

Idealab:
First Mover, Last Survivor

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EXECUTIVE SUMMARY

In 1996 Idealab introduced a new way of investing by becoming the pioneer of the incubator industry. Although it rose to stardom during the Internet bubble, Idealab is now one of the last incubators standing in what was once a successful industry. Idealab's business model revolves around providing three essential elements to start-up companies:

- Financing
- Access to and consulting from technical and business experts
- Support in everyday tasks

In order to recover from the dot-com bust and sustain long-term growth, Idealab needs to continue evolving its business model to fit today's economy. For Idealab to grow and sustain investor confidence, it must continue to diversify its holdings of operating companies. Idealab must also continue to foster a focused entrepreneurial and innovative environment. At this time, it is important for Idealab to quickly take a few more of its operating companies to profit while protecting its core competencies of supplying capital, ideas, and human resources to start-up companies.

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IDEALAB'S IDEA: MEETING THE NEEDS OF STARTUPS

Founded in 1996 by Bill Gross and a team from Pasadena, California, Idealab is centered around Mr. Gross' view of what entrepreneurial ventures need to succeed. The Idealab mission statement reads:

Idealab shares with its operating companies its market-tested knowledge, operational support and strategic guidance. Today, Idealab is focused on creating technology businesses based on proprietary technologies that enjoy high margins and have significant potential for sustainable, profitable growth. (see Appendix 1 for full mission statement from www.Idealab.com)

In order to foster growth, Idealab's core competencies provide an environment that allows startups to thrive. The three necessary components include providing capital to finance operations, accessing, using, and recruiting technical and business experts, and providing support for what Mr. Gross calls the "mundane." Combining these assets, connections, and services allows Idealab to form a synergy to jumpstart its operating companies.

Any newly formed companies require funds to finance activity. Because Idealab acts as an investment fund much like a venture capital (VC) fund, Idealab is entrusted with outside investment dollars to fund start-up companies.

Idealab also provides access to experts in both the technical arena and the business world. On the technical side, Idealab uses its extensive network of academics, inventors, engineers, and scientists to evaluate and optimize the technology of a startup, as well as reducing the time and costs of product development. This results in the formation of a

technology core that is now focused around four areas of expertise: wireless communication, automation (robotic and equipment), renewable energy, and data management. This shared research and development (R&D) not only allows Idealab's operating companies to avoid building technology from the ground up, but also forms a base that can be used to augment existing technologies and business models.

According to Mr. Gross, start-up companies need four types of people: the entrepreneur, the producer, the administrator, and the integrator. Each of these personalities is essential to growing the company at different times. The entrepreneur generates the ideas and provides the vision required to both initially grow the company and to survive difficult times. The producer focuses on the product the company creates and crafts the ideas of the entrepreneur into a reality. Next, an administrator expands the company beyond the few individuals by establishing procedures that add structure and process to doing business. Finally, the integrator pulls everyone together and continually acts as a peacemaker and motivator between the other three types of people. Appendix 2 shows how a company forms and what it needs in order to become successful. Because a start-up company requires different types of people at various times, Idealab seeks to provide the necessary human resources at critical junctures to speed up the development of a start-up company (Gross, April 2004).

Finally, Idealab offers startups the chance to focus on their business by taking care of many time-consuming tasks. The belief is that Idealab can efficiently take care of logistics by providing office space, travel arrangements, and administrative assistance. Consolidating support becomes more efficient because it allows a greater number of people to

specialize in what they do well, lowering the support costs for each operating company. Idealab also uses its experience in marketing to help the company create a logo and begin building a reputation. In order to help companies become financially grounded, Idealab allows startups to use company accountants, financial managers, and sometimes lends startups a CFO for a short period of time (Gupta 8-10). By taking care of the mundane, entrepreneurs can focus on innovation instead of being hindered by time-consuming tasks.

