Date:	**4/29/02**
Symbol:	**OVER**
Price:	**$33.77**
Position:	**SHORT**

MAJESTIC RESEARCH
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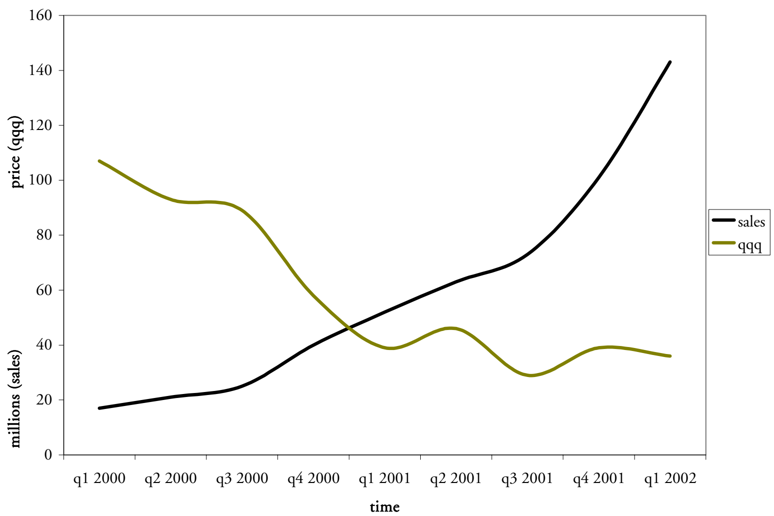
``Two years ago our advertisers were very much interested in guarantees and limited risk. Now they are very interested in upside potential,'' Ted Meisel, CEO

Introduction

Ah, the lure of speculation. On Thursday after the market closed, Overture Services released its 1st quarter numbers. The company reported $142.8mm of sales and $29.3mm of net income-- $15mm more in sales than analysts expected. The robust revenue growth of Overture is impressive, especially in the context of the decline in market valuation of the broader Nasdaq market:



In addition, the company announced that it had extended its distribution deal with Yahoo! for an additional three years. It did not disclose the terms of the deal, although it reportedly calls for Overture to pay Yahoo! $50mm per year in exchange for a revenue share on the sponsored search revenue generated by Yahoo! search traffic. Overture spent $77mm during the first quarter on traffic acquisition costs to generate its $143mm in revenue. On his earnings call a few weeks ago, Terry Semel, CEO of Yahoo! told analysts that he was evaluating three options for sponsored search: (1) continue with Overture; (2) work with Google; or (3) develop and launch in-house. Semel bargained with Overture to generate the highest up front annual payment. With such a large guaranteed payment, Semel was quick to praise Overture, "Search and paid listings are key growth areas for Yahoo! and with the strong success of Sponsor Matches since its launch in November, we are looking forward to providing even more comprehensive and enhanced search opportunities for advertisers and consumers." For a company like Yahoo! whose advertising revenues have dropped hundreds of millions of dollars in the past year, a purported $50mm anchor tenant deal is a positive signal of renewed enthusiasm in the online advertising medium. Either that, or simply some easy cash in exchange for excess Search inventory.

Since the release of this news, Overture's stock rallied from a close of $24 on Thursday to a close of $34 on Friday, a 10 point increase representing an increase of more than $500mm in market capitalization (or a 33% of its total value) in 24 hours. The stock has ranged from a low of 17 to a high of 40 in recent months, and is poised for the release of new positive recommendations from research analysts. The company increased guidance for the rest of the year and will disclose the full details in the coming week (along with the conclusive status of its relationship with AOL that expires on May 1).

Here are four reasons why I hold a short position in this stock:

1. Google wins search

It is unclear what value Overture serves the online consumer. Search is a basic commodity of Internet usage, along with email, news, chat, and ecommerce. It helps us find things we are looking for across the Internet. As a commercial service, search began in 1994 with the advent of akebono.stanford.edu (aka Yahoo!). Many subsequent search services disappeared or else been absorbed into larger entities (GNN, McKinley, Infoseek, Excite, AltaVista…).

Currently, Google does the best job providing a useful web query service. Consumers do not pay for searching the web, and it is questionable how much or even if consumers would pay Google if it turned into a subscription service. This is not to call into question the utility value of the Google application. Personally, I consider Google, Microsoft Outlook Express and AOL Instant Messenger key components of my online behavior, even though I don't necessarily pay for any one of them.

