3-SIGMA VALUE

Where are the GlenGarry Leads?

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As described in 3-Sigma Value's separate report titled Software Economics – Volume II, we measure the value of technology and discriminate between (1) innovative technology companies with intellectual property (IP) and sustainable business models, and (2) companies that market themselves as innovative technology companies but in truth sell someone else's technology. The issue is not whether a company is a reseller or wholesaler or retailer or developer, the issue is that the company is what it presents itself as. We see this all the time when companies are pumped up with hyperbole in the marketing of IPOs.

An entire segment of internet services fails every test in terms of intellectual property, margin sustainability, and cash flow generation. The inevitable consequence of burning cash is the issue of the day, and the issue of all-time, the same issue that drives much of 3-Sigma Value's focus on the short side of the equation in a market agnostic strategy. It seems obvious at this point but bears repeating: as companies continue to burn cash they will continue to lose value.

Online marketing services is a broad segment of business on the Internet with valuations so robust that dozens of unproven companies have gone public in recent years, all with a singular goal:

> *These are the new leads. These are the Glengarry leads. And to you they're gold, and you don't get them. Why? Because to give them to you would be throwing them away. They're for closers.*
> *-Blake*

The classic strategy for generating leads is the cold call. Thankfully, our children won't have to know what that means. In the age of technology, access to potential customers has fragmented into a panoply of channels including email, websites/digital storefronts, deals/coupons, mobile, and social networks, with value added analytics and pre-packaged solutions further differentiating the vendors.

The list of companies on the next page represents Segment 1 of 3-Sigma Value's online marketing service provider universe[1]. Excluded from this analysis are digital advertising platforms[2], market research and consulting firms[3], advertising agencies and various other

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[1] 21 companies, 4 are micro-cap.

[2] Digital Generation (DG), Interclick (ICLK), Millennial Media (MM), ValueClick (VCLK), and Velti (VELT).

[3] Acxiom (ACXM), Arbitron (ARB), Comscore (SCOR), Harris Interactive (HPOL), GfK AG (GFK), Ipsos SA (IPS), INTAGE (4326.Japan), MACROMILL (3730. Japan), Nielson Holdings N.V. (NLSN), and many others.

integrated service providers. All of the companies included in this analysis share a common business model – leads. Whether it is via email, websites, social networks, or mobile applications, all of these companies make money the same way, by selling services that generate leads for their customers.