BUSINESSES SPAWNED FROM IDEALAB

In the past, Idealab focused mainly on dot-com businesses. Since their formation, they have successfully founded several companies. By 1997, the company had already started 26 companies, and the list continues to grow today, albeit at a slower rate. Some notable companies (both for their profitability and for their failure) have been Overture, Eve.com, and eToys (see Appendix 3).

RECENT TROUBLES

Idealab ran into trouble with its investments in 2000, after investors purchased \$725 million of series D preferred stock in December, 1999. This type of stock gives the investors a partial stake in the company, if the value of the company were to dip below a certain value. Because several Idealab-spawned companies, such as eToys and Eve.com, failed after initial success, investors sued Idealab to dissolve the company. They were looking to recover their lost investments by liquidating Idealab on the grounds of intentional negligence. Although Idealab filed for an IPO in 2000, the offering never came to market due to the adverse market

conditions and the impending lawsuit. Without a source of capital investments, Idealab entered into difficult times during the dot-com bust (Brown).

More recently, the lawsuit against Idealab was completely thrown out by the court—the shareholders did not hold a large enough stake in the company to demand liquidation (Friendly, May 14, 2004). For the past several years, the lawsuit has been a dark cloud over Idealab's future. Now that it is over, Idealab will be able to completely concentrate on its revised focus area: more technology-based startups with less dot-com emphasis (Kong, May 14, 2004).

BUYERS

Idealab seeks to take new, profitable ideas and quickly turn them into successful companies. A common challenge to small start-up companies is the numerous initial costs as mentioned before. The incubator can supply all of these items at in an efficient and cheap manner, in exchange for shares in the start-up company.

Having considered this, there are a couple ways to think of Idealab's buyers. The first and most straightforward way categorizes them as a maker of startups. Idealab does not hold their start-ups companies indefinitely, and often spins off their start-ups as separate companies. Thus, Idealab's buyers are the investors in or buyers of these spin-off companies. These buyers purchase the final ideas or final spin-off companies, and establish them in the overall market. In this way, Idealab sells its ideas, in the form of start-up companies, to investors and firms.

The other way to view Idealab is to look not at the buyers of their spin-offs, but instead at the buyers of the services provided by these spin-offs. Because there is a variety of spin-off companies, there is an equally diverse set of buyers of the spin-offs' services. A large proportion of Idealab's spin-offs have been dot-coms, so Internet users that use the listing or marketing services of the dot-coms could be considered buyers. However, following the Web market crash in 2000, Idealab has diversified and focused less on dot-com companies.

SUPPLIERS

As is the case with buyers, Idealab's suppliers are more than just the ideas that they cultivate. Although Idealab produces many spin-offs, their real business is setting up useful synergies to turn ideas and financial capital into successful companies quickly and efficiently. There are thus three primary inputs: personnel, ideas, and capital (from investors).

Good business ideas and the technical expertise to implement these ideas drive Idealab's production. However, because these ideas must come from people, it is important for Idealab to retain a strong base of employees. The company does so by recruiting top talent from outside companies and schools like Caltech, the ArtCenter College of Design, and business schools. Ideas are then supplied by Bill Gross, other members of Idealab, or outside sources (various entrepreneurs). Using the supplies of capable staffs and creative ideas, Idealab is able to produce inventive and successful spin-offs.

INCUBATORS

THE ROLE OF INCUBATORS

Incubators fulfill a unique roll that traditional investment groups such as venture capitalists and angel groups can not—they not only generate ideas for new businesses, but they typically manage the administrative/startup aspects of a new company. The incubation industry as a whole focuses on a wide variety of business ventures. Many self-proclaimed incubators do not create ideas on their own. In practice, they are a source of start-up advice, consulting, and funding. Within the technology incubation industry of 2000, the major players were Idealab, CMGI, Internet Capital Group, and university-affiliated think-tanks. During the dot-com boom of the late 1990s, the three large incubators created viable business ideas and developed these ideas in new companies. The incubators worked with the companies until the new business had a chance to mature and compete without their incubator's help.