Overture describes its first quarter as having facilitated more than "587 million paid introductions." By this it means that search users have clicked on a Overture-sponsored link that many times. According to this logic, the user benefits by finding advertisers that it couldn't find, or else needed a better guide to find. It charges advertisers an average of $.25 per click—or in some cases such as flowers more than $1—for making this introduction.

Many have argued that Overture is a direct comp to the Yellow Page business in the offline world. The company has 60,000 current advertisers that pay it an average of $2500 for enhanced listings. Overture introduces these advertisers into search results across its affiliates. To Overture, every search request is an opportunity to redirect the user to a commercial destination. It plays a classic intermediary role and assumes that the Internet is not efficient enough for linking buyers and sellers as it stands.

What services such as Google have demonstrated however is that companies that give consumers exactly what they want as simply and efficiently as possible succeed in the Internet arena. Companies that try to come between consumers and sellers and profit from the toll booth-type mechanism inevitably get trumped by services that are more useful and to the point. People that search the web want the best results, not those that advertisers have paid the most for. Google understands this and will dominate the search category in the same way that Amazon dominates retail e-commerce and Ebay dominates auctions. By partnering with Overture (in exchange for substantial guaranteed fees) AOL, MSN and Yahoo! have inflated the near term value of the paid search model while cementing the long term value of Google's position as the pure-play provider of high integrity search services.

2. Overture sells to analysts

Overture devotes substantial effort to building its reputation among the sell-side research community. This is not in and of itself a bad thing, as companies need to foster analyst support. But the extent to which Overture markets to the investment community is reminiscent of the days of momentum day traders. One does not get the impression that this is a company looking to underpromise and overdeliver through humility, cost containment, and long term discipline in the Buffet/Munger school of management.

The sell-side analyst community has been a strong supporter of the company since its name was Goto.com. For an interesting discussion of the company's relationship with one of the more prominent banks, consider the following excerpt from Elliot Spitzer's case against Merrill Lynch:

> *When, in January 2001, Merrill Lynch initiated coverage of GoTo, an institutional investor e-mailed Blodget asking, "What's so interesting about GOTO except banking fees????" Blodget responded, "nothin." (ML 03806). Blodget's candid response was not included in the initiation report, nor did the report disclose that Merrill Lynch had promised research coverage in exchange for GoTo's investment banking business.*
>
> *Disturbing discussions about the ratings were also occurring within Merrill Lynch. On November 16th, Campbell e-mailed Blodget that she did not "want to be a whore for f-ing management" and initiate at a 2-2 (accumulate/accumulate) rating: "if 2-2 means that we are putting half of merrill retail into this stock because they are out accumulating it then i don't think that's the right thing to do. We are losing people money and i don't like it. john and mary smith are losing their retirement because we don't want todd [Tappin, GoTo CFO] to be mad at us."*

Clearly, the revenue growth in recent years has been impressive and would seem to make Overture (GOTO) more interesting to the sell-side than simply banking fees. But it is hard to shake the impression that the company (who maintains the same CFO btw) has substantially changed its stripes in the past two years. After all, it has managed to promulgate the concept that it should be valued in terms of the number of "paid introductions" it generates on a quarterly basis. At last review, this was not a standard financial metric as per GAAP instructions.

In his case against Merril Lynch, Spitzer focuses on four companies: Excite, Aether, Infospace and Overture. Each was valued in excess of a billion dollars at its peak for claiming to have developed breakthrough Internet marketing technologies. Excite was sold for $5mm to iwon.com. Aether Is currently trading at $3.99, off of about $25mm in quarterly sales, for a market cap of less than $200mm. Infospace now trades at $1.25, generates about $30mm per quarter in sales, and is valued at less than $400mm. Overture, valued at almost $2b would seem to be the exception among the group. The question is, for how long?

3. Overture was founded by Bill Gross and idealab!

The trend in public market sentiment is not simply against the excesses of 1999 and 2000 hi tech speculation, but also towards a more value oriented approach to management and directors. The Internet companies that survive and thrive have reduced expectations of exponential growth and instead demonstrated solid results and accountable uses of capital. In addition, the best values are recognized by management and investors who hold onto their equity because they are so confident in the prospects of their ownership stakes.

