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Industry

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GICS SECTOR	INFORMATION TECHNOLOGY
Strategist's Recommended Weight	13.9%
S&P 500 Weight	15.2%

Industry Overview

July 8, 2005

An Update from the Digital World: Netscape IPO — Ten Years Later

On August 9, 1995, Netscape went public. It helped spark the rapid growth of the Internet, massive infrastructure investments, and unprecedented innovation. It also helped drive what we have called "a boom → bust → boom-let period for new-company creation and a boom-let → bust → boom period for wealth creation."

The ups and downs of the evolution of the Internet are well documented. That said, what's especially startling here — ten years later — is just how far we have come.

In this note, we highlight 19+ events from the past 12 months that hammer home the progress since Netscape's IPO. Part of the interesting news we see here is that we are still in the early innings of the impact and development of the Internet. The innovation pipeline is more vibrant — and the pace of change is faster — than we have seen in our lifetimes. Strap in!

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An Update from the Digital World: Netscape IPO — Ten Years Later

19+ Events That Few People Would Have Predicted Ten Years Ago…

August 19, 2004 — **Google goes public with a valuation of $23 billion**. For CQ2:04, the company supported $700MM in gross revenue and $423MM net revenue (+97% Y/Y) with a 58% operating margin (on net revenue, excluding stock compensation expense).

October 6, 2004 — **China has more Internet users under the age of 30 than any other country**, according to Morgan Stanley estimates. In addition, there are ~876MM Internet users (23% in US, 77% outside US) – up from ~5MM (75% in US, 25% outside US) when Netscape went public.

January 21, 2005 — **Dow Jones pays $453MM for CBS MarketWatch**, an Internet-content company, which carried an enterprise value of -$15 million in September, 2001. Other traditional media companies follow suit and on March 18, The New York Times pays $410MM for About.com, an Internet-content company, which carried an enterprise value of $254 million in November, 2000. Then on June 6, EW Scripps agrees to pay $560MM for Shopzilla, an Internet comparison shopping company.

April 13, 2005 — **Rupert Murdoch calls himself a "digital immigrant."** In a speech to the American Society of Newspaper Editors, the Chairman and Chief Executive Officer of News Corporation says, "My two young daughters...will be digital natives… I didn't do as much as I should have after all the excitement of the late 1990s. I suspect many of you in this room did the same, quietly hoping that this thing called the digital revolution would just limp along… We need to realize that the next generation of people accessing news and information, whether from newspapers or any other source, have a different set of expectations about the kind of news they will get, including when and how they will get it, where they will get it from, and who they will get it from… Consumers between the ages of 18-34 want control over their media, instead of being controlled by it."

April 15, 2005 — **There are 151MM global broadband subscribers** (+45% Y/Y, CQ1), and South Korea achieves 70%+ penetration (of online households), according to Morgan Stanley estimates.

April 19, 2005 — **Yahoo! reports it has 372MM unique** users (+36% Y/Y) as of the end of March.

April 20, 2005 — **eBay reinforces its position as the world's leading vendor of pre-owned cars**. Based on eBay's CQ1 Gross Merchandise Volume (GMV) figures, an estimated $13B (+48% Y/Y) in annualized sales of cars (cars, trucks, motorcycles, and other vehicles) and parts were sold on eBay.

April 20, 2005 — **72 million Internet users have PayPal online payment accounts** (+57% Y/Y, CQ1), according to eBay, exceeding the 65 million consumers who have American Express cards.

April 21, 2005 — **Google supports $1.3B in gross revenue and $795MM in net revenue** (+109% Y/Y) with a 62% operating margin (on net revenue, excluding stock compensation expense).

May 19, 2005 — **Bill Gates refers to Microsoft's next-generation video game console as "one of the most ambitious things the company has ever done."** Gates, Chairman and Chief Software Architect of Microsoft, expressed optimism about the potential for Xbox360 when he said that it represents "the big move towards the digital living room using gaming – the world's best gaming – as a way to kick that off."

May 10, 2005 — **Apple has sold more than 400MM iTunes** since the online music store opened in April 2003, and the company carries 70% share of the global online music market.

May 11, 2005 — **AOL ends its 'for pay' online service.** After 20 years of offering a "for pay" online service AOL announces it will re-launchAOL.com as a free Web site. This was done in an effort to stem a decline in the subscriber base, which had fallen to 22MM from 27MM in 2003. AOL CEO Jonathan Miller states, "Very quietly, the walled-garden era has ended."

June 8, 2005 — **Barry Diller's InterActiveCorp continues to phase out offline businesses (in favor of online efforts)** as the company sells its 5% interest (common and preferred) in Vivendi Universal Entertainment (VUE) to NBC for ~$3.4B.

June 13, 2005 — **Skype achieves the fastest new product ramp in history with its VoIP offering.** It reports 42MM registered users of its VoIP (voice-over-Internet-Protocol) service.

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June 13, 2005 — **Offline advertising begins to show some cracks from a major buyer.** Procter & Gamble (the #1 US advertising spender in 2004, per VNU's Nielsen Media Research) announces that — during its annual "upfront" negotiations, the annual round of talks — it would reduce cable TV spending by 25% and broadcast TV spending by 5%.

June 27, 2005 — **Google's market value exceeds $88B,** making it the 23rd most highly capitalized company in the US and the 42nd most highly capitalized company in the world.

July 6, 2005 — **Man charged with felony for drive-by theft of Wi-Fi signal.** Police in St. Petersburg, Florida, arrested a man who was observed using a wireless-enabled laptop in an SUV parked in front of someone else's home.

July 7, 2005 — **Bloggers and camera-phone photographers are first to chronicle London bombings**. Postings on blogs provide almost instant first-hand accounts, accompanied by still and moving images of the events in the London transit system.