INCUBATOR INDUSTRY OVERVIEW

From its founding in 1996 to 2000, Idealab and its competitors flourished. Primarily, incubators had invested in or created Internet-based sales companies. At its peak, Idealab owned eMachines, eToys, GoTo.com, and other highly valued companies and was itself valued at over \$10 billion with more than \$1.2 billion in private investments (Brown). Companies such as Dell Computer, 24/7 Media, and T. Rowe Price invested \$1 billion for a 13% stake in Idealab, indicating high future expectations (Munarriz). The typical incubator expected to turn profits by receiving a 25% to 40% stake in their start-up (and providing investment/support services) (NBIA, Dec 03). However, at the start of 2000, the dot-com industry bottomed out (see Appendix 4 for Idealab's seven publicly traded investments). In

April of 2000, Idealab filed for an IPO and eventually withdrew it due to “adverse market conditions” (DiCarlo). By October of 2000, the publicly traded shares of Idealab’s main competitors, CMGI and Internet Capital Group (ICG), were trading at 91% and 96% of their 52-week high, respectively (Munarriz). However, CMGI and ICG’s stock value parallels the plight of most dot-coms and Internet incubators after the dot-com bubble burst (see Appendix 5). During this time, Idealab itself was forced to close branch offices in Silicon Valley and Boston.

IDEALAB’S COMPETITION

After the market drop in Internet-based companies, other incubators such as divine interVentures entered the software industry or completely dropped out of the incubation industry (Scasny). Internet Capital Group struggled to remain competitive by laying off 35% of its staff in November, 2000. ICG repeatedly attempted to cut costs and reduce its monthly burn rate (investment spending) to \$25 million, but continued to suffer losses due to decreased value in its company holdings. Essentially, ICG’s continued investments in its start-up companies were going to waste, as newly spawned companies were not able to effectively use any investments. In 2003, ICG lost \$136 million on a per quarter basis, and its revenues continued to decrease (ICG B/S).

CMGI did not fare much better—according to its balance sheets, the company lost a total of \$7.3 billion from August 1, 1999 to July 31, 2002 (CMGI, Income). By 2004, CMGI had sold or disbanded its Internet venture capital firms and all 12 of its start-up companies except for SalesLink, a majority-owned subsidiary. SalesLink provides supply chain and outsourcing operation support services, a far cry from CMGI’s original

goal. CMGI is now focused on providing services to SalesLink and is not looking to enter back into the incubation business (CMGI Description, Reuters).

After barely surviving the post-2000 fallout, Idealab's current incubator competition primarily consists of university based non-profit incubators. Although most university-spawned companies end up using consultants and venture capitalists to start their entrance into a particular industry, there are a few that are similar to Idealab. One example is the Software Business Cluster near San Jose State University. The company provides space and services to local-area startups and any university projects that might be commercial successes (NBIA, Dec 03). Essentially, this type of company use university-created ideas to fuel start-up companies.

Despite labeling other incubators as competition, Idealab does not perceive either for-profit or university non-profit incubators to be a threat to their business. The now defunct for-profit incubators did not attempt to sell the same product as Idealab. Hence, only companies that directly competed with Idealab's companies within those industries would be considered Idealab's primary competition (since it is assisting its spin-off companies in their industries). University nonprofits mainly provide shared office space and share IT resources for fledgling companies. They allow individual entrepreneurs from a local university or the community to utilize their space/resources, but do not fund or provide professional support. Most non-profit incubators were set up to bring in jobs to the surrounding area (Friendly, May 14, 2004). These companies do not compete with Idealab because they do not offer the same type of support as Idealab.

