

Search-Engine Marketing: Growth Companies in Play

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By Ken Sonenclar

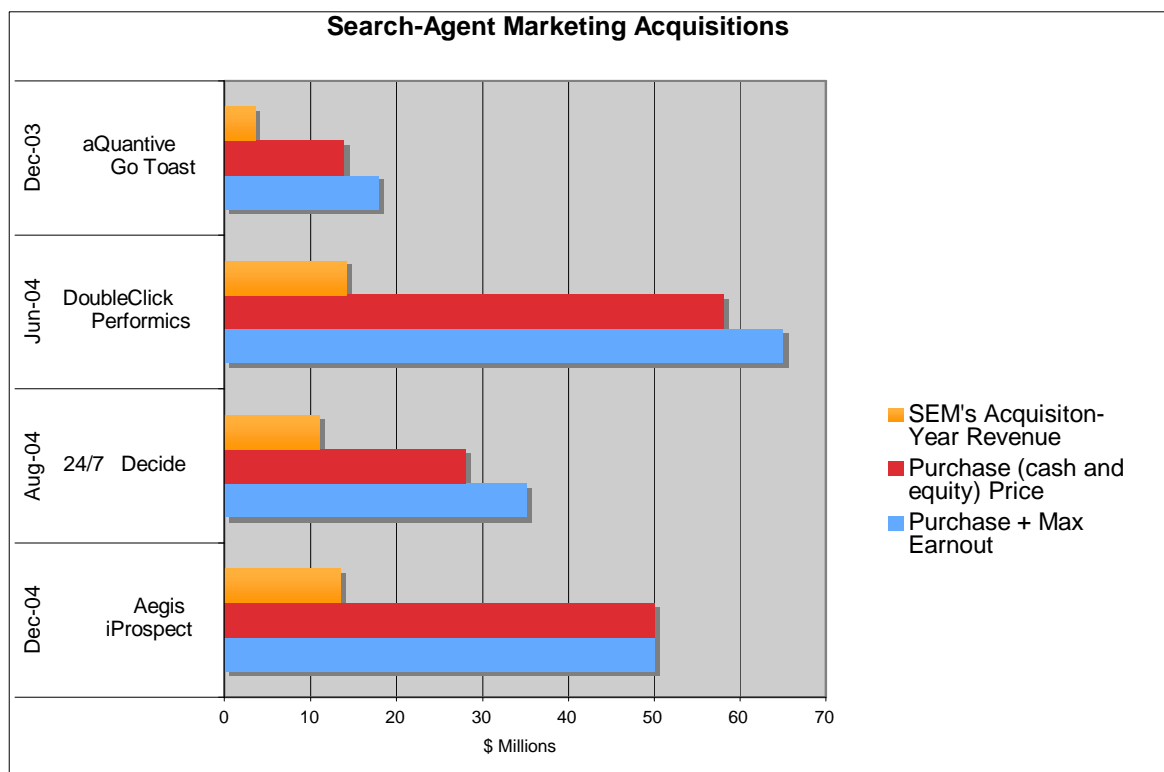
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Demand for the rarified skills of search-agent marketers is surging. Several specialist firms have sold for hefty multiples. What's behind this rush to grab the talents, tools, and clients of these small but growing companies, pushing up their valuations in the process? What does the future hold for this sector?

Since UK ad agency Aegis plc shelled out \$50 million to acquire high-flying search-engine marketing firm iProspect last December, the online world has been waiting for another shoe – or maybe a whole rack – to drop.

Aegis's acquisition, made on behalf of its Isobar unit, secured one of the stars of search-engine marketing (SEM) for an agency that is assembling a full-line digital ad/marketing network intended to service clients worldwide. The front-loaded payout is spread over three years and needs to be slightly discounted, but the price was still a robust 3.5-4X iProspect's 2004 revenues.