July 7, 2005 — **Aggregate market value of the five leading pure-play Internet companies (Google, Yahoo!, eBay, Yahoo! Japan and Amazon.com) surpasses $231B**, up from less than $1B a decade ago.

Credit goes to Paul Saffo, Director of the Institute of the Future…

As these headlines have scrolled over the past 12 months, we've also thought about Paul Saffo's prescience ten years ago, when he said:

It's a very consistent pattern in this business that collectively as a society and as individuals we all suffer from what I call macro-myopia. A pattern where our hopes and our expectations or our fears about the threatened impact of some new technology causes us to overestimate its short-term impacts and reality always fails to meet those inflated expectations. And, as a result our disappointment then leads us to turn around and underestimate the long-term implications — and I can guarantee you this time will be no different. The short-term impact of this stuff will be less than the hype would suggest, but the long-term implications will be vastly larger than we can possibly imagine today…this revolution is more than unpredictable. We are performing a great unwitting experiment that is changing our social structures, our governmental structures and our business structure. Everything, absolutely everything, is up for grabs and nothing's going to make any sense at all for a couple of decades, so we may as well sit back and enjoy the ride.

You can find Paul Saffo's comments and a great Q&A session from June 1995 at *http://www.pbs.org/wgbh/pages/frontline/cyberspace/saffo.html*.

In addition, if you are interested in a decade-old framework for how the Internet could evolve, check out Morgan Stanley's *The Internet Report*. *http://www.morganstanley.com/institutional/techresearch/inet.html*

Updates from the Digital World – An Overview

Since our first "Digital World" report, published in 2002, we have used this series to discuss some major events and inflection points related to the Internet that we thought were underappreciated. Below, you will find a list of our "Digital World" reports to date. In this report, we update our Internet Ecosystem Framework and review current trends for key Internet usage and user metrics.

- **Update to our Internet Ecosystem Framework**

December 2004: We compile what we believe are the most relevant publicly available metrics that represent key market trends in various parts of the Internet usage/user spectrum.

- **Syndication, Blogs and RSS**

October 2004: Getting news/information when you want it is getting easier and easier. We focus on three factors that are combining to help drive online momentum: 1) rising usage of RSS (Really Simple Syndication) by content providers as a standard distribution platform for online content; 2) ramp in creation of blogs and other user-generated content and 3) Yahoo!'s easy-to-use integration of RSS feeds with My Yahoo!. Google may have set the pace for *searching* information, but Yahoo! may be *setting* the pace for new ways of serving information…"next-generation content" should gain usage / revenue traction in C2005E.

- **Who Has the Momentum?**

November 2003: To determine which Web sites are supporting the greatest growth momentum, we reviewed multi-factor rankings aggregating absolute and sequential trends for visitors, page views, and usage minutes at 1,217 leading properties/sites (using US Media Metrix data). Growth trends for advertising, commerce, content, and community continue to look encouraging.

- **Microsoft, it's the Sound of Online Music?**

June 2003: In our view, the day (May 29, 2003) that Microsoft agreed to pay AOL Time Warner $750MM to settle the lawsuit related to Microsoft's Netscape-targeted business practices marked an end, and a beginning, for the evolution of the Internet. To put this event in a historical context in our report, we told a short story of the evolution of the commercial Internet to date. Recent data related to online music — a natural SFO business — gave us the sense that music could, finally, become a catalyst that changes the rules of the game in the evolution of the Internet. We also focused on Microsoft's front- and back-end Internet-related initiatives with forthcoming releases of Internet Explorer, MSN, and Windows (Longhorn), and ongoing developments to the company's Web services (.NET) efforts.

- **What's New at Yahoo!?**

April 2003: We focused on the positive core secular trends in Internet advertising and drilled down on Yahoo! as a proxy and driver of these trends. In addition, we touched on what we saw as an impressive list of improvements by Yahoo! to provide a better experience for users and more effective marketing for advertisers.

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Updates from the Digital World – An Overview *(continued)*

- **Who's Keeping the Customer Satisfied — and How?**

Late-March 2003: Internet leaders such as Amazon.com, eBay, and Expedia had just scored strong relative results in customer satisfaction in the highly regarded American Customer Satisfaction Survey. Convenience, low (and transparent) prices/pricing, uniquely strong 24x7 customer service, and extensive selection had long been key factors behind the growth for leading online commerce (and information) sites. These attributes were becoming increasingly apparent to us (and measurable). Owing in part to the power of their technology platforms, Internet leaders were raising the bar on customer satisfaction and loyalty.

- **What Brought on the Strong Momentum of CQ4:02?**

March 2003: In addition to improvements in the SFO experiences of the Internet, a key part of the answer may have been the scale and ramp of residential broadband usage, which made possible the emergence of what we saw as a group of Internet-enabled "power consumers."

- **The Great Online Migration — Is eBay a Replay of New York City's 18th Century?**

February 2003: We focused on the relevance and magnitude of sellers and buyers migrating online, as illustrated by eBay's momentum, and we drew some historical analogies to the dynamics of the settlement and growth of New York City.

- **Is Search/Find/Obtain (SFO) Becoming the Internet's Third Killer Application?**

December 2002: Our first "Digital World" report examined online vs. offline momentum related to expanded global distribution, lower relative pricing related to transparency and the ramp in the sale of used goods, and the rising impact of replacement products.

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Underweight/Sell	362	19%	91	14%	25%
Total	1,922		654		

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Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months. Ratings prior to March 18, 2002: SB=Strong Buy; OP=Outperform; N=Neutral; UP=Underperform. For definitions, please go to www.morganstanley.com/companycharts.

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Attractive (A). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark named on the cover of this report.

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