

Equity Research
North America

Industry

Internet

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Industry Overview

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February 2003 — An Update From the Digital World

GICS SECTOR CONSUMER DISCRETIONARY	
US Strategist Weight	13.3%
S&P 500 Weight	13.3%

- **While 'vision' is as important as ever...**
Recent experiences of many Internet companies have illustrated that great vision *without* execution is painful. But, when great vision is combined *with* great execution, the results can be very powerful.
- **Strong CQ4 trends, despite weak economy, were encouraging**
In CQ4, the single data point that really surprised us was eBay's store statistic. eBay indicated that 85,000 stores had been set up on the eBay platform, up from 51,000 in CQ3 and 29,000 in CQ2.
- **Digital World vs. New World?**
We compare the early days of the commercial Internet with the early days of America. Specifically we draw parallels between the development of commerce on eBay and on the island of Manhattan.
- **It's still early days for the Internet, but leaders and laggards are emerging**
The surprise may be that some emerging leaders have more potential than they get credit for and that an ever-expanding list of emerging laggards are more at risk than is widely understood.
- **Our Internet & PC Applications Software Industry View is Attractive**
We continue to believe that, at the margin, online is gaining share from offline, that this will occur for some time to come, and that this should continue to benefit the Internet leaders. So far, it appears that trends in 2003 have been strong.

February 2003 — An Update From the Digital World

Vision only Matters if Execution Follows

When we published our December 2002 report, *An Update From the Digital World*,

http://www.morganstanley.com/institutional/techresearch/digital_world1202.html, we used the words “digital world” with hesitation. We hadn’t heard them for a while — they sounded like an echo from some other time, a time of seemingly endless optimism, a time when vision was hot. Now, it seems a good visionary is hard to find — while they still exist, they are hesitant to speak too loudly and even when they do they often speak to themselves.

Looking at its evolution to date, many believe the Internet has already been through its boom and its bust. And in terms of company creation, we agree. But in terms of wealth creation and fundamental change, we continue to maintain that when all is said and done, what we have just lived through will be considered to be a boom-let followed by a bust — and we have just now begun to enter the boom stage. The trends reported by the Internet leaders over the past six months have led us to believe that the fundamental changes related to the aggressive adoption of the Internet will be bigger than we ever imagined. That’s our vision, and we are sticking to it.

Great vision can help set direction. Flawed vision can set one astray. Even great vision *without* execution is painful. But bring together unique, and great vision *with* execution, and the results can be very powerful.

Those Who Execute Grow, Others Don’t

Rewind to January, 2000, when it seemed like the crew behind the pending combo of AOL and Time Warner was in a great spot to combine digital vision and execution. Fast forward to the present, and AOL Time Warner’s (AOL, \$10.56, NAV) execution hasn’t been good. Nevertheless, we note that the growth that AOL hasn’t seen (related to broadband and the pure-play Internet) has been picked up by others. The momentum in CQ4 for the likes of Yahoo!, eBay, Amazon.com, and the broadband players was impressive, in our view. And by our estimates, global Internet user/usage growth remains strong, up 15-20% and 30%, respectively, Y/Y with 550-600MM users.

Step back and consider the CQ4 trends in perspective. The economy is struggling, most businesses are experiencing customer erosion, and yet, the Internet leaders are thriving and experiencing very strong customer (and revenue per customer) growth. Is there a theme here? Yes, we think so.

We continue to believe that, at the margin, online is gaining share from offline, that this will occur for some time to come, and that this should continue to benefit the Internet leaders.

An eBay Data Point...Stores and More Stores...

One of the great things about quarterly earnings season is that number scrubbers and business people get to sift through reams of data. The challenge is to find the most relevant nuggets and to determine what they mean. In CQ4, the single data point that stunned us (as in over the top) was eBay’s store statistic. eBay indicated that 85,000 stores had been set up on the eBay platform, up from 51,000 in CQ3 and 29,000 in CQ2. Note that eBay didn’t even begin offering eBay stores until CQ2:01.

Let’s compare eBay’s ramp to a traditional shopping mall. You know what? We can’t. There’s no comparison in the ramp. Pause — 34,000 businesses set up stores on eBay from October 1, 2002, to December 31, 2002, and these businesses have the opportunity to tap into an estimated market of 550-600MM global Internet users.

