ENTR 3600 - Business Essentials for Technology Entrepreneurs

Case Study 1 - Tom.com: Valuation of an Internet Company

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Executive Summary:

This case talks about a portfolio manager, Andy Lau. Andy is the portfolio manager of EuroGlobal Funds, and he uses a variety of valuation techniques to estimate Tom.com's present and future values to decide whether EuroGlobal Funds should make a long-term or short-term investment in the company. Andy has connections in the sector, one of them being Li Kai-Shing, a wealthy and influential businessman who contributed to the growth of Tom.com. This investment in Tom.com by Li Kai-Shing is the main argument of this case study. Andy Lau, the business, investors, and customers were among the numerous stakeholders in this case study. After looking at several options, it was decided that not buying the company's stocks would be the best course of action because it would benefit investors in the long run.

Problem Statement

Valuing Tom.com, an internet company, is critical due to the "Internet bubble" of the late 1990s and early 2000s. During the bubble, many internet businesses were overvalued, including Tom.com, which initially seemed worth over $10 billion. Tom.com went public in 2000 but faced a big drop in value when the bubble burst, leading to major changes in its structure and selling off assets. Traditional ways of valuing companies, like looking at cash flow or earnings, didn't work well for high-growth, uncertain internet companies like Tom.com. Investors, like Andy Lau, might be tempted to invest quickly without enough information, risking their money. The big issue was finding a balance between making money now and making smart, long-term investments. Stakeholders need to navigate the market volatility of valuing internet companies during uncertain times, ensuring sustainable growth and avoiding speculative bubbles.

The **overarching** issue was determining Tom.com's actual value between a speculative market, impacting its worth and business model. Investors learned from the dotcom bubble how to take advantage of tools prioritizing due diligence, strength on sustainable growth metrics, analyzing the risks, and evaluating past marketing hype when companies had inflated valuations. The downfall of Tom.com was due to struggles faced by management in adapting to the shifted market.

Users and Objectives:

1. Andy Lau - Investor (main user)
    - A portfolio manager at EuroGlobal Fund
    - Informed investment decisions aligning with risk appetite and return expectations. Utilizes discounted cash flow analysis for investment decisions.

2. Li Kai-Shing - Family Group (main user)
    - A wealthy group from Hong Kong that owned 62% of Tom.com.
    - To maximize shareholder value - aligning with management's goal, they aimed to execute the IPO, achieve growth targets, and position Tom.com as an industry leader.

3. Customers
    - Significant stakeholders as users of Tom.com's products and services.

4. Other Stakeholders and Investors
    - Hold stakes in Tom.com and have a genuine interest in the company's success and profitability.
    - Include Romfield, Easterhouse, Chung Kong, Handel, and Pacific Century CyberWorks Limited (PCCW).

5. Schuman and Handel
    - Bring expertise in project development and planning in China.
    - Holds 23.75% and 14.25% respectively in Tom.com and contributed to securing licensing and content provision contracts.

6. Employees
    - Contribute to the company's success, potentially benefit from stock options, and ensure job security in advanced career opportunities.

7. Underwriters and Financial Advisors
    - Ensure a smooth transition in the IPO process and maximize fundraising potential while adhering to regulatory requirements.

8. Regulators and Government Authorities
    - Ensure the legality and transparency of the IPO process, safeguarding investors' interests and market stability.

- Figure 1 explains the power and interest among these different users discussed above.

