

# Surfbuddy.com: Advising Internet Start-Ups

## ASSIGNMENT 1

### Professor Cockfield – Corporate Finance Narrative

You are a sole practitioner who concentrates on corporate law clients. On September 1, a twenty-five year old man named Warren comes into your office.

**The Potential Clients:** Warren and two friends (Steve and Tammy, both age twenty-four) are trying to start up an Internet company they want to call Surfbuddy.com. Warren has an undergraduate degree in business and works full-time as a record store manager. Warren works part-time on Surfbuddy.com and, so far, is in charge of the legal and business end of this potential company. Steve has a computer science undergraduate degree and is enrolled full-time in a masters program for computer science. Steve works part time on Surfbuddy.com products and services. Tammy has an undergraduate degree in computer science and is a Java-certified software engineer. Tammy works full-time on the product and services described below. Steve and Tammy have been dating for eight months.

**Product and Services:** Surfbuddy.com plans to create a product and several services designed to protect privacy of Internet users as well as to facilitate electronic commerce purchases. The main product is the “Surfbuddy”, a graphical interface represented by a young superhero icon that accompanies the Internet user on her voyage through cyberspace. The Surfbuddy warns the user when Web vendors are planting “cookies” in the hard-drive of the user, updates the user on computer viruses, and has an artificial intelligence function that helps locate e-commerce goods and services for the user. A Beta version of the product with minimal functionality (Surfbuddy1.0) has been created without the graphical interface of the superhero. Further, Surfbuddy.com plans to offer a service to allow Internet users to surf the Web on an anonymous basis.

**Client Needs:** Warren thinks the company will have a web site going and will be able to offer the product and services within the next four months. He wants your help in incorporating a company. Warren has \$3,000 for start-up capital, but Steve and Tammy do not have any money and only have their labor to contribute. Warren hopes his parents will also become shareholders and contribute \$10,000 to get the company going. Warren says the company needs this money to pay an artist to design the icon; to pay miscellaneous start-up costs; and to pay Tammy a salary of \$1,000 per month so she can eat.

### Questions

1. Should the parties form a corporation or use some other business entity like a partnership? Does it matter?
2. What ethical issues do you face in representing Warren, the other parties or the proposed company?

3. Given the parties lack of business experience, should you help them out with business tips?
4. What are some of the initial matters you should discuss with the clients?

## ASSIGNMENT 2

Two weeks have passed since your initial meeting with Warren. He returns to your office and, after thinking over your advice, instructs you to incorporate a company to be named Surfbuddy.com. Warren tells you that the company will create a web site after incorporation to announce its planned products and services.

**The Corporation:** There will be three shareholders; Warren, Steve and Tammy. As indicated in assignment 1, Warren will contribute \$3,000 for shares and the other two shareholders will contribute their past and future services for shares. Ownership should be divided equally among the shareholders. The parties agree each one will act as a director and that Warren will be the Chief Executive Officer, Tammy will be the President, and Steve will be the Secretary and Treasurer. Warren's parents still agree to contribute \$10,000 but do not want to be involved in the management of the business.

**Legal Work:** You have a number of initial tasks to perform in addition to the incorporation process. You must register the domain name and trademark for "Surfbuddy.com" (assuming another third party has not already done so). You suggest to Warren that the shareholders enter into a shareholder agreement and Warren says he'll discuss it with the other parties. Further, Warren tells you that Tammy is aware of a venture capital company that is looking to invest in hot Internet start-up companies. Warren has begun to work on a business plan for Surfbuddy.com to shop around to outside investors. You tell Warren that any investors should first sign a Non-Disclosure Agreement before reviewing the business plan. Warren agrees and you draft the NDA (attached).

### Questions

1. How should the equity ownership of Surfbuddy.com be structured?
2. Are there any restrictions on the issuance of shares for consideration other than cash?
3. What type of voting mechanism should the directors use?
4. Can Warren try to sell shares of Surfbuddy.com to anyone he wants?
5. Should the parents lend the \$10,000 to the corporation? What are the tax implications?
6. How will the choice of business entity affect tax liability?