Online Marketing Service Providers

	Price as of 5/15/12	Fully-Diluted Shares Out	Market Cap	Debt	Cash	Enterprise Value	Consensus (a.k.a. pro forma) Revenue 2012	Revenue 2013	EBITDA 2012	EBITDA 2013	EPS 2012	EPS 2013
Segment 1: Cross-Channel Marketing (Email, Websites, Social, Mobile, etc.)*												
1a: Email Marketing												
Constant Contact (CTCT)	22.36	31.1	695.4	0.0	143.0	838.4	252.5	292.2	46.9	58.0	0.28	0.44
Email marketing is the orginal product, expanding in event marketing, social campaigns, coupons (SaveLocal), mobile (acquisition of Cardstar), and local (acquisition of SinglePlatform).												
							3.3x	2.9x	17.9x	14.5x	79.9x	50.8x
ExactTarget (ET)	25.99	62.2	1617.0	1.5	211.5	1827.1	271.8	329.4	4.3	14.9	-0.50	-0.40
3/12 IPO @ $19 of cross-channel marketing software - entirely email until Nov 2011; now mobile, social, websites - serving large Internet companies incl. ANGI, GRPN, BBY, & LYV.												
							6.7x	5.5x	424.9x	122.6x	NM	NM
Responsys (MKTG)	11.36	53.2	604.6	1.8	97.5	700.3	164.1	194.8	26.0	34.2	0.11	0.16
4/11 IPO @ $12 of The Responsys Interact Suite, providing marketers with integrated applications to create and automate marketing campaigns across e-mail, mobile, social and web.												
Enterprise customer base, with higher ASP and a higher services component than its best comp, Exact Target (ET).							4.3x	3.6x	26.9x	20.5x	103.3x	71.0x
Vocus (VOCS)	15.60	22.5	351.8	1.0	108.2	458.9	172.3	207.7	15.1	24.7	-1.21	-0.46
Expanded into email marketing via Feb 2012 acquisition of iContact for 3.4x $50 million run rate revenue; public relations software is the original business.												
							2.7x	2.2x	30.4x	18.6x	NM	NM
1b: Website Platforms												
Demandware (DWRE)	27.95	12.1	338.9	4.7	109.3	443.5	73.9	100.0	-8.1	4.0	-0.72	-0.32
3/12 IPO @ $16 of customizable e-commerce platform including websites, mobile and other digital storefronts. 101 customers (12/31/11) w/ 361 sites incl. Crocs, Nine West, and Zabars.												
Competes against GSI Commerce (EBAY), Yahoo Stores, Amazon, IBM WebSphere, Hybris, Venda, etc.							6.0x	4.4x	NM	110.9x	NM	NM
LivePerson (LPSN)	16.30	56.4	919.2	0.0	107.9	1027.0	161.9	196.0	40.2	49.4	0.24	0.30
Software enabling websites to offer chat, voice/click-to-call, email, analytics, and other personalized functionality to create meaningful online connections with customers.												
Competes against Art Technology Group, which was acquired by Oracle for 4.3x revenue / 16.3x EBITDA (11/10).							6.3x	5.2x	25.5x	20.8x	67.9x	54.3x
1c: User-Generated Ratings & Reviews												
Angie's List (ANGI)	13.14	59.9	787.1	14.9	65.5	837.8	155.0	223.0	-51.0	-22.0	-1.01	-0.55
11/11 IPO @ $13 of user-generated ratings and reviews at risk of free/freemium competition.												
							5.4x	3.8x	NM	NM	NM	NM
Bazaarvoice (BV)	16.16	66.2	1069.8	0.0	121.6	1191.4	121.7	157.5	-26.6	-13.9	-0.70	-0.51
2/12 IPO @ $12 of social analytics platform that gathers and analyzes feedback from online consumers via consumer-generated ratings and reviews, Q&As, and stories.												
5/24 acquisition of PowerReviews for $152 million eliminates BV's primary competitor. Reevoo is a UK competitor.							9.8x	7.6x	NM	NM	NM	NM
Yelp (YELP)	20.80	71.2	1480.7	0.0	122.6	1603.3	136.3	202.2	4.5	21.2	-0.31	0.05
3/12 IPO @ $15 of user-generated ratings and reviews characterized by high churn and depreciation as reviews become stale and worthless over a short period of time.												
Relies on Google for 75% of its web traffic.							11.8x	7.9x	356.3x	75.6x	NM	416.0x
1d: Content Farms												
Demand Media (DMD)	8.46	82.9	701.7	0.0	95.6	797.3	350.0	403	98	113	-0.01	0.11
2/11 IPO @ $17 of internet publisher of sites including eHow.com, LIVESTRONG.COM, Cracked.com, Tyra, etc; also, eNom, with over 10M domain names, is the #2 registrar.												
Content farming is a business model under constant duress of disintermediation by Google.							2.3x	2.0x	8.1x	7.1x	NM	76.9x
QuinStreet (QNST)	7.94	45.8	363.6	108.2	115.4	370.8	365.0	366.0	73.0	73.0	0.33	0.34
2/10 IPO @ $15 of online direct marketing, delivering qualified leads and clicks to clients in several verticals, but mostly education (44% LTM 12/31/11) and financial services (43%).												
Content farming is a business model under constant duress of disintermediation by Google.							1.0x	1.0x	5.1x	5.1x	24.1x	23.4x
Tech Target (TTGT)	6.08	40.9	248.4	0.0	60.8	309.2	110.0	116.9	27.0	29.6	0.14	0.15
Sells customized marketing programs for IT vendors to reach corporate IT decision makers; operates a network of over 100 websites.												
							2.8x	2.6x	11.5x	10.4x	43.4x	40.5x
1e: Other Sources of Leads												
The Active Network (ACTV)	13.86	68.9	955.2	13.4	95.0	1036.9	431.6	511.1	50.1	74.7	-0.65	-0.28
5/11 IPO @ $15 of online registration and event management software for organizations with large numbers of participants for sports, community activities, outdoors and business events.												
							2.4x	2.0x	20.7x	13.9x	NM	NM
Eloqua (ELOQ)	11.50	38.335196	440.9	0.0	85.5	526.3	93.4	114.3	-3.3	3.1	-0.29	-0.17
7/12 IPO @ $11.50 of provider of marketing automation software, integrates with CRM suites, mostly Salesforce.com (likely acquirer). Competes against Marketo (IPO 2012?), Microsoft Dynamics,												
Teradata/Aprima, IBM/Unica/Coremetrics/DemandTec, Oracle/Siebel, SAP CRM, Adobe Digital Marketing Suite, Exact Target/Pardot, Neolane, Alterian, Hubspot, Silverpop, etc.												
							5.6x	4.6x	NM	NM	NM	NM
Groupon (GRPN)	12.17	663.7	8076.8	7.2	584.5	8654.1	2,400.0	3,100.0	370.0	728.0	-0.02	0.45
11/11 IPO @ $20 of local group coupon service provider. Cash is net of $576.5 million of accrued merchant payable.												
							3.6x	2.8x	23.4x	11.9x	NM	27.0x
Marchex (MCHX)	3.37	55.1	185.7	0.0	37.4	223.1	144.4	160.0	19.3	23.6	-0.16	-0.14
Mobile and online advertising provider that connects consumers to businesses over the phone (leads) and provides analysis of those connections.												
							1.5x	1.4x	11.6x	9.5x	NM	NM
ReachLocal (RLOC)	9.10	36.4	331.3	0.0	90.8	422.2	375.2	445.5	11.6	19.5	-0.06	0.09
5/10 IPO @ $13 of online marketing solutions for small businesses; 90% of 2011 revenue was generated by one product, the original ReachSearch search-engine marketing solution.												
							1.1x	0.9x	36.3x	21.6x	NM	101.1x