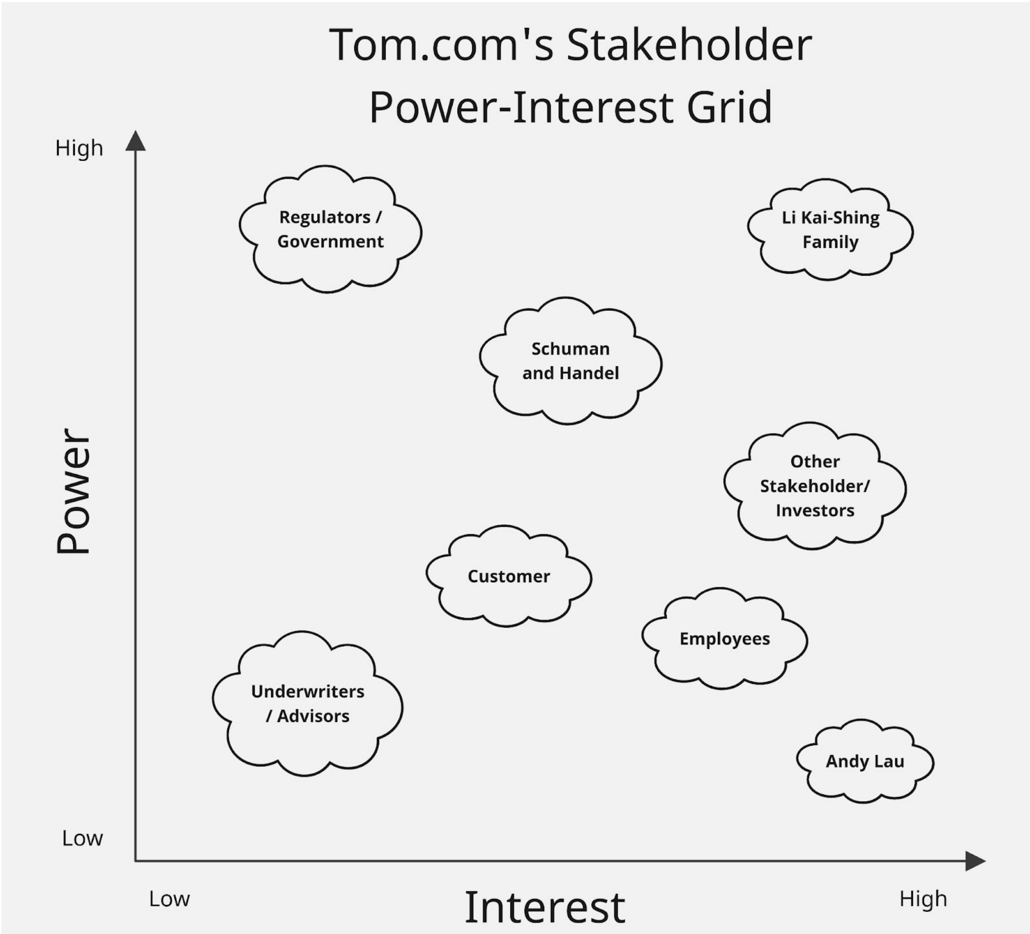

Figure 1: Tom.com’s Stakeholder Power-Interest Grid

Company Analysis:

1. External Environment
    - Opportunities:
        i. China's digital advertising sector is expanding quickly. Tom.com may benefit from this growth by collaborating with advertisers to efficiently reach their target audiences.
        ii. When comparing Tom.com with some of the most popular PRC portals like Sina.com, 163.com, etc, Tom.com could see a growth in their page views ranging from 210 to 399 million per month.
        iii. From 1998 to 2003, the overall annual growth rate of online spending in Asia will reach 104%. Due to the expansion of the Asian market, this was an opportunity to generate US$118.4 billion in revenue by 2003.

    - Threats:
        i. Tom.com had a market that was densely populated with competitors coming from diverse sectors, saturating the industry

with formidable rivals that were also trying to be dominant in the industry.

ii. Internet companies have intense competition because this industry is growing constantly. This constant growth is another threat.

iii. Modifications to Chinese government laws about data privacy, content censorship, or foreign investment may present difficulties for Tom.com's operations and expansion plans.

2. Internal environment
    - Strengths**:**
        i. Tom.com had many sources of income as they planned to have four revenue streams over time.
        ii. Tom.com was one of a kind for the Chinese market and had the potential to get 1 billion customers.
        iii. They were also ahead of their competition because of their connection with Hong Kong's most high-profile tycoon Li-Kai Shing.
        iv. They achieved tremendous brand recognition which helped draw users and advertisers to its platform locally (from China) and eventually internationally - allowing them to expand.

    - Weaknesses**:**
        i. Tom.com had a short history as compared to other companies that were in the same category (internet).
        ii. The business model of Tom.com was immature. This was due to a lack of knowledge and experience in the company.
        iii. High marketing expenses and high development spending could make Tom.com experience negative cash flows in the foreseeable future.

Sub-Issues:

Market Penetration Strategies Sub-Issue:

- **Introduction**: TOM.COM desired to be the top choice for people interested in China by using a special platform called Tomcast.
- **Impact on the Company**: Trying to do too much at once could cost a lot of money, making it hard for people to start using Tomcast, and confusing the company's main goals, thereby hurting TOM.COM's success in important areas.
- **Solution**: TOM.COM should target a specific group to maintain the material is relevant. Gradual improvement of services and user feedback. Additionally, a company can reduce expenses and increase its reach without going over

budget by developing innovative marketing strategies and collaborating with others to share information.

Valuation Methodologies Sub-Issue:

- **Introduction**: The challenge lies in valuing TOM.COM, a high-growth and high-uncertainty Internet company, using traditional approaches like Discounted Cash Flow and Price/Earnings Multiples, as opposed to speculative methods emerging during the dot-com era.