Idealab's true challengers are companies that exist in the market that they are entering. As past high-tech incubators have shown, companies looking for quick profits will not survive. Incubators need be willing to concentrate fully on their individual companies to ensure that they are financially successful in the long run. The dramatic reversal in market climate has prompted changes in high-tech incubator competition, forcing out most of the companies. Idealab must adapt to those changes to maintain a successful business.

SUBSTITUTES – IDEAS OUTSIDE OF IDEALAB

Idealab's substitutes can be broken down into two categories. The first is substitutes for the technology solution provided by its operating companies. The second category is the financing, services, and support Idealab offers startups. The first category cannot be widely addressed due to the many markets that are served by its operating companies. Each market has its own substitutes that Idealab must face while launching a company. The second category addresses the substitutes to Idealab as an incubator and can be more specifically discussed.

Typically, start-up companies cannot raise the necessary capital to finance the activity needed to bring the company to profit. In order to produce prototypes, test potential markets with first line products, market the new product, and sell the product, start-up companies traditionally turn to two major types of investors: angel groups and VC funds. The idea of incubators has added a third potential source of funding as well as a more involved role in start-up companies. Because incubators are involved in the day-to-day affairs of their companies, the last substitute to Idealab consists of consulting firms. Idealab's substitutes include all three of these

possibilities as well as companies that choose various ratios of investment and consulting.

Angel groups typically fund very early stage startups and are made up of individual investors that combine group expertise to identify promising opportunities. Because angel groups invest around the time of the birth of a company by funding first products and prototypes for testing, they are also the riskiest form of investment. During the Internet bubble, angel groups invested \$250,000 to \$1,000,000 in early startups. However, after the dot-com bust, average angel investments returned to previous levels of several hundred thousand dollars. By providing “seed money” to potential companies, the payoff potential is very high but rarely realized.

Venture capital funds generally invest \$500,000 to \$3,000,000 in early stage companies. Early stage, in this case, usually means that a proven product and market have been established and additional cash is necessary to start a product line or take a company to the profit-making stage. Alex Suh, the managing director of California Technology Ventures, likens VC funding to a marriage while preparing for a divorce. Because of the large amount of money venture capital funds invest, a venture capital fund is often represented on the board of directors of the company. Thus, VCs often have considerable sway in the direction of the company. Like angel groups, VC funds followed the same pattern of spending, throwing away money at any business proposition during the Internet bubble, and pulling back on investment after the dot-com bust. Although many investors that have contributed to VC funds have kept their wallets closed, venture capital activity has increased in recent months (Suh, April 2004).

The last substitute facing incubators are consulting firms. While major consulting firms such as McKensie and Bain are known for their work with Fortune500 companies, some smaller consulting firms specialize in entrepreneurial activities and provide expert viewpoints for a stake in the company.

Idealab does not fall directly in any of the three categories above. Rather, it occupies a position that includes elements of an angel group, a VC group, and a consulting firm. Because Idealab takes a hands-on approach to its operating companies, it does not view startups solely as investments as angel and VC groups view them. In this regard, Idealab provides similar services as consulting firms, but has more influence to apply desired changes because of its investment in their companies. Idealab's financial involvement is also atypical. Idealab is generally involved from the very first stages of a company, funding the proof of concept and first round prototypes. However, as company and technology milestones are reached, Idealab not only continues to increase funding, but also seeks other outside VC groups to invest in the operating company to take developed products to market. Idealab's diverse role spans the function of these three substitutes, allowing it to occupy a unique space in the way start-up companies are launched.