The magnitude of the CQ4 store ramp was even a surprise for the eBay management team, which, at first, assumed the number had to be inaccurate (like an extra zero or two). They sent a team back to cross-check and double-cross-check the number, only to find out it was indeed accurate. Already, eBay has given eBay Stores some of the most valuable real estate at www.ebay.com (which, on average, receives 6-7MM unique visitors per day) by placing it in the upper-left-hand corner in the specialty sites area right under the eBay logo along with eBay Motors and PayPal. And, yes, as is eBay’s way, it’s aggressively listening to its store owners and is ramping up its offerings to help make the owners more effective at building their businesses.

For perspective, eBay generates less than 5% of its revenue directly from stores. However, a large percentage of eBay’s big sellers have set up stores on the site and, in fact, are ramping up their store initiatives by increasing services and merchandising thus demonstrating that the store concept is sticking. In the future, these efforts could become increasingly important as the number of stores (and the volume of products) ramp. Today, in our view, the store count helps illustrate the power, magnitude, and acceleration of the migration of sellers to the eBay platform, community, and way of doing business. eBay estimates that there are 100-200K (and rising) sellers in the US alone that make a living selling online with eBay as

either their only, or primary distribution channel. These trends/dynamics are a big deal - and we believe that they are still underappreciated by investors.

eBay's Powerful Store Ramp Revived Our Thinking About a Concept...

We have been trying to foresee the impact of online connectivity ever since Ray Ozzie and Jim Manzi showed us Lotus Notes in the early 1990s; since the early days of CompuServe, Prodigy, and America Online; since John Gage of Sun Microsystems took us on a tour of the Internet; and since Jim Clark, Marc Andreessen, and Mike Homer showed us the Netscape browser.

We have studied the evolution of computing and the evolution of media. But increasingly, we are convinced that we are dealing with *an evolution of society*. A while back, Evan Schwartz coined the phrase "Digital Darwinism." People don't talk about this stuff these days. But it has never been more relevant. The numbers and the trends are staring us in the face.

A Short History of the Evolution of the Major City in America...

Recently, after watching the beginning of Ric Burns's documentary, which focused on the early days of New York City from 1609 to 1825, I couldn't stop comparing the evolution of New York City as a commerce and cultural hub with the related evolution of the Internet. I confess to being a diehard fan of the brothers Burns (Ken and Ric). As I think any PBS fan and history buff knows, it's hard to find anything better than their documentary films (including *Lewis and Clark: The Journey of the Corps of Discovery*, *Thomas Jefferson*, *The West*, *The Civil War*, *Coney Island* and *New York: A Documentary Film*) when it comes to context, understanding, and pure enjoyment of history. I couldn't possibly replicate here their captivating mix of rhythmic narrative, vintage photographs, and evocative music. Nevertheless, I think one of their narratives bears repeating in abridged form.

In 1609 Henry Hudson sailed into New York Harbor and upriver. Realizing there was no Northwest Passage to China in that direction, he settled on the island of Manhattan to set up a hub for trading (initially for fur). Chaos soon ensued among the motley and diverse crew of Europeans who established themselves on Manhattan, owing to conflicts with the Indians and a lack of organization. They built a fort in lower Manhattan and levied taxes.

Back in Europe, the powerful Dutch East India Company realized that its New World asset had compelling potential but was poorly managed. So they sent over Peter Stuyvesant, in effect, to serve as general manager. He laid out basic plans to meet the needs of the community — planning and building the streets of lower Manhattan, ramping up fire and police protection. He fostered an environment in which the community conducted commerce in a somewhat orderly fashion, prospered, and grew to become a powerful commerce hub for the New World. In short, Stuyvesant brought order to chaos, and today he would probably be an MBA manager of the year.