Source: Company reports, DeSilva + Phillips estimates

As the chart above spells out, the iProspect acquisition falls in line with the handful of other search-engine marketing deals over the past 18 months, where purchase prices as

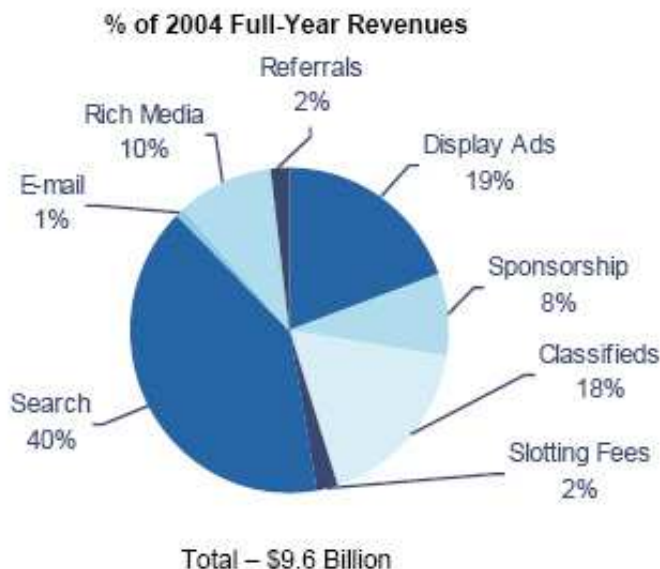
multiples of revenues have ranged from 2.9 to 4.1, even excluding potential performance-based payouts.¹

These sorts of valuations might not be surprising for software vendors in a hot new market. However, while proprietary tools may be part of the “solution” delivered to a SEM client, the typical engagement also includes substantial professional services work, which would normally merit a lower multiple.

Search Now the Key Ad Form

Online advertising of all types still accounts for fewer than four percent of total ad spending across all media. However, search has become the new darling for numerous good and *quantifiable* reasons detailed later in this report. No one can refute the dominant position search has assumed for navigating the web and the way it has catapulted search-based advertising to the internet’s preferred ad format.² Search now consumes 40 percent of all online ad dollars.

Internet Ad Revenues by Advertising Format



Source: Interactive Advertising Bureau

What is Search-Engine Marketing?

The basics of search-engine marketing are simple and straightforward.

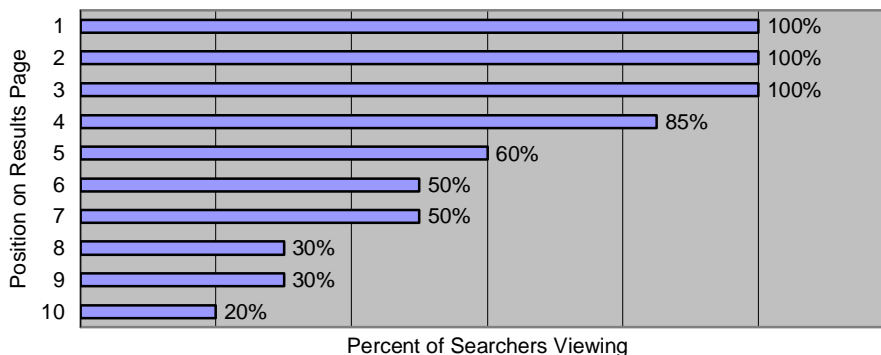
Whether you’re shopping to replace your favorite Nikes or tracking down your old boyfriend or doing your third-grader’s homework (just helping, of course), you’ll probably start by clicking on Google (most often) or Yahoo or MSN or maybe Ask Jeeves.

Research indicates that unless you have a single, specific web destination in mind and know the URL (address) for certain, you’re likely to let a search engine guide you. (This goes about equally for both genders, despite the male disdain for asking directions.) In many ways it’s like walking into a library and deciding whether to stop at the desk for help even if you’re pretty sure you know where the World Book is shelved. If you don’t ask and

ultimately find that the encyclopedias aren't where you remembered, you kick yourself for having to go to the desk and start again. Most people don't like kicking themselves. (For those who don't frequent the library much anymore, substitute a Blockbuster store.)

So whether you start at the search engine or backtrack there in frustration, your keywords ultimately produce pages of results – listings of web sites – to choose from. Running down the middle, usually at 10 per page, are the so-called “natural” or “organic” listings. Intimate knowledge of how those results are compiled and ranked (a moving target due to evolving algorithms and business practices) is the life's blood of search-agent marketing. Though the engine may return millions of results, most of us rarely look beyond the first page, and only one in five viewers scan even to the bottom of that first page.

