoiding?

**Mr. Kim:** Everything else. It is such a fragmented industry and a fragmented medium that it is difficult to reach critical mass. The old argument was that the Internet is going to liberalize everything and it would do it in a very democratic way. I would say it's exactly the opposite. It's a highly un-

democratic medium, where if you're small, chances are you can't make a critical mass large enough to make a business. Thus, the advantage accrues to those who are larger. It's a tough place to try to make money. You can try to focus on small verticals, much like niche magazines, but chances are it's very hard to make money pursuing that strategy. Whereas most traditional media, like television, started with few choices and then grew to

more choices (the television medium fragmented over time), the Internet was exactly opposite. It was so fragmented initially that it had to have some mechanism to limit choices for consumers so that a business could make money on the medium. That's exactly what happened with **eBay**, **Amazon** and **Yahoo**; those companies took the infinite nature of the Internet and made it more palatable, more finite, to make the business actually make sense.

***"It becomes a market share game for time for media companies. In that sense, for the Internet, as the secular growth rate of time that people spend on media is not increasing, it's a different competitive environment than it was 50 years ago when television began. So it has to carve out a niche for itself and it has to provide some value for the consumer. If it doesn't, then no one is going to use it."***

1-Year Daily Chart of AOL Time Warner



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST:** Will the Internet replace television as a dominant medium?

**Mr. Kim:** No. I would say the Internet is probably another attractive media segment, but it's not going to dominate the world. I think television will continue to be the dominant electronic

medium. The metamorphosis, I believe, will continue to happen in this medium, but I look at the Internet as more of a functional medium, not an entertainment medium. So to suggest that streaming media through broadband could replace the television just seems to me pure folly. I seriously doubt that will occur. The television and the computer perform their separate functions very well. I think in that, as a passive medium, television will continue to garner significant economic value. So for the Internet, I think it's a powerful niche medium in the entire media landscape, but it's not going to take over the world.

And now we're seeing some convergence with **USA Networks** (USAI) as they're now an isolated business from **Vivendi** (V). And that company, with Home Shopping Network, is looking for acquisitions. It just naturally follows that they will do some type of transaction with likes of a **Yahoo** or an **Amazon** or **eBay** to try to kind of bridge the gap. But I think that's more an exception rather than the rule.

#### 1-Year Daily Chart of Yahoo



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: Are we seeing anything else as far as convergence or M&A within the field?**

**Mr. Kim:** In terms of a massive scale? No. There are probably small companies that are lead-

ers in their small verticals that are not necessarily viable by themselves but would make more sense in a large entity with shared costs and a large infrastructure. I think a **Yahoo** and a **USA Networks** will pursue those kinds of deals, so I think you'll just see natural progression of those types of deals happening over the next couple of years. These large entities will get even larger and the M&A cycle will continue to occur. But there are not that many pieces out there that are attractive on a large scale today.

**TWST: What is the future for the Internet?**

**Mr. Kim:** At the end of the day people like to compare the Internet with television but it's a comparison of two periods of time in terms of development and environment that can't be compared. When television initially developed, we had a dearth of choices; before television there was basically print and radio. So there was a lot of time usage that one could grow into for the average household. That's what television did. The medium didn't have to take market share away from any other medium because the average household had an excess of time to spend on media, and the total number of households was growing strongly. I would say since the early 1990s, that time that the average person spends on media has become saturated. We're maxed out basically, unless one wants to work less or sleep less.

So now it becomes a market share game for time for media companies. In that sense, for the Internet, as the secular growth rate of time that people spend on media is not increasing, it's a different competitive environment than it was 50 years ago when television began. So it has to carve out a niche for itself and it has to provide

***"I would say covering just content, I guess from an investment perspective, is as narrow as covering just children's books. The time came and went. It was an interesting party and the hype was great, but it was not based in reality. So yes, investor interest is low and getting lower, and right now if you're going to play 'pure Internet,' the choices are shrinking."***

some value for the consumer. If it doesn't, then no one is going to use it.