A few more things transpired before Stuyvesant's settlement emerged as what we now know as New York City, including the British takeover in 1664, a slave uprising in 1741, the Revolutionary War after 1775. Setting up the Bank of New York in 1784, Alexander Hamilton helped create the banking system and the plumbing for American commerce; with his appointment as the Secretary of the Treasury in 1789, he also helped set the stage for a culture of meritocracy and democracy. The capital of the United States was moved from New York to Washington in 1790, which some argue allowed New Yorkers to focus on commerce rather than governing. Timely transportation on New York's waterways took off after 1807, when Robert Fulton launched the world's first practical steamboat off the West Side, and 1810, when 16-year-old Cornelius Vanderbilt of Staten Island started a ferry service to Manhattan. Meanwhile, John Jacob Astor became the wealthiest man in America by buying up as much undeveloped Manhattan land as he could get his hands on, just one step ahead of the northward expansion of the island.

And — this turns out to be key — in 1811, New York City Mayor and later Governor of New York State, DeWitt Clinton had a vision to transform Manhattan into the commerce and cultural capital of the world, anticipating a ramp in population from its then 100,000 to over 1 million. His controversial strategy was twofold: 1) to level the rugged island of Manhattan, replacing its hills, dells, streams with a systematic grid of streets; and 2) to build the 363-mile Erie Canal, connecting New York's Hudson River with Lake Erie in upstate New York, so that New York (and the world) could conduct commerce with the agricultural interior of the North American continent.

Thomas Jefferson derided the canal project as "a little short of madness," and along with President James Madison opposed public funding, warning it would bankrupt the Federal government. So, against significant odds, Clinton went on an extended and aggressive road show and garnered a combination of public (New York State) and

private funds to build what had come to be known as “Clinton’s Big Ditch.”

It took seven years to build the artificial waterway, which has been compared in scope to the efforts of the ancient Egyptians. The building of the canal benefited from superb execution, coming in below projected cost and three years ahead of schedule. It also turned out to be a most profitable venture, turning a profit from its first year of operations, recouping the original investment in seven years, and remaining a profitable venture until the tolls were abolished in 1883. To this day, the Erie Canal is acknowledged as the most successful canal ever built and a significant contributor to the economic progress, growth, and significant cash flow streams for the city and state of New York.

America kept its ports open to ambitious immigrants who came from all over the world to build a better life, to set up shop, and to participate in the growth of New York and America. The New World became a magnet for people who had the courage or, simply, the need, to try something different or start over.

Digital World vs. New World

So where are we going with this? The Internet -- specifically eBay. We started with the observation that eBay added 34,000 stores in CQ4 and has a total of 85,000 stores on its site. And we are comparing this with the creation of Manhattan? Right, yep, officially off the rocker.

The reality is that the cost (time and money) to launch an eBay store (or simply trade items on the eBay site) is diminutive — no small business loan is required, there’s no need to uproot family, get on a boat, and stand in line at Ellis Island. In the near term, at the current clip of item and store growth, it’s conceivable that the supply of products at eBay stores will begin to exceed the demand. Though we do note that in spite of the massive growth in items listed on eBay (from 4MM in 1997 to 638MM in 2002) we have been pleasantly surprised that eBay’s conversion rate for the actual sale of these items has been relatively stable, near 50%. Will this stability continue? In our view, it probably declines a bit (note that we have thought this for a long time and have been proven wrong), but with the relatively low-cost seller economics that eBay offers, it probably doesn’t create major issues for key sellers. And, we consistently reflect on the simple fact that there are an estimated 550-600MM global Internet users and only 28MM active eBay users, implying to us that there’s still lots of buyer upside.

Now, for the relevance of our history briefing. Here’s our Digital World vs. New World comp.

eBay started out as an online trading venue for Pez dispensers. Almost as loopy, without the benefit of perspective, as the fact that modernization of the island of Manhattan started out as an offline trading venue for skinned animals (aka beaver pelts).

For eBay, the management team played a role equivalent to that of Peter Stuyvesant, insofar as it helped organize the layout, the rules, the security, and the game plan. Thinking big and thinking ahead, it made a few Alexander Hamilton-like moves and helped significantly improve the commerce system (for both eBay and the Internet) with the purchase of PayPal. Then, taking a page from the DeWitt Clinton playbook, eBay ramped its Erie Canal equivalent and opened up the eBay platform with the debut of the eBay application programming interface (API) — the ramp in items listed (and stores) demonstrates the success of this effort, in our view. The equivalent of DeWitt Clinton’s leveling of the playing field (Manhattan for this analogy) has been a part of eBay’s nature from the beginning. The ships keep going in and out of the harbor, bringing in millions of people who, yes, buy and sell things. How apt that the name eBay is derived from “electronic bay.” Open harbor...open platform?

