Economist | http://www.economist.com/PrinterFriendly.cfm?Story_ID=2173573 30 Oct. 2003

How good is Google?

Google is now more than a business: it is a cultural phenomenon. But where will it be in a few years?

If the ultimate measure of impact is to have one's name become a new verb in the world's main languages, Google has reason to be proud. When they founded the company five years ago, Sergey Brin and Larry Page, friends at Stanford University, chose a word play on "googol"—the number 1 followed by 100 zeros—because their ambition was to organise the information overload of the internet in a transparent and superior way. These days, singles "google" suitors before agreeing to a date, housewives "google" recipes before cooking, and patients "google" their ailments before visiting doctors. Dave Gorman, a comedian, even has a popular show, the "Googlewhack Adventure"—a Googlewhack being what happens when two words are entered into Google and it comes back with exactly one match.

As search engines go, in other words, Google has clearly been a runaway success. Not only is its own site the most popular for search on the web, but it also powers the search engines of major portals, such as Yahoo! and AOL. All told, 75% of referrals to websites now originate from Google's algorithms. That is power.

For some time now, Google's board (which includes two of Silicon Valley's best-known venture capitalists, John Doerr of Kleiner Perkins Caufield & Byers and Michael Moritz of Sequoia Capital) has been deliberating how to translate that power into money. They appear to have decided to bring Google to the stockmarket next spring. Bankers have been overheard estimating Google's value at $15 billion or more. That could make Google Silicon Valley's first hot IPO since the dotcom bust, and perhaps its biggest ever.

That alone is enough to have some sceptics whispering "Netscape". Now that the worst of the dotcom hangover is clearing, they wonder, will Google become one of the few valuable internet survivors, joining Amazon and above all eBay? Or will it simply be the next overhyped share sale to make its founders rich only to wither away miserably, either for lack of a sustainably profitable business model, or, like Netscape, because it finds itself in the path of that mighty wrecker, Microsoft?

The search for profits

Google, naturally, is determined to avoid Netscape's fate at all costs. This was why it made Eric Schmidt its chief executive in 2001. Mr Schmidt was 46 at the time—Messrs Brin and Page were in their twenties—and was the boss of Novell, a software firm decimated by Microsoft but given another lease of life under his leadership. He seemed suitably "adult" to turn Google into a money-making machine.

Mr Schmidt understood that the key to monetising all those customer searches (now 200m a day) was to place small, unobtrusive and highly relevant text advertisements alongside Google's search results. Advertisers like this system because they pay only if web surfers actually click on their links. And consumers either do not mind, or even learn to love these commercial links for their relevance, just as they appreciate the Yellow Pages.

Google did not pioneer this "paid search" advertising. That honour falls to Overture, a Californian firm bought this year by Yahoo! which still has about half of the $2 billion-or-so market. Nor did Google's founders readily embrace the concept. Mr Page was once heard to say at a trade show that commercial exploitation was "bastardising" the search industry. Mr Schmidt made the concept uncontroversial at Google, thereby helping paid search to become the fastest growing part of the advertising industry today.

The next step is to take this approach to advertising from the results pages of search engines and on to other web pages. Increasingly, web publishers—from hobby bloggers to small businesses—allow firms such as Google to crawl through the content of their pages and place relevant text advertisements in the right margin. Once page visitors click on the links, the webmasters share the revenues with Google. At a stroke, this so-called "contextual advertising" makes much of web publishing self-financing. This may result in better web content by making hitherto unprofitable online activities economically viable.

Meta Group, a consultancy, reckons that the market for paid search and other contextual advertising will grow to $5 billion by 2006. This is Google's main market opportunity (although it also gets some revenues from licensing its search technology). Currently, Google is thought to make annual profits of about $150m.

To be worth the rumoured $15 billion for longer than it takes a bubble to burst, it will need to raise its profitability substantially. That means matching such internet stars as eBay (market capitalisation $37 billion), but without the natural-monopoly advantages that have made eBay so dominant—the classic network effect of buyers and sellers knowing they do best by all trading in one place. For Google to stay permanently ahead of other search-engine technologies is almost impossible, since it takes so little—only a bright idea by another set of geeks—to lose the lead. In contrast to a portal such as Yahoo!, which also offers customers free e-mail and other services, a pure search engine is always but a click away from losing users.

Yahoo!, in fact, will probably be the first to attack. It now owns rival search technologies including AltaVista, AlltheWeb and Inktomi. With the contextual-advertising technology of Overture, Yahoo! now has under its own roof all the elements of the business model that made Google such a success. It cannot be long before Yahoo! turns from a lucrative customer of Google's into a powerful rival.

Even more frightening (especially to those who remember Netscape's fate in the browser wars), Microsoft smells blood. It is currently working on its own search algorithm, which it hopes to make public early next year, around the probable time of Google's share listing. Historically, Microsoft has been good at letting others (Apple, Netscape, Real) pioneer a technology before taking over, exploiting its dominance in desktop operating systems.

Google the new-age advertising agency makes money, but it is Google the search engine that builds the consumer brand which makes the ad agency powerful. Whenever users click on advertisements on Google's own site, Google gets all the revenues. Whenever users stray to other search engines, even ones where Google has placed sponsored links, Google has to share the revenues with the site owner. As the competition between Google, Overture and others heats up, Google's profit margins will fall.

This may already be happening. Craig Pisaris-Henderson, the chief executive of FindWhat.com, a smaller rival to Overture and Google in contextual advertising, reckons that Google's operating margins on sites other than its own must be much worse than FindWhat.com's (23%) or Overture's (12%) because it has been wooing advertisers away from Overture by being more generous to webmasters.

One thing that might help against Microsoft, says Danny Sullivan, the editor of SearchEngineWatch.com, an online consumer guide to the industry, is Google's image of "niceness"—at least by implicit comparison with the forces of darkness in Redmond. Scott Banister, a pioneer of paid-search technology (and now a founder of IronPort, an e-mail infrastructure firm), thinks that Google has already built sufficiently deep networks with advertisers to mount an effective resistance to Microsoft's impending assault.

Even so, Google is no sure thing—as those who hope to sell its shares are no doubt aware. John Doerr and Michael Moritz, for instance, between them also brought Netscape and Yahoo! to market, and may remember their lessons. With luck, Google's owners will remember to work out a viable strategy for Google beyond the point at which they cash out.