IDEALAB'S FUTURE: THE KEYS TO SUCCESS

ADJUSTING TO ECONOMIC WAVES

The dot-com bust has forced Idealab to change its strategy. Mr. Gross detailed a general shift in strategy by stating:

When [Idealab] first started, we were starting a company a month. Now, we're starting about a company a quarter. We're looking to build larger, more impactful companies, rather than more numerous smaller companies. The companies we're starting right now require a lot more upfront research and development, and often more patent protections. (Glasner, July 2002)

Now, Idealab is dedicated to starting and sustaining solid cash flow businesses. While the focus in the late '90s was Web-based companies, Idealab is now diversifying its company portfolio to include hardware companies as well. In addition, instead of looking to quickly take companies to IPO, as was the trend during the dot-com bubble, Idealab has adapted its view on exit strategies. Now, Idealab allows spawned companies to pursue the growth avenues that are focused on creating positive cash flow. Other possible exit strategies include selling the company to larger companies or filing an IPO. One of Idealab's most stunning successes in this was its \$1.6 billion sale of Overture to Yahoo ("Yahoo-Overture Deal"). However, the focus has shifted from quickly creating companies and offloading them to holding on to successful companies.

Moreover, it is important for Idealab to be sensitive to economic changes. Idealab should have a good idea of what technologies are truly meeting growing market needs, and should not pursue temporary trends. While the most recent change in strategy seems to fit well with the current economic climate, Idealab must respond to market changes by keeping a close connection with customers of operating companies and by continuously checking for changes in technology demands.

MEETING IDEALAB'S MAJOR HURDLES

According to the Idealab management team, Idealab faces four major challenges: keeping the pipeline of ideas flowing, effectively managing operating companies, finding outside funding, and continuing to draw top talent to its companies. According to Mr. Stuart MacFarlane, the VP of the New Ventures Group at Idealab, the first two concerns are long term interests that deal with Idealab's culture and operation. Idealab has three sources of ideas: Bill Gross, formal and informal brainstorming sessions, and outside ideas from entrepreneurs and local research institutions (MacFarlane). Bill Gross is Idealab's most fertile source of ideas and Idealab must continue to keep that idea pool alive by allowing Mr. Gross to efficiently use his time. Internal brainstorming should continue to be used to augment Mr. Gross's ideas and generate new ones. Finally, fostering ties to outside communities, most importantly to academic institutions such as Caltech and Stanford, will allow Idealab access to academia-born ideas and to stay at the forefront of technological development. Cultivating company creativity is essential in protecting the ideas that sustain Idealab. In this sense it is important to foster an innovative environment, perhaps by allowing employees freedom to modify their workspaces, always sharpening creativity by frequently using brainstorming sessions, or by emulating the academic environments that are conducive to growing creative sparks.

The second major hurdle is keeping Idealab-spawned companies focused on their core competencies. Because Idealab has many complementary technologies, it remains essential that operating companies do not become so broad that they lose focus on the competitive advantages they hold in the marketplace. Thus, the companies must identify the best business opportunities, leverage their innovative ideas, and capitalize on

those ideas by aggressively using Idealab's shared R&D, marketing, and support.

The third major hurdle is dependent on the current economic environment. While Idealab operating companies initially rely solely on Idealab funding, Idealab brings in additional investors to take tested products to market as milestones are reached. While venture capital funding has increased after the drought following the dot-com bust, securing these investments relies on Idealab's reputation, track record, and operating structure. As long as Idealab can continue to cultivate ideas into successful companies, this hurdle will become increasingly easy to overcome.

The fourth major hurdle Idealab faces is drawing top talent to its operating companies. Idealab usually fills the management teams of its operating companies by recruiting experienced individuals from the outside. At this level, this how the positions of CEO, CFO, COO, and CTO are filled. On another level, operating company employees are recruited internally and externally. For example, Ms. Gladys Kong, VP of Development, manages the team that spearheads early stage prototyping and testing. Because the development team often specializes in various products, many team members are asked to join companies that are spun off. The result is the need to continually rebuild and augment the development team.

In order for Idealab to effectively draw top talent to fill management teams and technology teams, it must rely on two major methods of recruitment. The first is relying on referrals and the valuable network Idealab has established. Because Idealab is well known for its dedication

to startups in wireless communications, automation, renewable energy, and data management, the company can continue to build ties to experts in these fields. When necessary positions open up, they can quickly be filled with these experts. The second method is recruiting individuals through traditional means of posting jobs publicly, using headhunters, and relying on Idealab's culture and incentive structure. Because human resources are so important, Idealab has been known to offer temporary contracts to see if an individual can contribute to Idealab's success while fitting well in its unique company culture.

