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Market Roundup

April 26, 2002

This Week

Network Associates Shelves McAfee.com Buyout Bid

RealNetworks Offers a Real Development

Switchboard/AOL Provide Services to AT&T mMode

Network Associates Shelves McAfee.com Buyout Bid

By Jim Balderston

Network Associates announced this week that it was withdrawing its offer to buy the outstanding 25% of McAfee.com it does not already own, citing a new set of company accounting irregularities dating back to 1999. Network Associates said the accounting irregularities did not involve McAfee.com's books and were related to the previous management team. According to the company, the present management team, led by CEO George Samenuk, needs time to gain a complete understanding of scope of the accounting issues, and will in all likelihood be forced to restate earnings for the years 1999 and 2000. Samenuk noted that the McAfee.com buyout was a stock swap and without a clearer picture of Network Associates' financial picture, no such transaction could go forward. Samenuk said the deal was off indefinitely, and gave no indication if such an offer would be made in the future. The latest revelations come as the SEC is investigating Network Associates for other, unrelated accounting issues. Network Associates had offered $224 million for McAfee.com; the offer was scheduled to expire Thursday night. McAfee.com CEO Srivats Sampath told analysts in a conference call that the company was going ahead as though the offer had never appeared in the first place, and said McAfee.com would continue its product rollout plans as scheduled before the unanticipated Network Associates bid surfaced earlier this month.

Earlier this month, an apparently ardent Network Associates sprung its acquisition offer on McAfee.com without consulting the company's board of directors, and seemed in a hurry to get the deal closed as quickly as possible. Things stalled after the SEC's announced investigation, then got back on track with a slightly higher offering price. Now that this latest round of accounting irregularities has shelved the deal, Network Associates could be permanently frustrated in its oft-delayed attempts to consolidate its product offerings. However, we believe this forced separation will be a substantial blessing (in disguise now, but out in the open in the future). What the delay does is give McAfee.com the time and opportunity to continue to grow its subscription base, draw more clients to its model and demonstrate the key element in its continuing success — high renewal rates among existing, satisfied customers.

McAfee.com offers automated renewal services of antivirus, firewalls, and other online security services. The company's renewal rates have been much higher than traditional shrink-wrap products have garnered, and may offer a powerful illuminator to the value of online services versus boxed products. As

836 W El Camino Real
Mountain View, CA 94040-2512
650·390·0700 fax 650·649·2302
London +44 (0) 20·7900·2819
Munich +49 (0) 89·4201·7144
Amsterdam +31 (0) 35·588·1546

sageza.com
info@sageza.com

we see it, a conflict between a reabsorbed McAfee.com and Network Associates would likely have arisen over NA's boxed products versus McAfee.com's services for consumers, an argument that the folks at the Network Associates mother ship would eventually have had the final say over. With this respite from re-absorption, McAfee.com has the opportunity not only to add to its subscriber base and product portfolio, but also to demonstrate that the holy grail of online service providers — customers for life — is possible to attain. Such a demonstration will go a much longer way in convincing Network Associates that there is considerably more to the value of the software-as-a-service model than vague talk about new paradigms or other such gobbledygook. Overall, we believe the failure of the deal offers McAfee.com an opportunity to control its destiny, and gives Network Associates a chance to learn a new business model that might actually bring the company real, and not restated, income.

RealNetworks Offers a Real Development

By Jim Balderston

RealNetworks has announced the latest version of its RealVideo technology, version 9, which the company claims will offer a 30% reduction in bandwidth requirement. In other words, RealNetworks claims its latest video player will give broadband users broadcast-quality video, and dialup users subscription-quality video. According to RealNetworks, broadband users at 160Kbps and up experience VHS quality video, and those with 500Kbps and up will have DVD quality video with the new RealVideo technology. RealNetworks also announced the availability of the latest version of its RealAudio player, which also allows for higher quality sound on lower bandwidth connections. RealNetworks claims its RealAudio Surround will give dial-up users (at 44Kbps) multi-channel surround sound. RealNetworks also submitted components of its RealVideo 9 to the Joint Video Team, which is working on the next version of MPEG-4.