Organic Listings: Who Notices?



Source: Enquiro, Did-it.com, and Eyetools, via ECNext

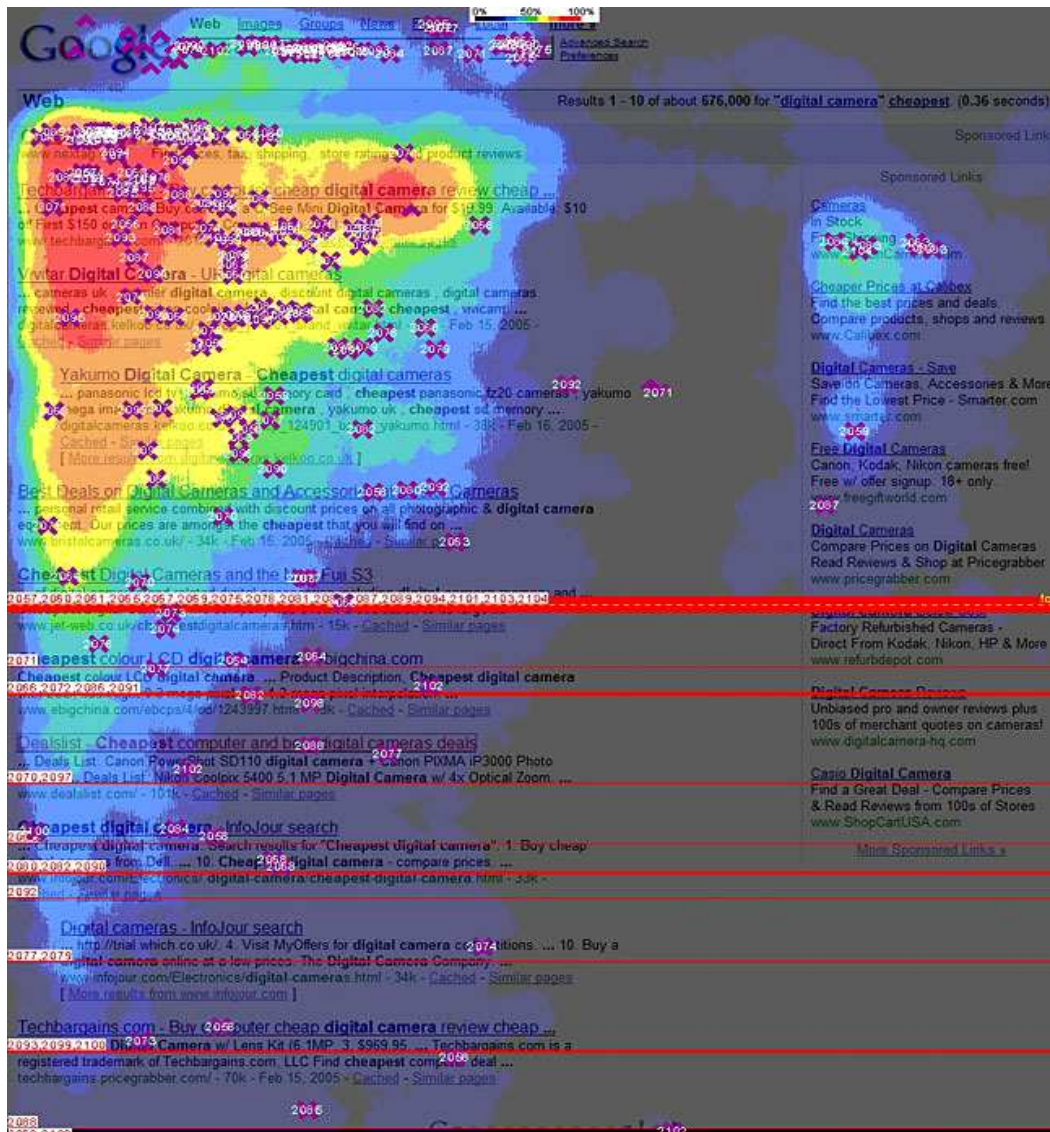
The SEM's most challenging assignment is to “optimize” a customer's web site so that the site ranks as high as possible in the organic results. This is the most technical aspect of the business and calls for skills far afield from what is found in the typical marketing or ad agency. (No, it's not sub-micron chip design, but it's not storyboarding a new Budweiser commercial either.)