Without any significant change in strategy after 2000, Idealab would most likely have followed CMGI and ICG and vanished. By choosing core competencies and spreading out its investments, Idealab is firmly rooted in many aspects of the high-tech frontier. Distributing the risk in various technology fields will prevent another dot-com-like disaster for Idealab in the future. Their increased emphasis on long-term profitability by creating/incubating a smaller number of companies (2-4 per year) in different fields will hopefully yield continual profits in the future and support further development. The create, incubate, and release cycle will continue so long as Idealab continues to foster successful ideas and add value to those companies.

CONCLUSION

After the dot-com bust of 2000, Idealab refined its strategy and began moving away from focusing only on Internet based companies by diversifying its operating companies. Now, Idealab emphasizes the long-term profitability of both hardware and software companies. In order to sustain long term growth, Idealab must protect and develop its core

competencies. It must continue to generate novel ideas, efficiently consolidate the everyday tasks of its startups, secure outside investors, and maintain talented team members. Because of its unique market position, as long as Idealab can differentiate itself by reducing the risks of starting companies, it can avoid losing opportunities to angel and venture capital groups. Idealab has survived the major disruptions of the dot-com bust and a major lawsuit, but despite these past challenges, Idealab is now better positioned to successfully reach its goal of developing ideas that may significantly impact the modern world.

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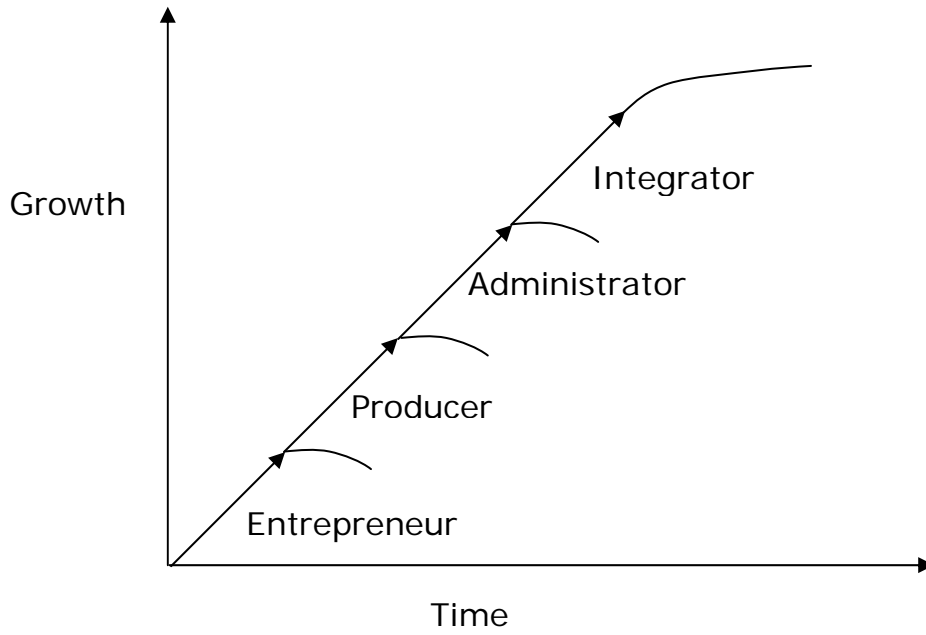
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APPENDICES