* Micro-caps include Local.com (LOCM), LookSmart (LOOK), PFSweb (PFSW), and Autobytel (ABTL).

The main conclusion drawn from our research into online marketing service providers is **these are not technology companies**. Not one of these 20 companies has a credible path to sustainable profitability. Over the long term, the only hope for any of these companies is a take-out by a larger company with greater financial wherewithal. Therefore, the principal risk in shorting any of these companies is the risk of a take-out.

Feet-on-the-Street & the Absence of Operating Leverage

Because online marketing is a services-based model as opposed to a software-based model, the same opportunity for operating leverage does not exist. For most of these companies, revenue growth is tightly correlated to sales & marketing (S&M) expense growth. R&D is negligible in comparison. Whereas a typical software vendor should generate 80-90+% gross margin (GM) and 30-40+% operating margin (OM), a services-based provider will struggle to reach 20% OM.

With negligible EPS and negligible free cash flow (FCF), the valuations in this sector not only presuppose M&A, they also suggest these companies own valuable intellectual property (IP), something that is obviously not the case given low cumulative R&D, low margins, and zero EPS.

For this analysis, we focus our attention on one particular Internet company, chosen because it is a microcosm of the whole sector. It is not unique. It should not even be public. There is no technology. No intellectual property. And without irony, this Internet company's strategy is something they call ***Feet-on-the Street***.

ReachLocal (RLOC) is a search engine advertising (SEA[4]) company that went public in May 2010 at $13 per share with a singular goal of delivering *leads* to its 20,400 active advertisers (30,100 active campaigns; 1.5 campaigns per advertiser). 90% of revenue derives from ReachSearch, a search engine advertising platform that generates a list of keywords and decides what search engines / local directories to pay for.

Because all they do is generate a list of keywords, barriers to entry are low and churn is high. SEA/SEO/SEM is integrated and automated and widely available in free/freemium offerings. This is not high technology. Gross margin is below 50%. R&D as a % of sales is a piddly ~4% while S&M is closer to 40%. In other words, ReachLocal spends 10-times as much on sales and marketing as it does on research and development.

[4] Search Engine Optimization (SEO) and Search Engine Marketing (SEM).

The S&M effort, which the Company calls Feet-on-the-Street, employs so-called Internet Marketing Consultants (IMC) with no previous experience required, and classifies them as "upperclassmen" or "underclassmen" depending on tenure. The key to success, according to management, is "graduating" IMCs from underclassmen to upperclassmen because only after a period of training (defined as one year) are salespeople accretive. In other words, upperclassmen are revenue while underclassmen are cost. Management expects the number of underclassmen to remain flattish while the number of upperclassmen to accumulate, driving sales growth.