Like Manhattan, eBay brings together millions of diverse people from around the world, who nevertheless share one common pursuit: the buying and selling of goods. And, while vendors in New York have tended to gather in neighborhoods defined by a shared interest (Garment District, Diamond District, Wall Street...) the same applies on eBay (with its 18,000 categories including Motors, Collectibles, Sports, Duck Stamps, Yahtzee and other Dice Games...). The interactions in these communities have helped create a state of continuous change on the two sites (Manhattan and eBay). And as the forms of capitalism evolve, the communities of users who drive the change expand along with it. “The first thing about a commercial culture is that it will be continuously changing,” said former New York Senator Daniel Patrick Moynihan in the Ric Burns documentary about New York. “It will embody what [Josef] Schumpeter called the *creative destruction* of capitalism.”

These types of changes don’t typically occur painlessly. The community of Manhattan serves sociologists well as a laboratory for the interaction of people of disparate interests in a very intense environment. And the history of New York City is dotted with chaos and rebellion. It’s also known for its mix of strict enforcement *and* freedom, unification *and* disparate cultures, gridlock on crowded

streets *and* space in Central Park, excellence *and* failure, “in your face” competition and feedback, and a sense of constant discovery. Mmm, to us it almost seems like a perspective on the short life of eBay.

Sound crazy? Perhaps, but the “Digital World” is a vast “New World” too. This time, the ability to get to the “New World” is somewhat frictionless, but the data suggest to us that while the migration of people to this world is massive (and is occurring at an unprecedented rate), the number of places they set up shop (like eBay) is quite small. And, while the “barriers to entry” are not insurmountable, they certainly are significant. It’s our view that there will likely only be a small number of sites that Internet users use as hubs for searching for information and products and that networking effects will make the leaders stronger.

Depending on how you define Day One, we are, give or take, barely a decade into *this* New World. And like “the forest for the trees,” it’s hard to see history when you are living it...

In Conclusion...

For the Internet and its impact on all of us, it’s still early days, but many of the leaders and laggards have begun to emerge. We believe that the surprise will be that some of the emerging leaders have more potential than they are being given credit for and that the likely ever-expanding list of emerging laggards are more at risk than is widely understood.

We think it’s kind of simple. The economic environment is challenging. Most companies have the wind in their faces. A few have the wind at their backs. Pick one. Wind in face? Wind at back? We’ll take the later.

Moving from Sailing 101 to Marketing 101, we paraphrase Philip Kotler (see textbook ‘Marketing Management’).

There are three ways for successful growing companies to expand their total market size: 1) adding new users; 2) expanding new uses of products; and 3) expanding usage of products.

Moving from Marketing 101 to Investing 101, we quote Peter Bernstein (see 1956 ‘Harvard Business Review’ -- ‘Growth Companies vs. Growth Stocks’). ‘Economic development or growth occurs in three different processes: in the increase of population, in the accumulation of capital, and the technological progress which enables us to produce more things, better things, different things, or the same things more cheaply.’

We think that the Internet leaders have (and are) demonstrating these trends in size. Our secular trend is demographic and it’s a significant growth in population (defined as Internet users *and* usage). The trend is big, and, we maintain that, at the margin, online will continue to gain share from offline, and we believe that the companies that benefit should benefit big.

Again, we remain optimistic about the outlook for a portfolio of Internet leaders (including eBay, Yahoo!, and Amazon.com and Expedia), as we believe that the potential for the businesses is still underappreciated...See our company-specific reports for more detail. In addition, our recent industry report, ‘The Online Classified Advertising Report: It’s About Search / Find / Obtain (SFO),’ http://www.morganstanley.com/institutional/techresearch/online_classifieds1102.html, is especially timely, in our view. Our industry investment thesis follows.

For a discussion, if applicable, of the valuation methods used to determine the price targets included in this summary and the risks related to achieving these targets, please refer to the latest published research on these stocks. Research is available through your sales representative or on Client Link at www.morganstanley.com and other electronic systems.