Alongside or above or below (depending upon the search engine) the organic results are paid ads. Research confirms that the typical user – or shopper or researcher – is far less likely to click on these “paid placements” than on the organic results. Nonetheless, ranking is even more crucial to gain clicks on paid ads. As the chart below shows, the bell tolls even faster for ads not positioned near the top of the paid listings.

Winning top spots for paid ads is largely a function of bidding appropriately on key words that will match products and services with user searches. Mastering the entire bid-management process is a critical element of successful search-agent marketing. However, this skill set is more akin to traditional marketing. (The notion that optimizing a website to earn high organic listings is “harder” than paid placement is suggested in that two-thirds of advertisers responding to a recent survey said they would outsource organic search-engine optimization, compared to just under half for paid placement.)

Google Eyes

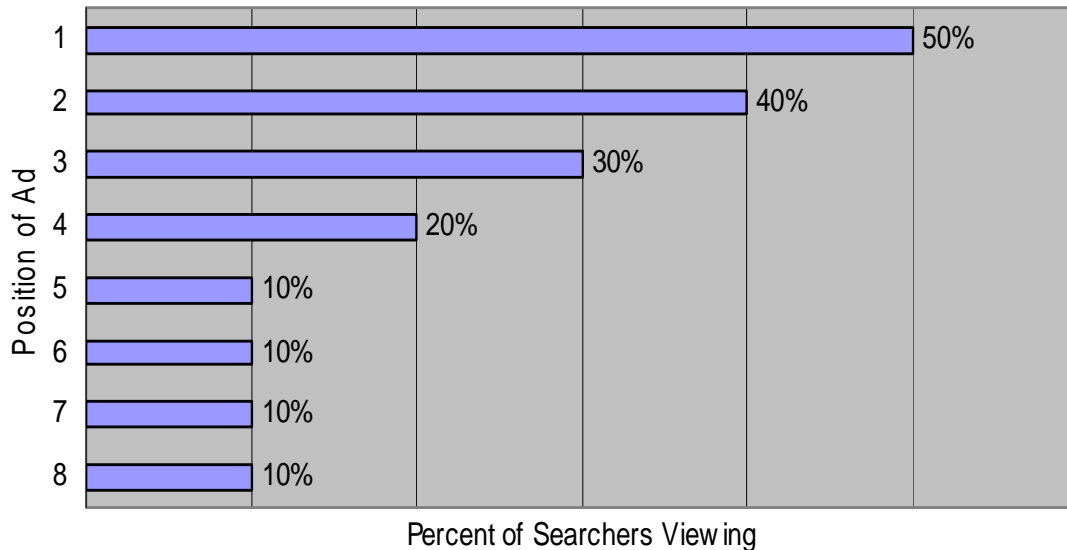
Though this illustration looks like a map of volcanic activity in South America, it's actually a study of eye movement across a page of Google search results. Its revelations are simple but profound: the red/orange/yellow hot spot (upper left under the Google logo if you're watching in black & white) is clearly limited to the first few *organic* results. As for paid ads, the cool greenish-blue (the island adrift on the right) reveals much diminished interest, but enough to justify buying the few lead results. SEM firms that hoist their clients to the top on either side of the page will be pursued.



Source: Enquiro, Did-it.com, and Eyetools, via ECNext

The final offering from many SEM firms is campaign management: analytical tools for tracking the fate of “search-optimized” websites and the success of paid placements. Superior campaign-management tools today report back virtually in real time, which is critical for insuring the most bang for the buck with paid placements. The SEM which generates information and insight that lets the customer accurately monitor its campaign – to give it an incremental nudge, expand it, or even scrap it altogether if it’s a dog – is delivering real value.

Right-Side Paid Listings: Who Notices?