ReachLocal (RLOC) Financial Summary - Base Case Operating Scenario			
	2011	2012	2013
# of Internet Marketing Consultants (at period end):			
Underclassmen	424	417	417
% Growth	11.9%	-1.7%	0.0%
Upperclassmen	372	396	416
% Growth	30.1%	6.5%	5.1%
Total # of Internet Marketing Consultants	796	813	833
% Growth	19.7%	2.1%	2.5%
The # of Advertisers is correlated to the # of Upperclassmen			
Active Advertisers per Upperclassmen	51.3	51.1	50.7
% Growth	-13.1%	-0.4%	-0.9%
Active Advertisers	19,100	20,246	21,087
% Growth	13.0%	6.0%	4.2%
Active Campaigns	27,500	31,178	34,161
% Growth	21.1%	13.4%	9.6%
Campaigns per Advertiser	1.44	1.54	1.62
Revenue:			
Direct Local	291,444	332,687	364,515
% Growth	33.8%	14.2%	9.6%
National Brands, Agencies and Resellers	83,797	90,257	94,961
% Growth	13.5%	7.7%	5.2%
Total Revenue	**375,241**	**422,943**	**459,476**
Cost of Revenue	190,559	212,340	230,682
Gross Profit	184,682	210,603	228,794
% Margin	49.2%	49.8%	49.8%
S&M	139,929	156,343	169,847
% of Revenue	37.3%	37.0%	37.0%
R&D	15,602	17,958	19,509
% of Revenue	4.2%	4.2%	4.2%
G&A	33,313	39,807	40,000
% of Revenue	8.9%	9.4%	8.7%
Total Operating Expenses	188,844	214,108	229,357
Operating Income (EBIT) = NOPAT	**-4,162**	**-3,505**	**-562**
+ D&A	10,274	11,856	11,856
+ Stock Comp, net	8,381	8,384	8,384
- Capex (incl. software capitalization)	-12,441	-18,259	-19,836
Free Cash Flow	**2,052**	**-1,524**	**-159**

Because revenue growth depends on growth in the number of Upperclassmen, S&M expense rises at a similar rate to revenue. With no S&M leverage and therefore no path to profitability (and no IP), ReachLocal must figure out some other way to make money before they run out of cash. It’s dot com déjà vu all over again.

On ReachLocal’s first quarter 2012 earnings conference call, management introduced the latest strategy to combat the absence of operating leverage – telesales. A business practice seemingly at odds with ReachLocal’s high-touch Feet-on-the-Street Internet Marketing Consultant (IMC) strategy, it shows just how non-tech this company is.

One final and massive risk is ReachLocal’s dependence on Google's ever-changing algorithms (and Bing to a lesser extent). While management touts its global reseller deal with Google (covering eight countries), the Company is nothing more than a commoditized middleman that will eventually get squeezed out of the supply chain.

What is $8-$12 million of EBITDA worth? 5x = $40-60 million, plus $90 million of cash equals $130-$150 million, or $3.57 to $4.12 per share. 3-Sigma Value’s scenario-based discounted cash flow (DCF) methodology generates a probability-weighted target price of $3.26.

Final Thoughts

While we have focused this analysis on ReachLocal's services-based approach to generating leads via search engine advertising, most of the companies in 3-Sigma Value's online marketing services segment analysis share the same fundamentally flawed characteristics:

1. **Unsustainably high level of sales and marketing (S&M) as a percentage of** revenue – ReachLocal in fact is near the low end of the range at 40%. **Angie's List (ANGI)** and **Yelp (YELP)**, for example, are user-generated ratings and review websites that spend 80%+ and 60%+ on S&M respectively[5].

2. **No technology advantage or intellectual property (IP)** – at least ReachLocal spends about 4% of its revenue on research and development (R&D). **Groupon (GRPN)** spends so little on R&D that it doesn't even bother reporting it as an expense on its income statement[6].

3. **Misleading investor and corporate communications** – the fact that ReachLocal derives 90% of its revenue from generating a list of keywords for its customers is obfuscated by a communications program featuring cross-channel claims of web marketing and brand building, display advertising and ad tracking, live chat, banner ad design, and video production that all add up to little more than nothing. The same can be said of the email marketers – **Constant Contact (CTCT), Exact Target (ET)**, and **Responsys (MKTG)** – who all of a sudden sell integrated cross-channel marketing platforms that include websites, social, and mobile in addition to their core email marketing services. Prior to November 2011, 100% of Exact Target's revenue came from sending emails on behalf of large Internet customers including Angie's List (ANGI) and Groupon (GRPN)[7].

In conclusion, the three flaws identified above – high expenses, low investment, and misleading communication – together make a recipe for failure. Within the vast universe of technology companies, Internet marketing services is a rapidly commoditized, intensely competitive sector that meets much of 3-Sigma Value's criteria for potential inclusion on the short side of a hedged portfolio. The sector is reminiscent of IPOs during the Internet Bubble (dot com 1.0), with business models changing so rapidly that the inevitable consequence is excessive vicissitude.

[5] Separate analysis of ANGI and YELP is available.

[6] Separate analysis of GRPN is available.

[7] Separate analysis of email marketers, CTCT, ET, and MKTG, is available.