**Confidential Information Agreement{PRIVATE }**

1. It is understood and agreed by Surf Buddy.com (the "Discloser") and [\*] (the "Recipient") that certain property is being made available to the other party hereto in the form of hardware, software, documentation, product, sales and marketing information and/or other information (herein referred to as "proprietary information") for evaluation purposes only. Proprietary information made available by the Discloser to the Recipient shall be, and remain, the sole property of the Discloser and shall be returned promptly when called for by the Discloser or upon completion of the business relationship, whichever occurs first.
2. The Recipient shall maintain the confidentiality of the Discloser's proprietary information for a period of three (3) years with the same degree of care as it treats its own proprietary information which it desires to remain confidential and shall not utilize the information obtained hereunder in any manner without prior written approval from the originating party.
3. Any ideas, suggestions, modifications, etc., made by a Recipient to the proprietary information provided by the Discloser shall become the property (together with all rights therein) of the Discloser and may be used without any obligation to the Recipient.
4. The provisions of this agreement shall not apply to any other information that was known to a Recipient prior to its receipt under this Agreement; received from a third-party that is not under a direct or indirect obligation of confidence; or with respect to information which was or later becomes publicly known other than through fault of the Recipient.
5. All additions or modifications to this Agreement must be made in writing and must be signed by both parties hereto to be effective.
6. This Agreement imposes no obligation on either the Discloser or the Recipient to purchase, sell, license or otherwise dispose of any proprietary information.
7. This Agreement is to be construed pursuant to the laws of the State of California, U.S.A.

**SURFBUDDY.COM**

**[\*]**

By: \_\_\_\_\_

By: \_\_\_\_\_

\_\_\_\_\_  
(Typed Name of Signatory)

\_\_\_\_\_  
(Typed Name of Signatory)

\_\_\_\_\_  
(Title of Signatory)

\_\_\_\_\_  
(Title of Signatory)

\_\_\_\_\_  
(Date)

\_\_\_\_\_  
(Date)

## ASSIGNMENT 3

Four weeks have passed since your initial meeting with Warren. You have incorporated a company and registered a domain name for Surfbuddy.com.

**Business Plan:** Surfbuddy.com needs approximately \$50,000 to pay for computers, start-up costs, an outside technical consultants and a small salary for Tammy. Warren has prepared a business plan (attached) and wants to give it to Tugwald Riley, Inc., the venture capital company that appears to be interested in Surfbuddy.com. But first he wants to have your input. Warren tells you that he and Tammy have had a serious argument concerning the direction the company should take. Warren feels that the company should only serve the consumer market (i.e., consumers who want to have their web sites protected and who want some anonymity when they surf the web for e-commerce goods and services). Tammy wants to develop privacy security features for businesses, especially for the companies' intranets (i.e., an internal network on the Internet that can only be accessed by company employees) and extranets (i.e., an intranet extended to select customers, suppliers or other business partners). Warren feels Surfbuddy.com will not have sufficient resources to compete in this field. Again, Warren wants your advice concerning the company's direction.

**Financing:** Warren has heard that the venture capital companies normally want a large ownership stake in any company they invest in. Warren thinks that maybe Surfbuddy.com should seek a loan from a bank in order to preserve the current ownership levels where the company has been split evenly among Tammy, Steve and Warren. But he also wants advice concerning other potential debt financing alternatives.

### **Questions**

1. Should you provide input on the business plan? If yes, what are your thoughts on the business plan Warren has given you?
2. Should you try to resolve the argument between Warren and Tammy?
3. What is the relationship between risk and return in different types of investments?
4. What are some of the main differences among debt financing alternatives such as bonds, bank loans, commercial paper or trade credit?
5. Warren has heard that the venture capitalist might want an equity interest with a put or an equity interest with a repurchase right for the corporation. Explain these financing alternatives.

To: Tugwald Riley, Inc.

Date: September 13, 1999

From: Warren

**Re: Business Plan for Surfbuddy.com**

This memo will set out the business plan for an Internet startup company to be named "Surfbuddy.com." We have not completed our main product nor have we had any sales.

**I. Overview**

Surfbuddy.com will provide a product to protect the privacy and security interests of consumers of electronic goods and services (hereinafter "E-commerce Consumers"). Internet security and privacy concerns are inter-related: for example, both security and privacy concerns become an issue when a hacker breaks into someone's hard-drive because the hacker can access private information and the integrity of the computer has been breached.

Our product is designed to facilitate the purchase of e-commerce goods and services. The main product is called Surfbuddy, a young superhero that accompanies the E-Commerce Consumer on his voyage through cyberspace. Surfbuddy acts as a companion, a guide and a protector. In essence, our product attempts to recreate the experience consumers have grown to trust in the physical world of traditional commerce: consumers expect anonymity while they browse for goods until they wish to voluntarily give up information in order to make their purchases.

**II. Company History**

The founders include myself, Tammy and Steve. I have an undergraduate business degree in management from San Diego State University and have worked full-time as a manager at MusicNow! in San Diego for the past two years. Tammy is a Sun-certified Java software engineer. She has an undergraduate degree in computer science from University California San Diego and has worked full time on the product described below for the past four months. Steve also has an undergraduate degree in computer science from UCSD and is currently enrolled full-time in this school's Masters in Computer Science program. Steve works part-time on the product described in the next section.