APPENDIX 1: MISSION STATEMENT

“Idealab's mission is to turn innovative ideas into successful technology businesses. Founded in 1996 by entrepreneur Bill Gross, Idealab has developed and evolved a process for maximizing the potential of its new businesses. Once an idea is prototyped, Idealab shares with its operating companies its market-tested knowledge, operational support and strategic guidance. Today, Idealab is focused on creating technology businesses based on proprietary technologies that enjoy high margins and have significant potential for sustainable, profitable growth.” (Idealab.com)

APPENDIX 2: ESSENTIAL PEOPLE IN START-UP COMPANIES



APPENDIX 3: OVERVIEW OF IDEALAB-SUPPORTED COMPANIES*NetZero*

Founded in July 1997, NetZero began to provide free internet service starting in October of 1998. By giving Netzero personal information and allowing a computer program to send ads to the user's computer based on that information, the user could get free Internet access. However, the free internet program did not generate enough advertising revenue to produce profits. The Premium Service, where the user pays for unlimited access, was launched in 1999, and eventually all NetZero subscriptions were converted to pay subscriptions. After merging with Juno, another free internet service provider, United Online was formed in 2001. The new company weathered the Internet depression of the early 2000s, and has posted its largest quarter revenue at \$108 million in the first quarter of 2004.

(United Online)

Overture (GoTo)

The Overture search listing service, formerly named Goto.com, is a distribution channel for websites. Founded in 1997, the company takes in registration from websites that want to be listed. Furthermore, the website bids a fee to pay Overture every time a user clicks the website link in a partner search engine (such as msn.com or altavista.com). Websites with the higher bids appear first in the listing, while websites with the lower bids appear later in the listing. Thus, the business was deemed pay-for-performance searching. In 2003, Overture was projected to have revenues near 1 billion, and purchased AlltheWeb and Altavista to bolster their standings. The company was then sold to Yahoo in the October 2003 for \$1.6 billion. This large sale generated a large cash infusion into Idealab.

("Yahoo-Overture Deal")

Eve.com

The online beauty product seller officially opened in June 1999, and quickly closed in October 2000. The major reason for closure was cited to be a lack of advertising targeted at the right audiences.

(Glasner, October 2000)

Etoys.com

The online toy seller was founded in 1998. It generated a very successful IPO in the same year, quadrupling its initial price within a few months. However, after the 1999 Christmas season, when the company failed to deliver the ordered goods by Christmas Eve, eToys earned a poor reputation that greatly decreased its sales. The company did not yield profits in 1999 and 2000, and subsequently filed for bankruptcy in March, 2001.

(Sabila)

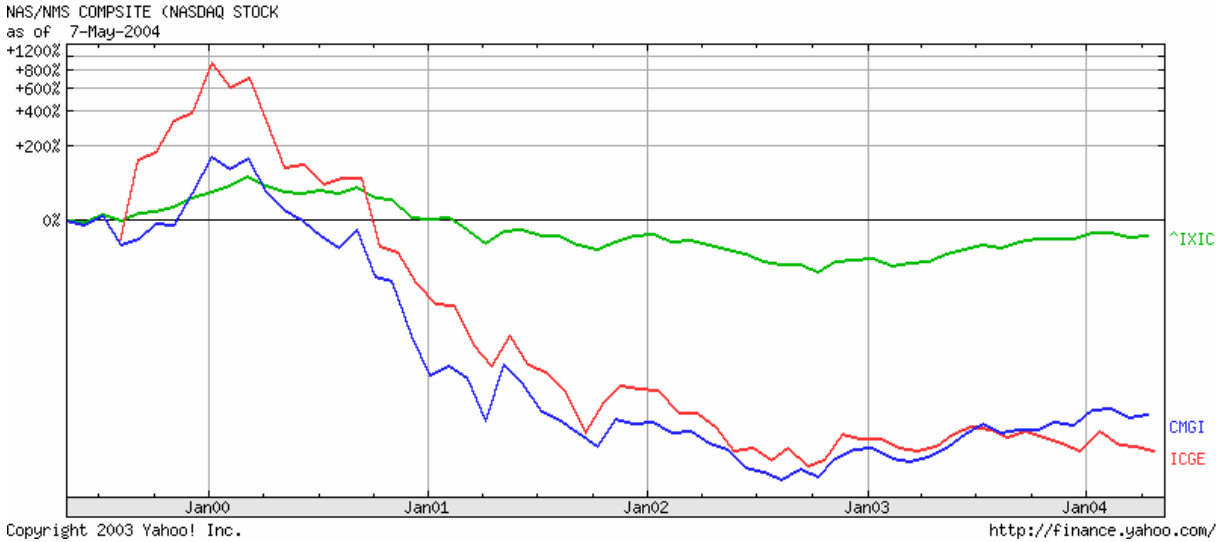
(Phoenix)