Compare this to the case of Overture where in the last six months Bill Gross and his incubator idealab! have each sold more than $125mm worth of stock in the company to put into their respective coffers. When I looked at the insider trading reports, the instances of stock withdrawls by Bill Gross is between $200,000 - $1mm *each business day* for the past 90 days. Fortunately so as not to exhaust the paper required to support this tremendous liquidation drain, they together maintain more than 8 million shares of stock (or roughly 15% of the company).

The recent sorrid history of stock market profiteering belongs to a number of figures in the Internet arena. Naveen Jain of Infospace cashed in $250mm of his equity at the peak of the market, just like Eric Goldberg of Scient and countless others to different degrees (come on, we all took *something* off the table). It is a question of degree, of both amount and self-importance. There are some like Mark Cuban who never pretended to be a visionary but knew how to take advantage of the hype and turn his Yahoo stock into $1b of cash. At least with the Mavericks he is producing quality entertainment. They are somewhat less devious than the Milken-era junk financiers like Saul Steinberg or Victor Posner, but in the same way we feel like we are somehow atoning for their spoils. Working them off in the kitchen might be the better analogy.

Regardless of what Bill Gross knows or does not know about the future prospects of the innovation he developed (did we learn anything from the demystification of enron's energy trading?), we can be clearer as to the motivations of idealab! since it has a number of credible institutional investors, including Citigroup, Dell USA, T. Rowe Price Science & Technology, Hikari Tsushin, JW Seligman and Moore Global Investments. Currently, this investor base is at odds with the management of idealab! over being made whole on their investments. In January, the LA Times reported that:

> **Investors Want Idealab Liquidated**
>
> Internet: Lawsuit against the Pasadena company's founder claims Bill Gross mismanaged the incubator. The plaintiffs want the $500 million that remains.
>
> A group of blue-chip investors who poured nearly $1 billion into the once-highflying Internet pioneer Idealab Inc. filed a lawsuit Friday demanding that founder Bill Gross liquidate the company and return the $500 million that's left.
>
> The suit alleges that Gross, Idealab's chief executive, and his fiancee, company President Marcia Goodstein, badly mismanaged the company and have kept the enterprise alive simply to preserve their sumptuous lifestyle.

> "In just two years, the defendants burned through more than $500 million," the lawsuit says. "Idealab's 'incubator' business, for all practical purposes, is nonexistent, and in fact, other 'incubators' are winding down, dissolving and refunding investor money." Gross responded to the suit, saying it is "completely and totally baseless."
>
> "It's just embarrassing that these people are so immature and crybaby that they want to take an investment that they made and carry it out this way," he said after reading the allegations. "There's a market downturn, but Idealab as a company is doing great."

The most valuable equity asset left within idealab! is its 5 million shares of OVER. It is unclear exactly how much of the $175mm stake is being claimed by the plaintiffs, but it is nowhere near enough to satisfy half of the $1b of capital they invested in the company in spring 2000. 31 plaintiffs representing about 90% of the money invested in idealab! are involved in the suit. It is reasonable to assume that should they end up in possession of the OVER shares that they may be weary of dealing with Bill Gross and idealab! and promptly dispense of the shares in the open market.

4. The history of online marketing is littered with bodies

Since the first Internet IPOs in 1995, a number of companies have come public with better online marketing mousetraps. These have ranged from online communities, to advertising networks, to list managers, to affiliate models and incentive systems. The value of these companies has lagged even within the laggard Internet sector. They tend to be derivative models that provide neither content nor commerce but propose to intermediate between the two. The power of the Internet medium relative to other distribution channels is that it is direct. It may never provide the emotional stimulation of televion or film, the utility of newspapers and magazines, or the atmosphere of a store or dealership. Nonetheless, the medium is dynamic, interactive, and takes credit cards.

In this direct sales medium, where buyers find sellers and do business in private, Overture assumes the role of a marketing intermediary. Capturing and modifying general interest has always been an uphill battle. Marketing supports sales, not the other way around. The history of Internet marketing has been a succession of click thru enticements, from banners, to anchor tenants, to email. At first, there is tremendous interest in the novelty. In 1995 a banner of a woman looking out at you generated 40% response, today XO web phone pop ups yield clicks from less than 1% of the people that see them.

