What Is Google Worth?

Published : December 03, 2003 in Knowledge@Wharton

Anyone with an insatiable craving for a dot-com-era hype-fest need not look far. The prospect of uber-search engine firm Google Inc.'s considering an initial public offering seems to have Wall Street salivating. As rumors swirl around the five-year-old privately held company -- $800 million revenues? $200 million profits? takeover interest from Microsoft? -- handicapping its future is becoming something of a parlor game. Analysts are struggling to put numbers on intangibles, while technology boosters hail the potential IPO as if it were the second coming.

The frenzy intensified this month when the company approached several major investment banks recently for exploratory discussions. Some reports even claim that the firm is toying with an unconventional crowd-pleaser: An open auction to distribute shares, allowing small investors to get into the game.

Grand visions aside, how sound is Google's business model in the face of partners-turned-possible-competitors? While Google still powers portal giant Yahoo!'s Internet search results, Yahoo!'s acquisitions of Inktomi (search technology) and Overture (paid search listings) signal a coming change in strategy. Even Amazon has entered the fray, announcing the creation of a new group to work on achieving best-in-class shopping search tools, which could put it in competition with Google's "Froogle" product finder as well as Yahoo!'s Product Search function.

With all this plus Microsoft's MSN to worry about, can Google emerge as a viable and robust product that can stand on its own two feet -- or is all the IPO excitement merely a case of the emperor's new clothes? Experts at Wharton point out that the company has enormous strengths because of its unique search technology and powerful brand. Still, they say that Google faces huge risks because economic models on the web tend to be volatile and that makes the task of predicting future cash flows -- and hence the company's value -- particularly challenging.

Built to Go Solo?

Although countless web surfers use Google each day, the nature of the company's product causes some to wonder whether it shouldn't simply be, well, part of something else. After all, its main function, search, can be added on to a web browser or other software.

Not so fast, says Wharton marketing professor Peter Fader. "It's easy to justify Google's being a stand-alone company. If you look at all the things it's doing -- search-word optimization, news, 'Froogle,' etc. -- it's a set of services that are mutually consistent. It leaves open the possibility that the company can just keep adding best-in-class unique services. So I can definitely see Google competing with Yahoo! as a complete portal solution. The first thing I do on my own computers and on the computers in my classroom is change the homepage to Google. It's inconceivable that I'd consider doing that with any of the others."

Raffi Amit, professor of entrepreneurship and management at Wharton, agrees. “Look back at the early days of Yahoo!, eBay, and other companies, and look where they are today,” he notes. “No one thought the eBay auction engine would make it as a stand-alone product, for instance. Google already has news and other features. So the company can develop the search engine, the paid listings, the rankings optimization, and so on, and turn it into a major portal. The question is whether Microsoft can do to Google what it did with Netscape -- that is, with its marketing and technology power, develop an algorithm, add it to Internet Explorer and crush Google. That’s the risk an investor takes.”

So far, Google has been amazingly resistant to rival threats. “About every six months you see some new offering that’s trying to compete with Google, like Teoma and others,” says Fader. “But there’s been no reason to switch. Microsoft really can’t compete with Google on that basis. It occupies a relatively small niche. Even if it’s selling keywords, no one’s talking about Google as the 900-pound gorilla. What’s especially valuable is the goodwill it has accumulated. Microsoft doesn’t have that installed user base, nor does it have carte blanche to do whatever it likes. If Google is perceived as selling out, however, people will turn on it.”

“There are lots of competitors in this space, and Google still manages to win, based on its technology and its brand,” adds Wharton legal studies professor Dan Hunter. “The built-in-the-browser issue is a non-starter, since the desktop search button is available to all systems that provide for plug-ins. Google has this, and it's been a big success for them. Microsoft could block plug-ins of this sort, but then they'll face an antitrust claim that would be a strong one against them. Since they just went through a bruising antitrust loss on the browser side, I wonder whether they would want to push their luck again with the Department of Justice. I doubt it, but no one ever went broke betting on Microsoft’s using its monopoly powers.”

“Google has survived many other search engines,” agrees Wharton marketing professor Jagmohan Singh Raju. “The fear people have as users of Google is, once it’s run like a public company, will the search engine become less important versus other revenue generators?”