APPENDIX 4: MARKET PRICES FOR IDEALAB-OWNED COMPANIES

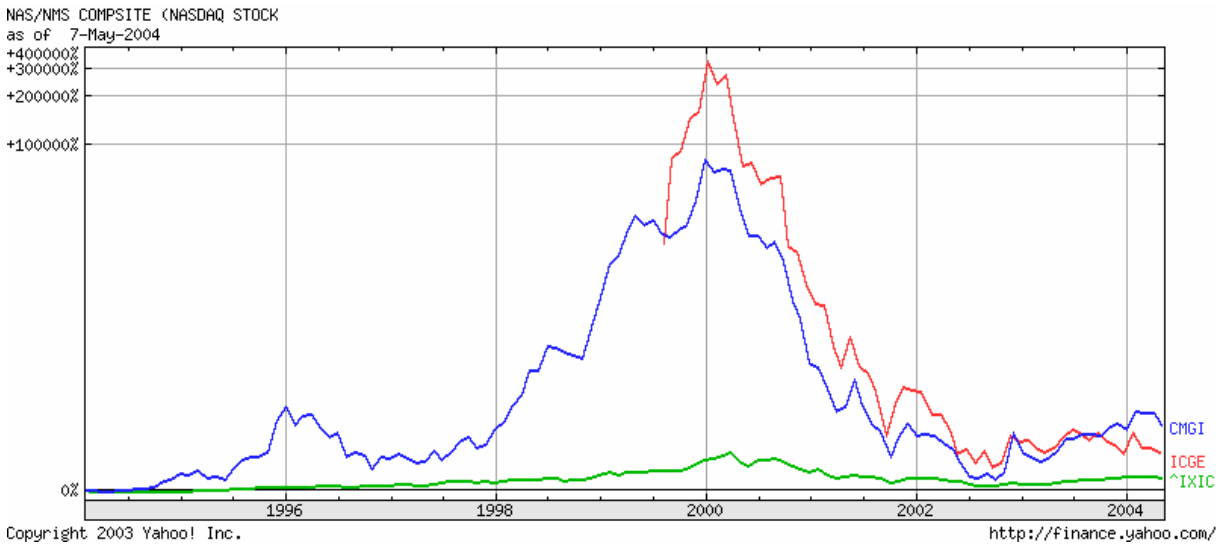
Name	10/18/2000 Close	52-Week High
eMachines	\$1 1/32	\$10
eToys	\$3 9/16	\$86
GoTo.com	\$10 1/4	\$114 1/2
Centra	\$5	\$40 3/8
NetZero	\$2 1/32	\$40
Tickets.com	\$1 1/4	\$32
Ticketmaster Online-Citysearch	\$10 5/8	\$42 3/8

(Munarriz)

APPENDIX 5: STOCK QUOTES FOR COMPETITORS (INDUSTRY ANALYSIS)



Value of Dow Jones Industrial Average (IXIC), CMGI, and Internet Capital Group (IGCE) from January, 1999 – March 7, 2004



Value of Dow Jones Industrial Average (IXIC), CMGI, and Internet Capital Group (IGCE) from January 1, 1994 – March 7, 2004