Source: Enquiro, Did-it.com, and Eyetools, via ECNext

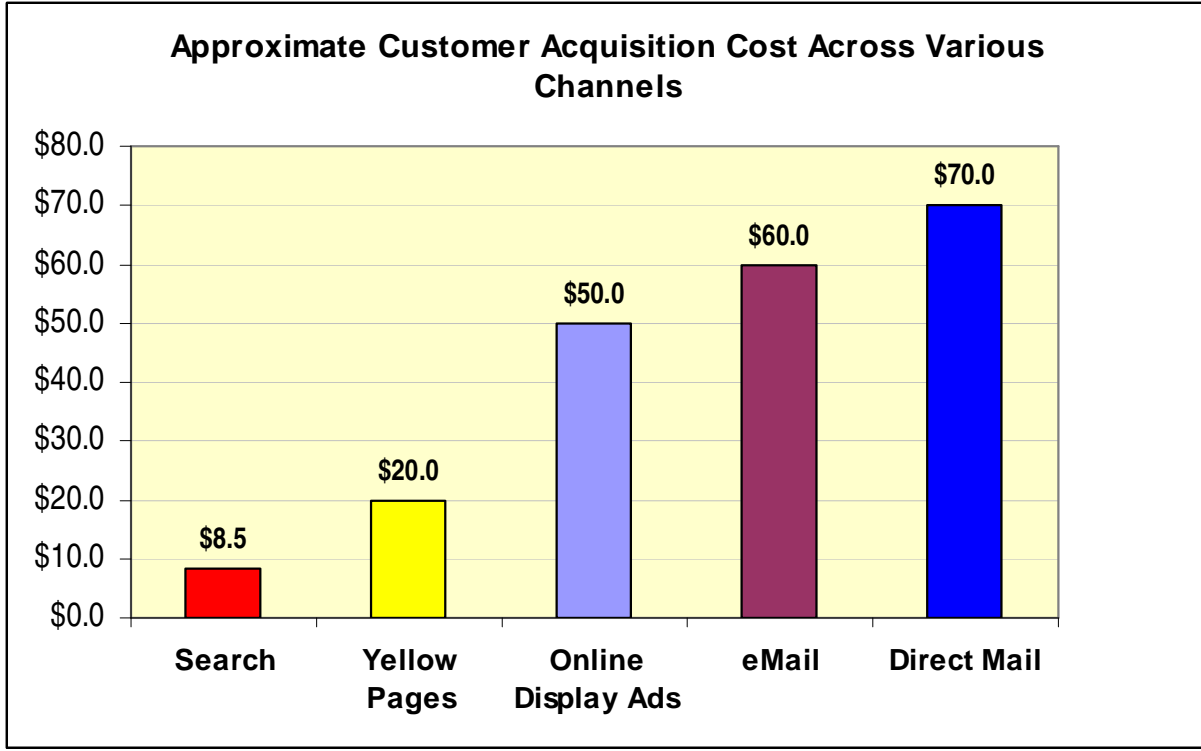
Of course, no two SEM firms are exactly alike and any agency may offer additional services. One frequent offering, called “conversion optimization,” tailors the design of a client’s site – once the search engine has gotten you there – toward closing a sale (or taking some other desired action) in as few clicks as possible.

High Rankings: Only Part of the Story

In a world where low ranking equates with invisibility, high rankings are obviously preferable. And search-agent marketing firms which can produce high rankings will earn fat rewards. However, to understand more fully why these firms are being valued so highly – despite the consulting nature of much of their work – requires a fuller understanding of the prospects for e-commerce.

First, despite an inevitable creep up in prices paid for key words at auction (caused by healthy demand), the economics of search advertising remain arrestingly attractive.

For instance, as the chart below demonstrates, generating sales via search is more economical than even other net-based approaches. The comparison to traditional direct-marketing methods is yet more striking.