Internet & PC Applications Software (2/21/03)**Industry Investment Thesis (Attractive)**

We continue to believe that the Internet is still in the early stages of becoming a central communications, information, commerce, and entertainment medium. We estimate there are 550-600 million Internet users worldwide using the Internet an estimated average of roughly 30 minutes per day. We expect the number of Internet *users* to grow at 10-20% annually for the next several years, with stronger growth in non-US markets. And we estimate that *usage* growth (in part because of ongoing broadband adoption) should continue to be higher, thus, we believe, demonstrating relatively compelling underlying growth trends.

Given this robust underlying growth, we continue to believe that the leading Internet companies should, over time, be able to generate strong double-digit top-line growth, and as the financial models scale towards higher long-term margins, should be able to generate even stronger earnings growth — AKA leverage. If the leaders execute to their opportunities, we believe that the leaders could demonstrate classic growth-stock undervaluation characteristics.

While the general economic environment continues to be challenging — we note that according to our analysis, most GDP forecasts for 2001 were too high by 90%+ AND 97% of the companies in the S&P 500 missed earnings estimates at least once in 1999–2000 — we point out that many of the leading Internet companies are supporting very strong revenue growth, and that CQ4:02 appears to have been a positive inflection point. In C4Q:02, we note that Y/Y growth rates for the Internet leaders were compelling — 100% Y/Y growth for Expedia (70% pro forma with Classic Custom Vacations acquisition), 51% for Yahoo! (34% pro forma with HotJobs acquisition), 89% Y/Y growth for eBay (55% pro forma for PayPal acquisition), and 28% for Amazon.com.

In general, near term, we remain focused on what we consider to be key underlying positive trends:

1) **The Internet should prove to be the growth distribution channel of the decade** — As companies that benefited from leveraging the PC as their distribution channel (like Microsoft and America Online) created significant new businesses and shareholder wealth, we believe an emerging group of still relatively early stage companies should do the same with the Internet.

2) **Search/find/obtain (SFO) is becoming a global reality** — Google, eBay (EBAY, \$76.79, Overweight-V), Amazon.com (AMZN, \$21.36, Overweight-V), Yahoo! (YHOO, \$19.72, Overweight-V), Expedia (EXPE, \$63.30, Overweight-V), Microsoft (MSFT, \$24.15, Overweight-V) and Overture have driven this and it benefits users and vendors as it helps reduce friction and makes inefficient markets more efficient.

3) **Strong underlying growth rates for global Internet usage/users** — in spite of (and, perhaps, in part, because of) a very challenging economic environment.

4) **Online market share gains from offline markets** — such as Expedia in travel and eBay in collectibles. In the US, e-commerce accounts for only 1.3% (and rising) of retail sales.

5) **“Mind share” well above “market share” demonstrates growth opportunity** — 550-600 million-plus Internet users and, for example, only 29 million active Amazon.com customers?

6) **The consumer seems to be alive and well for key technology-related purchases** — Internet, digital cameras, video games... could the consumer (vs. the enterprise) drive the next leg of technology-related growth and a PC upgrade cycle? In addition, we believe that many **small to medium-sized enterprises (SMEs)** have benefited from the increased usage of the Internet as vendors/users/sellers.

7) **Convenience, low (and transparent) prices/pricing, uniquely strong customer service, and extensive selection** have been key factors behind growth in leading online commerce (and information) sites and should continue to spur growth for the leaders. In addition, we believe that positive trends for the ramps in *used* and *replacement* goods continue to be quite strong, assisted by rising user confidence in obtaining these types of goods/services.

8) **Online advertising trends could surprise on the upside** in next 6–12 months, and we believe the compelling ROI will become more apparent to advertisers. We believe online advertising (including pay-for-placement) could grow 20-30% in 2003 and accelerate in 2004.

9) **Handful of industry leaders gaining share** with less competition on almost all fronts.

10) **Operating leverage with inherently scalable models is powerful** — for example, Amazon.com got big fast, spent lots of money, now what? Fixed costs and operating leverage, in our view.

11) **Positive earnings surprises are, more often than not, followed by more of the same...** and improving operating margins and revenue growth acceleration can be found in this group, in our opinion.

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	607	32%	240	38%	40%
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