- **Impact on the Company**: These valuation complexities could lead to overvaluation or undervaluation, affecting investor confidence, fundraising capabilities, and strategic planning due to the difficulty in accurately forecasting future profitability and growth.

- **Solution**: TOM.COM must use a mixed way of figuring out its value, combining usual methods with changes to fit the online business world better. This means looking at various possible future scenarios to get a better idea of what the company might be worth.

Risk Management Sub-Issue:

- **Introduction:** Risk management at TOM.COM involves dealing with tough regulations in China, keeping up with fast technological updates, determining what customers want, and dealing with lots of competition online. Futuristic extensive plans involve significant operational and financial risks.

- **Impact on the Company:** These risks might negatively affect TOM.COM's financial performance and overall operation. Uncertain regulations in China could stop the company from growing. Rapid technological improvements and changing customer preferences could shrink product relevance, reducing its importance and potential for profit. Moreover, TOM.COM always needs fresh ideas and spends a lot on marketing due to its strong competition, which could greatly reduce its budget.

- **Solution:** To address these challenges, TOM.COM needs to implement a comprehensive risk management strategy, including dealing with regulations and lobbying, flexible technology and content strategy, and strategic partnerships. Staying updated with regulatory changes, engaging in lobbying efforts, and maintaining strong relationships with government authorities to make things move more smoothly. Investing money in identifying and creating new products, testing out the latest technologies to keep up with consumer preferences, and regularly improving their product range. By leveraging the technology and content of successful companies Tom.com can expand its customer base and save expenses through collaboration and minimizing risk.

Alternatives to the Problem:

Research and Analysis: The internet bubble required investors to conduct thorough research and analysis of the impact on the valuation of the emerging tech company tom.com. This would impact the decision on where the investments should have been made specifically in the company. This would have both short-term and long-term effects on the company as the investments would not just be based on speculation. Research, analysis, and resources were needed to make proper short-term investment decisions.

Financial Analysis: Investors should have properly examined the financial statements of Tom.com, such as income, balance sheets, and cash flow, to assess revenue growth, profitability, margins, and overall financial health. Key metrics include gross and net margins, return on equity (ROE), and earnings per share (EPS). These would have enabled the company to realize what they were doing wrong on a short-term basis and focus resources on rectification.

Leadership and Management Team: Evaluating the qualifications, experience, and track record of the company's leadership team, including the CEO, founders, and key executives. Strong leadership is often correlated with successful execution and strategic decision-making. In this case, TOM.COM seemed not to have identified a proper management team to be able to steer the company to the targeted success since the company was operating in a fairly new tech industry.

Recommendation:

Investors like Andy Lau & EuroGlobal should avoid the temptation of “get rich quick” strategies and instead stick to longer-term, safer investments. EuroGlobal has gotten to its position of being a top player in the mutual funds space through its strategy of long-term investments and it would be unwise to ‘fix what isn’t broken’. Moreover, Lau’s approach to assessing Tom.com hints majorly towards confirmation bias as he was seeking ways to justify investing in Tom.com, not vetting the company itself.

Given the nature of dotcom companies and their difficulty in being valued, this industry itself would be suited to investors with an extremely high risk tolerance as the then-current valuation of the company itself was speculation, not a fact.

Impact on Users and Objectives:

- **EuroGlobal:** EuroGlobal loses out on potential short-term profits but avoids the high risk, volatile investment on Tom.com. Given the benefit of hindsight, they would have indeed lost out long term since the dot-com bubble eventually burst.

- **Andy Lau:** The potential benefits of landing huge returns, as per Perkins' hyper-growth prediction, (and consequent commissions) as a portfolio manager will be the opportunity cost of not investing in the stock.

- **Li Kai-Shing - Family Group**: With fewer investors interested in Tom.com (which they own huge shares of through various subsidiaries), the overall value of the company goes down, affecting their net worth and overall business portfolio negatively.

- **Other (Current) Investors:** Similar to the above, their portfolio will take a hit. Moreover, due to demand/supply concepts - with lower demand for a piece of the company, the overall value goes down, affecting current shareholders/investors.

- **Employees:** Greater investment usually results in more opportunities, and more projects, which potentially lead to higher compensation packages. The employees will not get to enjoy this benefit if those investments don't come in the first place.

Conclusion:

Tom.com struggled to adapt its business model and value in the wake of the internet bubble. Additionally, management's pursuit of growth based on speculative information has led the company astray. The overvaluation of the business makes it difficult for management to steer the organization toward its goals, underscoring the importance of comprehensive research and analysis in investment decisions, especially in emerging markets. These factors in turn negatively affected the viability of Tom.com as an investment.