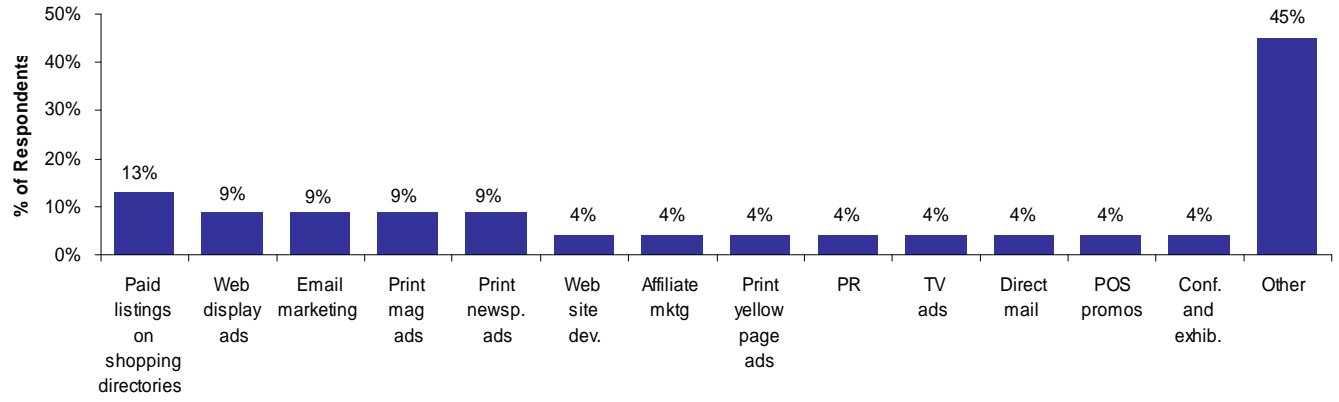


Source: Piper Jaffray

In addition, as suggested in the description of campaign-management tools above, search-based advertising can deliver an unprecedented degree of insight into the return on the advertising dollar. Effectiveness can be tracked moment to moment and adjusted on the fly. Advertisers are rapidly discovering – and demanding – the power of management tools for search-based campaigns that allow customized and comprehensive control.

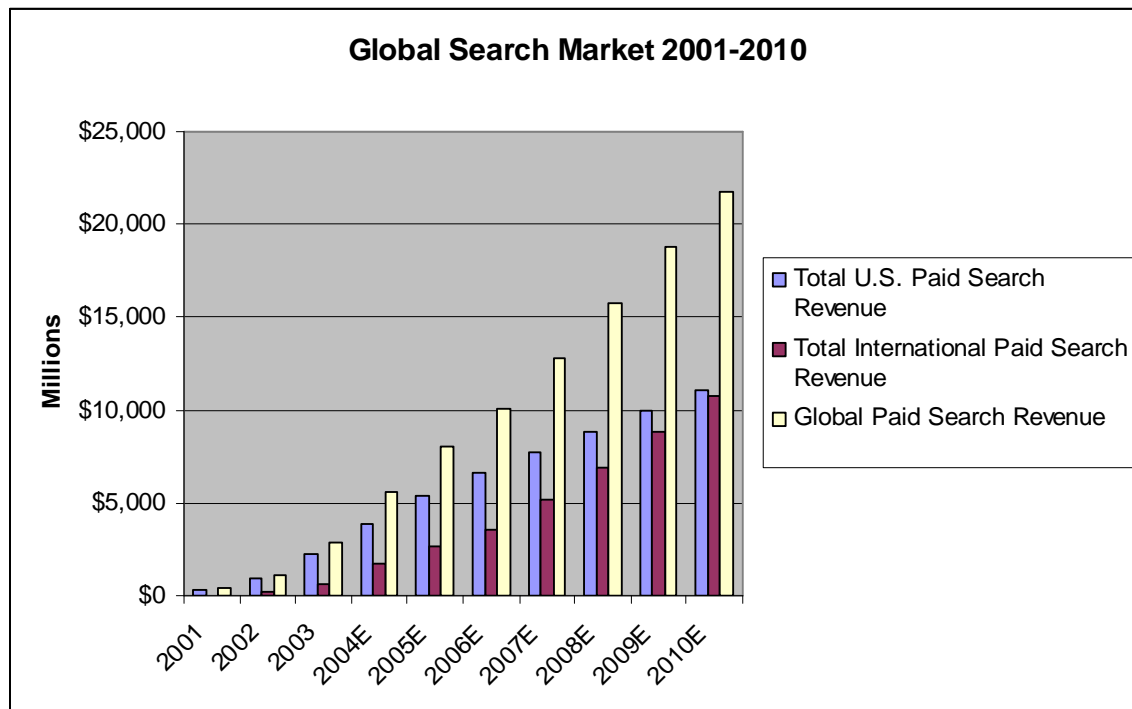
This cost effectiveness, the quickly measurable return on investment, and the enormous reach of the net, are combining to suck the air out of other ad and marketing programs. About half of all dollars directed at SEM campaigns these days are being drained away from other marketing and/or IT budgets.