Now people are pursuing convergent strategies like AOLTV, which is a silly value proposition for the mass market; it is basically duplicating the online function on television. That's a redundancy; that's not creating value that would want to make someone switch their time allocation to something else. That's the challenge of a new medium — any new medium that now wants to establish some presence. So that's the challenge the Internet faces and will continue to face, much like any other medium.

***"The real question is how to provide value to the subscriber so that they pay extra for your services. So that's how you monetize it; I think that's where things are headed for the AOL division. It's not content for content's sake. It's never been that, even in traditional media. You make money by distribution — on cable networks, television stations, radio stations — and that's pure distribution. Owning spectrum."***

the start of any medium, it takes a while for the infrastructure of buying and selling inventory to take hold. It takes at least 10 years or so, ultimately so I think it's not as easy as it looks and introducing a new medium to the advertising community is very difficult. It takes a very long time. I think eventually it will occur but I think one of the lessons that we've learned over the last couple of years is that hits don't necessarily translate into dollars.

**TWST: What is the Internet offering advertisers today? Are there any new innovations?**

**Mr. Kim:** Yes, the Internet companies that focus on Internet media were very arrogant before because when a lot of these dot-coms went public, these companies had a lot of money to funnel directly into **Yahoo** and **AOL**. That money is long gone. So now, as a business, one has to look at clients as clients, and actually try to figure out how to add value for those clients. So that's happening right now, which is a good thing. And that's what **AOL** and **Yahoo** are doing right now, trying to create sponsorship and packages that actually have impact for their advertisers. The whole point of advertising is to have a relationship with a certain customer and try to sell products and services. So one has to provide tangible results, especially for a new medium that's trying to compete with the old guard. You have to prove your value as a medium.

I think that will occur for the Internet. It's not necessarily going to be banner ads, and I think people mock banner ads, but one could argue that television ads aren't very effective either.

So looking to the Internet space, there's such powerful interactivity there that I think once

1-Year Daily Chart of CNET



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: Are there any other issues that have an impact on online Internet media in 2001?**

**Mr. Kim:** One issue of — I would say not necessarily just 2001, but probably the last couple of years — is advertising. The buying and selling of advertising is not an efficient process, so to suggest that once you have a certain amount of page hits, that you can sell that as advertising is unrealistic because the advertising industry doesn't work that way. You need a critical mass for the advertising industry to become interested, so like

the medium develops (half the households in the US are Internet-enabled), once they get past the majority level, maybe two-thirds or three-fourths, then I think you have a better chance to figure out how you can add value to an advertiser and marketer. But that takes time and I think that will occur, because naturally the immutable law of advertising media is that the dollars follow the eyeballs eventually. Once you have a certain critical mass, you have the ability to package that and sell it to an advertiser or marketer; that's when I think the value of the Internet will finally be apparent. I think it's going to happen but it will take time.

**TWST: There does not seem to be much room for online content companies to move. What can they do to grow?**

**Mr. Kim:** I would say generally speaking if you're a small company, not much. It's a tough game to play and eventually either you will provide enough value to a larger acquirer or, if you're still small and they can replicate what you're doing cheaper than the price that they can buy you at, then you're gone. So it's a very tough environment, much like the magazine business, and the failure rate is so high in that business because the market is saturated and mature, and it is hard to introduce a new vertical. So scale matters a lot in media in general, but I think it matters even more on the Internet. So if you're a small provider of online content in a small vertical, it's going to be a tough game to play because you have no differentiated product and not enough critical mass to make any economic value.

**TWST: What about the larger, dominant companies? How can they grow?**

**Mr. Kim:** I would say the large ones have a much better chance; I think eventually a player will have to sell out to a larger competitor at some point, just because scale is so important in media

right now and all the larger media companies or "traditional" media companies are consolidating. Furthermore, all of the advertising agencies and the marketers are getting larger and larger. So to be a small fish in this land of giants is a tough proposition. Your business may be viable, and you may have a great set of assets, but eventually it's tough to compete with such strong competitors up and down the value chain. So eventually they have to merge or sell to get critical mass, just to survive and grow. That's an inevitability.