A continuing stumbling block to the success of online video applications has been the relatively small numbers of consumer broadband adopters, and these numbers are dwarfed by vast majority of consumers who access the Internet via dialup connections. Furthermore, broadband is largely a fixed commodity; it does not travel with you from the office or home to a hotel room, so video conferencing from a hotel room just hasn't been in the cards. But with this latest incarnation of RealVideo, we may be seeing a Web-based application that could actually cause a real shift in behavior of users, who will apparently be able to view near-broadcast-quality video at slower connections, and enjoy top-of-the-line video experiences at the lower end of broadband speeds.

If RealVideo 9 performs as the company claims, we believe large shifts in the tectonic plates of the bandwidth geology could result, as the traditional demarcation lines — broadband and video through cable, email and limited media access through phone lines — move a few yards (or miles) this way or that. With increasing access to reasonable quality (and size) video online, will consumers begin watching the evening news over a phone line? How about the Super Bowl? Do broadband providers see pay-per-view in their future? Will watching a movie be something anyone can do via pay-per-view, Blockbuster, or a site on the Internet? If so, we suspect that the relative delivery costs for each of these methods play a significant role in their final appeal to consumers. Can you say 'price war'?

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Switchboard/AOL Provide Services to AT&T mMode

By Charles King

Switchboard, Inc., which provides online phone directory solutions, has announced an expansion of its relationship with AT&T Wireless. The company will deliver Switchboard free interactive services including yellow and white pages, reverse phone number lookup, and driving directions to customers of AT&T's new mMode service. In an unrelated press release, America Online announced that it would offer access to AOL Mail and Instant Messaging (IM) to mMode customers. AOL customers who use mMode will also be able to access the AOL address book and Buddy List features. No start date or pricing information was included in either press release.

From where we stand, one obvious and another more subtle subtext are visible in these announcements. On the obvious side, the stories illuminate AT&T's efforts to drive sales of mMode and the company's new GSM/GPRS-compatible phone services in the fourteen U.S. metropolitan areas where they are available. Due to the fractured nature of wireless standards and services in the U.S. (at least compared to the more technologically homogeneous European and Asian markets), American consumers have expressed only mild interest in wireless email and text messaging services that are sweeping the rest of the world. mMode represents an attempt to incite some of that same excitement, enthusiasm, and purchasing power among Web-savvy urban U.S. consumers. From that standpoint, AT&T's deals with Switchboard and AOL make perfect sense, given the substantial cost and time savings online directory services promise consumers, and potential new clients who might well migrate from AOL to mMode. In fact, we expect an ongoing flood of similar announcements from other wireless or Web-based content providers hoping that a bit of mMode's mojo might just come their way. Additionally, AT&T may serve as an example for other telecoms entering the GSM/GPRS space.

The subtler tale concerns AT&T's capability and willingness to cannibalize its own traditional services in order to drive sales in emerging markets. Until the Internet, people wrote letters when they wanted to communicate with friends and family afar, or picked up the phone when they felt like chatting. Email and instant messaging, which continue to be the most popular Web-based applications used by consumers, have impacted the revenues of the USPS and telecom service providers (SPs) with a significance that will likely increase over time. As SPs began to feel the financial pinch, they began charging, sometimes onerously, for services once provided gratis, including directory service. Local calling and service charges will remain with us for as long as the SPs do, and will continue to be used by countless phone users, but the pain can be seemingly dulled for consumers willing to pay for mMode. While AT&T may have seen calling revenues drop when customers embraced online messaging, mMode offers the company a chance to get some of theirs back as customers fork over a bit of green for mMode email and IM services. If new generations build their lives on the bones of their ancestors, AT&T has proven that the same can be said for new forms of wireless messaging and the services that preceded them.

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