Companies are Draining Many Other Budgets to Fund Search Marketing



Source: Search Engine Marketing Professional Organization

An April 2005 study from Forrester Research that interviewed 99 leading marketers found that internet advertising budgets will grow at the expense of traditional channels like magazines, direct mail, and newspapers. The report further indicated that tens of billions of dollars of newly budgeted funds will underwrite search advertising as well over the next few years. Prospective spending is staggering. These figures will put search-related ad spending in the same ballpark as cable and satellite television, as well as radio, by the end of the decade.³



Source: Piper Jaffray

Forecasts, of course, are one thing; but booked business is another. Google's barn-burning 1Q05 financials, coming on the heels of Yahoo's own stellar quarter, threw a pail full of cold water in the face of search's remaining doubters.

Urge to Merge

Despite the youth and vigor of the SEM business, consolidation will continue. But this will be a consolidation born of exuberance – not desperation – and strong acquisitions will not come cheap.

This is a new industry and search-agent marketing firms are small. Trends cited here suggest enormous opportunities for SEM firms with strong management, creativity, and capital. In addition, it's worth noting (as reported in *The New York Times*) that major multinationals who might have shied away from working with small (SEM-sized) firms not many years ago are now seeking out boutique advertising and marketing agencies for their fresh ideas and nimble implementations. If anyone is in the right place at the right time these days, it's a hungry search-agent marketer.

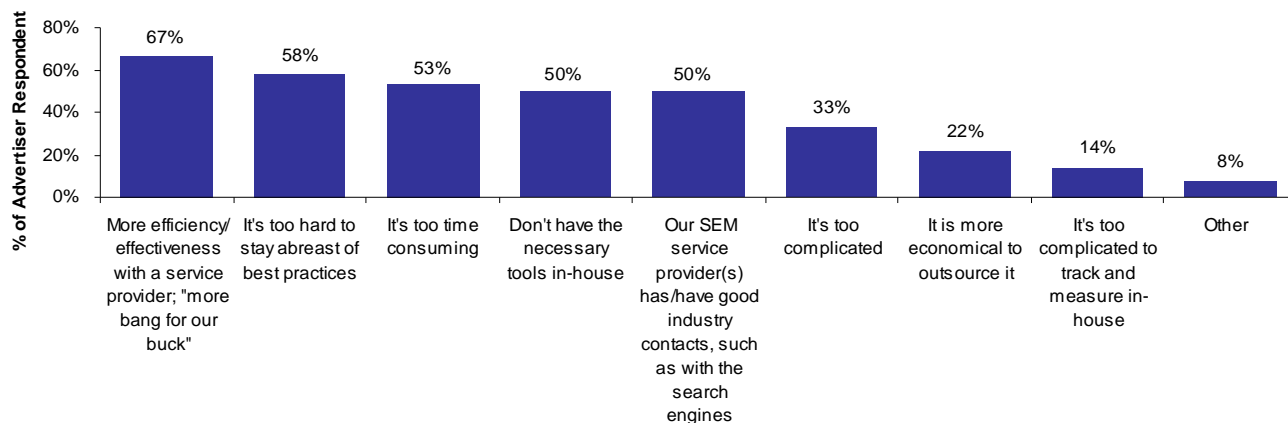
As in every start-up industry, some firms will have the desire and resources to remain independent and prosper, beating back the many challenges that accompany growth.

At the same time, many others will succumb to offers extended by bigger firms – as they should. Starting up a SEM firm takes a lot more guts and grit than cash. But feeding on early success and managing growth requires different skills, the nerve to face down significant risk (displacing the blind optimism of the start-up stage), and access to capital. In addition, many small firms are overly dependent on a handful of customers and could face devastation with one or two account losses. Being acquired should plant them inside stable environments with established client relationships, as well as sales, financial, systems, and administrative expertise that will allow them to grow their businesses in an orderly way.

That's the SEM side. What is pushing potential acquirers?