The Case for an IPO

Amit notes that Google’s incentive to go public is no different from that of other companies. “The IPO is to raise money and give liquidity to Google’s investors; it would be a means of giving investors a return. Of course, it leads one to ask, do they need more money? Yahoo! and Microsoft’s MSN are two big competitors, and both have deep pockets and a diversified range of businesses. They can invest in technology and marketing. As an independent company, Google must come up with a budget to compete effectively. Being publicly held will deter potential advances from Microsoft and Yahoo!.”

Amit also sees a Google IPO as a potential industry stimulant. “I’d suggest that perhaps, since it is a technology player, Google’s going public will revive the tech sector and facilitate the continuation of innovation and the ability of new products to get to market. The IPO market for tech companies was basically shut down for the last two to three years. Maybe this will be the beginning of the resurgence: Seagate Technology reentered the public market in December 2002, and today it trades at $19, well above the IPO price of $12. Google’s IPO might have positive externalities on the entire technology sector. Investors could regain confidence to put money in it, which would in turn be good for jobs, productivity and the economy.”

“The prime advantage of going public is access to capital,” says John Percival, adjunct professor of finance at Wharton. “It’s not clear, however, that there’s a necessity here for access to capital. One could say that maybe even Microsoft didn't have to go public. Part of the mystique of going public is being able to say to employees that they're millionaires because they own a portion of the company, and then getting the liquidity."

Going public does make it easier for Google executives to go out and acquire firms, adds Percival, "though it's not clear who they'd acquire. It's an interesting service, and okay temporarily, but it's really unclear what the cash flows will be. It's not clear that paid listings, or advertising, will be enough as a business model."

At What Price?

When it comes to valuation, says Amit, investors have learned their lesson. "The bubble burst before, so they'll be more cautious this time." Nevertheless, the numbers being tossed around in the press -- anywhere from $10 billion to $25 billion -- have been high enough to spark chatter about new bubbles.

"One approach to valuing the company would be to try to split it into its various businesses -- search engine, paid listings, ads, etc., and figure out what each is worth," says Raju. "My sense is that the valuations today will be more reasonable. We've learned how to value these things, and people might be more conservative."

But valuing the company by breaking it into parts only works if there's nothing in the combination of all the parts that needs to be captured, cautions Percival. "At the beginning of the dot-com boom we were told there was something new there, that the old ways didn't work, that you had to use new metrics. But there is only one way to value a company, and that is by figuring out the future cash flows it will generate.

"Are the numbers inflated? Well, you can take the number and back into it – that is, figure out what kind of cash flows it would have to generate, to get such a number," explains Percival. "You might find that even if those cash flows are feasible for a little while, it's not sustainable -- there's simply not enough demand for the product or service to justify it. And if there is, at some point someone's going to try to copy it at a lower cost."

Going (Really) Public

Amit finds the company's proposed auction model fascinating. "Instead of going the traditional route, hiring a syndicate of investment bankers, Google may auction off shares, thereby letting the market decide the price. This isn't a new idea; several years ago, a company was formed by William Hambrecht -- who co-founded Hambrecht & Quist -- called W. R. Hambrecht + Company. The key concept was their 'OpenIPO,' which allows individuals and institutional investors to bid online for shares. In such a system, everyone ends up paying the auction-determined price."

"All the talk about having an IPO auction, even if it's just talk in the end, gives Google executives some credibility – they look like they're thinking outside the box," adds Fader. "They're using words that are more appealing to their customers than to investors. That's a credit to them, or at least it's a great PR strategy."

Credibility, however, is relative. "There are tradeoffs," warns Amit. "From the standpoint of the issuing company's shareholders, it would save a lot of money and put more dollars into the pockets of existing investors -- since the valuation would not be subject to the usual 15% IPO discount. But what matters isn't so much the price at the initial offering; what matters is what happens in the longer term to the company's shares, which sometimes depends on whether investment bankers will cover it. If you auction off the company, chances are no company's analysts will cover you -- and institutional investors largely depend on analyst coverage. Even small investors might be anxious: One advantage of having a top-tier house as the investment bank for the issuing company is that investors can to some extent rely on their expert opinion as to whether it's a good thing to do."

But, Amit notes, Google might prove to be an exception: "All this would be less of a problem in a large IPO like Google's, since there will be a lot of trading and thus there would probably be coverage anyway. So it's possible that what might be in the cards is a sort of hybrid offering. Google could allocate some shares to the auction and offer some through the traditional investment banking route. That would put pressure on the investment banks not to discount too much, but at the same time provide assurances to the small investor that reputable firms are backing it. I haven't seen a precedent for such a hybrid, but it might be a very interesting model to consider."