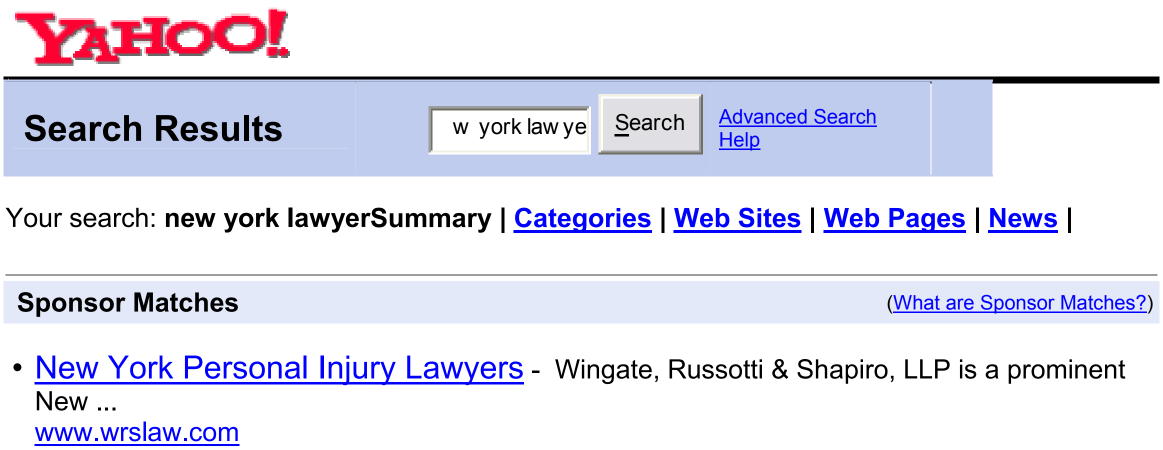
The goal of the marketer is to turn a general consumer into a customer and a customer into a loyal customer. At each step of the way, there is a moment of persuasion. I will never forget speaking with Proctor & Gamble in 1997 who remained skeptical of the power of the medium to generate an emotional response. Although the word introduction suggests intimacy, the technical reality is that Overture’s paid introductions are nothing more than clicks on hypertext links to other web sites. These clicks are in a certain way privileged because they are qualified by the search term that was entered into the portal. Fundamentally, however, these introductions are made of the same technology as that of a standard online advertising banner.

The basic mechanism of Overture's service is somewhat clouded by the impressive role that the company assumes in the Internet industry. As expressed in the following boilerplate description of the company, it credits itself as leading the industry of direct response marketing on the Internet (regardless of the fact that everything done on the Internet is by nature direct response):

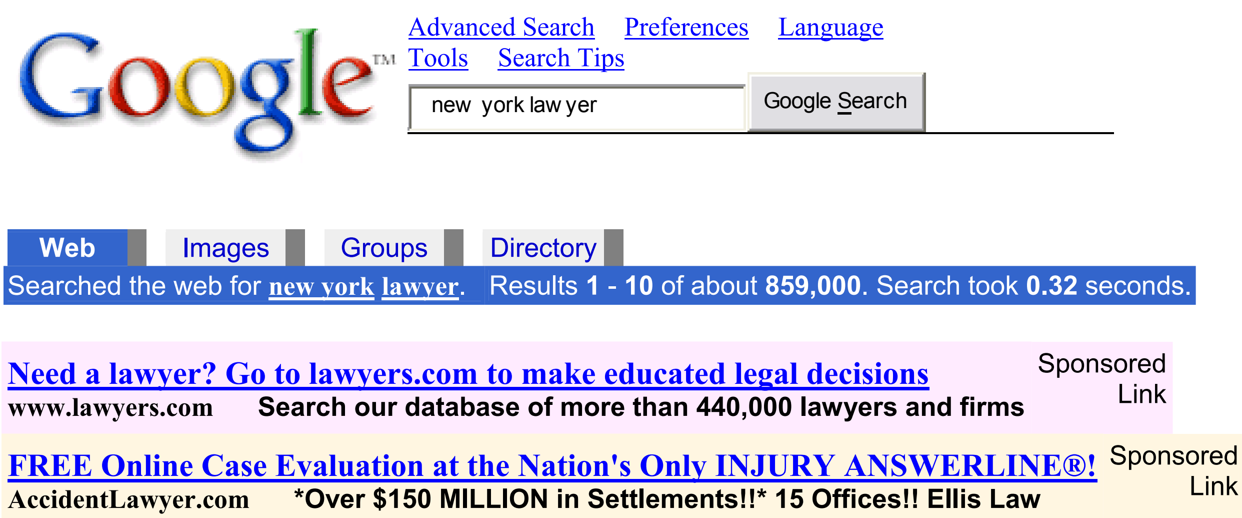
> *Overture (Nasdaq:OVER), formerly known as GoTo, is the world's leader in Pay-For-Performance search on the Internet. The company created the market for Pay-For-Performance search by redefining how businesses market online. In the first quarter of 2002, Overture facilitated 587 million paid introductions on a worldwide basis between consumers and its approximately 60,000 advertisers, who bid for placement on relevant search results and pay Overture only when a consumer clicks on their listing. Following a rigorous screening for user relevance by Overture's 100-person editorial team, the company distributes its search results to tens of thousands of sites across the Internet, including America Online, Microsoft and Yahoo!, making it the largest Pay-For-Performance search and advertising network on the Internet. Overture is based in Pasadena, California, with offices in New York, San Francisco, the U.K., Germany and Ireland.*