The motivations of the big ad and marketing agencies are very simple. Basically, the explosion of search-engine advertising from a standing start to a multi-billion dollar business has left many agencies woefully short of SEM resources. And without an SEM offering you cannot claim to be a full-service agency – no more than an agency 50 years ago could have offered only print services while America was entranced with Lucy and Ricky.

Reasons for Using Outside SEM Providers for Search-Optimization Programs



Source: Search Engine Marketing Professional Organization

In addition, as indicated by the chart above, advertisers don't want to handle these chores themselves, especially the technical demands of optimizing their websites.

Finally, as a Jupiter Media study disclosed at the end of 2004, SEM-specialized agencies are now directing more than half of SEM spending in the United States. (Interestingly, 31% of all advertisers accounted for 51% of domestic SEM spending, indicating that big advertisers have grown reliant on the SEM firms.) No general-purpose agency can afford to exclude itself from the fastest-growing segment of its business.

The indisputable long-term trend is for the major advertising and marketing agencies to offer broad SEM services. It's no different from where interactive services were in the late 1990's. To use a tired word that has probably cost people more money than it has made, there's an undeniable synergy here. As a result, the specialists will be absorbed into the mainstream. The issue for the mainstream ad/marketing firms is whether to build their capabilities in-house or acquire them – and at what price? Every notable agency has started

to build, but because of culture or business opportunities or geography, more than a few will be buyers as well.

Conclusions

In tandem with skyrocketing internet usage, most consumers and businesses increasingly rely on search engines to navigate the web.

Despite some upward pressure on prices, search-based advertising remains far more cost-effective than virtually any other tool in the marketer's kit. It also offers an unprecedented ability to track campaigns and modify them on the fly.

Given its unique and powerful attributes, it is no surprise that search-engine marketing has rocketed from nothing to a multi-billion-dollar business in just a few years.

Demand for expertise in search-agent marketing is escalating. Not surprisingly, much of that expertise – which draws on unusual technical skills – has developed outside the corporations that dominate traditional advertising and marketing services.

SEM firms, though small, face a golden opportunity. They can certainly try to satisfy clamoring demand by remaining independent. However, since the very success of search-engine marketing is redefining what constitutes “mainstream” marketing, there is no doubt that the giants of traditional marketing will acquire SEM skills. They have to.

Over the past 18 months, several traditional marketing and ad agencies have opted to buy their way into search-engine marketing. Though the typical SEM engagement involves many hours of “professional services,” the surge in demand for SEM skills has pushed the value of these specialty firms into the neighborhood of high-tech product companies. These valuations will fall as SEM skills become more commonplace in the marketing community. However, demand will outpace supply for the next 12-24 months, and more high-multiple SEM acquisitions can be expected.

Notes:

¹ Data behind the SEM Acquisition Chart:

Search-Agent Marketing Acquisitions			
	SEM's Acquisition- Year Revenue	Purchase (cash and equity) Price	Purchase + Max Earnout
aQuantive - Go Toast	3.5	13.9	17.9
DoubleClick - Performics	14.1	58	65
24/7 - Decide	11	28	35.1
Aegis - iProspect	13.5	50	50

Notes:

\$ in millions

SEM in **Bold**

Source: Company reports, DeSilva + Phillips estimates

² Several independent measurements of search advertising – from Merrill Lynch, Jupiter Research, Kagan, Piper Jaffray, and the Interactive Advertising Bureau – concur that search spending for 2004 reached approximately \$4 billion.

³ Newspapers are feeling the brunt of the internet hurricane. Not only has circulation been dropping, but the decline is accelerating as an increasing number of potential readers simply prefer their news delivered over the web (a dark omen for TV and radio news outlets as well, of course). Young adults in particular are abandoning newspapers, and advertisers are following the audiences. Classified advertising, which one newspaper executive described to the authors of a new McKinsey & Co. study of the problem as a “better business than printing dollar bills,” is facing disastrous erosion because of the web’s far more advantageous cost structure. So far it has largely affected only help-wanted, but may soon hit automotive and real-estate ads. Magazines, though not nearly as vulnerable to the web’s inroads, are also being undermined. The Magazine Publishers Association reports that circulation peaked in 2000, and although last year was better than the dreadful year before, circulation has retreated to 1994 levels.

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