**TWST: Are there any other issues affecting the space that we should touch on?**

**Mr. Kim:** There are still some pure-play Internet content believers out there, but I think they're not necessarily looking at the facts of what the environment is telling them. I guess a good example is the acquisition of **HotJobs** (HOTJ) by **Yahoo**. **HotJobs** occupies a very attractive vertical. That's an area where one can make a lot of money, but as a stand-alone entity, it has less value than perhaps it would within a larger network like **Yahoo** or perhaps as a stronger vertical with **TMP Worldwide** (TMPW). But either way, it's hard to be just a lone provider and an attractive vertical — you will eventually need more capabilities and more mass to really extract value, or else you'll just be sandwiched in between very strong competitors.

**TWST: Is there any investor interest left for online content?**

**Mr. Kim:** Pretty much nonexistent. But I would say covering just content, I guess from an investment perspective, is as narrow as covering just children's books. The time came and went. It was an interesting party and the hype was great, but it was not based in reality. So yes, investor interest is low and getting lower, and right now if you're going to play "pure Internet," the choices are shrinking.

**TWST:** Can investors look to get involved in the core businesses, such as AOL?

**Mr. Kim:** If you broaden the focus a little bit and include AOL, then definitely yes, but I would say the magic of cross-pollination and convergence is still yet to be proven, and I'm a skeptic toward that with respect to that dream anyway. There's nothing magical about convergence. If you're just cross-pollinating, basically all you're doing is selling inventory to yourself. And there's an implicit cost to doing transactions like that. So nothing comes free, whenever you're talking about media because you're always giving up opportunity costs for promoting your own products.

So the proof is in the pudding in terms of looking at each company separately. For AOL, it's not necessarily the content that really drives value. It's about how one can take advantage of broadband as that gradually occurs in the next five to 15 years and how one can make that transition on the distribution side. So how does the company transition from the dial-up subscriber where it has complete control to a broadband environment where it necessarily does not. If AOL goes through a cable plant that's not Time Warner Cable, the cable operator has the control as an ISP to the consumer and AOL is one step removed from that. So then how does the company manage that transition, that profound transition in distribution? One way to do it is through providing compelling services, and content is also part of that.

But the real question is how to provide value to the subscriber so that they pay extra for your services. So that's how you monetize it; I think that's where things are headed for the AOL division. It's not content for content's sake. It's never been that, even in traditional media. You make money by distribution — on cable networks, television stations, radio stations — and that's pure distribution. Owning spectrum.

**TWST:** Is there a final word you would offer to investors as they look at just specifically online media? Is there any hope out there and, if so, what kind of time frame can they look for to get involved in the space again?

**Mr. Kim:** I would say the deck is stacked against online content as pure plays and it's not just a cyclical downturn, it is repeating what media in general has shown historically, which is if you just sell content and you don't have an ability to monetize beyond the content, it's tough to be an ongoing economic entity. So I think online content was just flawed to begin with. So as we saw in the magazine business and in movies and pretty much all of media, to be a pure content provider is a tough business to be in.

**TWST:** In closing, would you like to touch on the rest of the companies in your universe? How would you advise investors to view the media sector as a whole?

**Mr. Kim:** I would say looking a little bit out, it's a diminished revenue environment. The industry is getting more mature and the prospects for top-line growth are diminishing. That's why you're seeing a lot of M&A activity. They have to merge to reduce costs and increase negotiating leverage. It's not because they see these great cross-pollination opportunities. It's because they see that all of media is maturing and they need to merge to basically effectively get rid of competitors and lower the cost base.

So in that sense, from an investment perspective, I think it's not the best strategy to just buy and hold, like media investors did in the mid-1990s. It was incredibly successful but that environment was completely different; the media companies had very unfocused strategies at that time, they were highly levered and they were trading at very low multiples. But I think that the majority of the valuation discrepancy has been realized over the last three to five years

and now you're at a point where valuations are relatively full. The secular growth rates are diminishing so that if you're investing in the sector, you have to be more selective and more nimble because in that sense, valuations become more important than any other kind of investment criterion. So I think that the primary consideration when investing in the sector is to figure out when to buy low and sell high.

**TWST: Thank you. (JK)**

*Note: Opinions and recommendations are as of 1/8/02.*

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