One can easily look at this cynically in the context of recent episodes of companies that hide behind the specter of *invaluable innovation* including Enron, Global Crossing, ImClone and Verisign. More effort is required, however, to call into question Overture's business from within.

The value proposition is simple enough: provide paid advertisements to consumers that are looking for things on the web. Try to target the product to the specific needs of the customer so as to be able to charge the highest rate. The problem is that consumers are not necessarily aware of the fact that what they are receiving for their first search result is driven more by advertising interest than by technical efficiency.



Granted, the sponsored search is noted as such, but the fact remains that most consumers don't know the difference between a sponsored search and a non-sponsored search and simply judge the quality of their experience based on whether they find what they are looking for. A similar search for New York Lawyers generates a similar response from Google.



Google, like Overture and its search portal partners, recognize the immediate opportunities to monetize its most commercial searches such as New York Lawyers. Most other searches—that are harder to satisfy than with a link to a local merchant—benefit from accuracy, precision and utility to express a latent part of the web. This is the service that Google provides above and beyond its sponsored categories, a service which Overture for all of its 100 human editors and 60,000 advertisers fails to offer.

What most likely happens to pay per click advertising is not that it goes away, simply that it loses its premium effectiveness as its novelty wears off. Over time, the following dynamic will most likely affect Overture's business:

- Searchers naively click on a sponsored result
- Consciously or unconsciously the searcher discounts the commercial pitch
- Experienced searchers begin to ignore the sponsored section of the search returns (just as with banners)
- Affiliates begin supplying more inventory and generate fewer click-thrus
- Overture raises its cost per click to compensate
- Advertisers change from wanting uncapped upside to wanting capped risk
- PPC becomes priced as an impression-based commodity along with the glut of billions of other impressions on the Internet advertising market

Conclusion

It is the nature of fast moving, hi tech industries that many of the more questionable businesses point to the future as a way of getting investors to support their present situations. This is what is meant by growth capital. The e-commerce market has been active for more than 5 years, not including other forms of telephone and television-based home shopping networks that have been around for much longer. The companies that have found their audience and are doing business are cranking out quarter over quarter growth that is organic even if it is incremental.

Overture is a critical component of Yahoo, whose challenge is to convert its 200 million active visitor base into 20 million paying customers. Overture is a party to this high risk enterprise by virtue of its role as the force responsible for monetizing search. The problem is that search does not want to be monetized, it wants to be answered simply with data of high integrity. The immediate revenue growth generated by the novelty of its page layout will inevitably come into conflict with the diminishing effectiveness of its core online marketing product. When the company's growth slows, it will not be temporary (as it is currently for the online advertising market for CNET and AOL), but rather permanent. The way that Overture has promoted itself in the industry, it will either continue its quarter over quarter unexpected growth or else it will fall apart. There is no middle ground. **The recent events of the Internet sector, not to mention a hundred years of public equity history, suggests that OVER is bound to lose at least 75% of its value in the next 12 months. What trades now at almost $34/share will be under $10/share by the end of 2002.**