**III. Product**

The main product will be the "Surfbuddy," a software program that accompanies E-Commerce Consumers on their journey through cyberspace. The key technological

advance of the product is that it is built into a server program between the user's web browser (e.g., Netscape) and the outside network. Essentially, the Surf Buddy protects privacy and security interests of the E-Commerce Consumer since the program is located between the E-Commerce Consumer's web browser (e.g., Netscape or Microsoft Internet Explorer) and the Internet.

At this point, we have a partly-completed beta product without any graphics. The envisioned graphical interface, however, will be Surf Buddy: a young superhero with flowing cape who holds a long surfboard. When the user clicks on a new URL, Surf Buddy jumps on his surfboard and we see his back and flowing cape as the surfboard moving beneath his feet while the search locate tries to locate the URL.

The goal of Surf Buddy is to give a sense of empowerment as well as protect the privacy interests of E-Commerce Consumers. Surf Buddy accompanies the E-Commerce Consumer as she surfs through the Internet and performing the following functions:

- (a) scans and deletes cookies by Web Vendors (if the user wants) and announces: "All systems clean!";
- (b) one click button Internet search capability which finds web pages on the Internet similar to the one the user is currently viewing;
- (c) prevents the transmission of serial numbers from Pentium III chips; and
- (d) provides updated information regarding newly unleashed computer viruses.

Additional functions to be added at a later point include so-called artificial intelligence functions that will record the web sites visited by the E-Commerce Consumer and suggest additional sites to visit.

#### **IV. ENVIRONMENTAL ANALYSIS**

##### *A. Market Opportunity*

E-Commerce Consumers had expressed concerns surrounding the fact that vendors of electronic commerce goods and services (hereinafter "Web Vendors") were, among other things, scanning the hard drives of E-Commerce Consumers, compiling profiles (and sometimes selling this information), planting cookies and otherwise infringing on the privacy rights of E-Commerce Consumers.

A recent study indicates more than two-thirds of commercial web sites collect information on web users, but less than 10% of the sites give consumers control over this information. Surveys suggest that these privacy concerns are inhibiting the growth of e-commerce.

Privacy concerns that are inhibiting e-commerce include:

- (a) the collection by Web Vendors of data (known as transactional data, click stream data or “mouse droppings”) left behind by E-Commerce Consumers;
- (b) companies such as Doubleclick use the data to provide targeted online advertising;
- (c) companies such as Adfinity combine various sources of data to create fully identifiable profiles of an individual;
- (d) Intel’s Pentium III chip permits E-Commerce Vendors to identify the serial number on the chip and relate this information back to the E-Commerce Consumer;
- (e) the lack of the use of cash (an anonymous payment system) in on-line transactions alters the privacy of E-Commerce Consumers financial dealings; and
- (f) government agencies pay for consumer profiles in order to amass information on individuals.

According to surveys, people who surf the World Wide Web have a greater expectation of privacy than shoppers in a physical world. But the Internet generates an elaborate trail of data that can be used by companies to create a “profile” of an individual’s online life. These developments are akin to a consumer walking into Sears and having the sales clerk rummage through your wallet even before you purchase anything. As a result, these developments raise significant privacy concerns on behalf of E-Commerce Consumers and present a market opportunity that Surf Buddy.com intends to fill.

## B. Market Demand

Predictions concerning the Internet are inherently difficult to make as a result of the newness of this commercial medium, the speed at which it is changing and a host of other factors (some known and some unknown). A review of twelve separate research studies conducted forecasts global electronic commerce revenues within the next few years at amounts between \$23 billion and \$1.5 trillion. In theory, every user of the Internet located anywhere in the world is a potential customer of our products and services: the same can be said, however, of many new Internet companies. The culture of the Web is notoriously pro-privacy and our product and services fit well within this culture.

Studies indicate that, at least in the near to medium term, business-to-business electronic commerce transactions will consist of roughly 80 percent of all Internet activity. The business-to-business market is exploding at an even faster rate than the consumer market. Businesses have a multitude of privacy concerns when they hook up with other related and unrelated businesses over the Internet. For example, most suppliers of auto parts are now hooked into the extranet of their customers (auto manufacturers). The suppliers are concerned that their company information and pricing information is kept private. Products and services will need to be developed to respond to these concerns. Still, the development of these products and services is currently beyond the technological capability and resources of Surf Buddy.com at this point in time.



But the development of these products (once SurfBuddy.com develops a reputation as a protector of privacy and security interests) represents a significant financial opportunity to the company at some future point.

#### C. Marketing

We have a number of marketing opportunities including:

- (a) enter into an arrangement through our contacts with San Diego State University or UCSD to try to convince them our product and services will help to curtail the problems the universities have been having with individuals hacking into the hard-drives and web sites of students;
- (b) traditional Web advertising;
- (c) give SurfBuddy product away for free to consumers and then enter into an affiliated program arrangement where e-commerce sites pay us a percentage of each transaction that consumers purchases while using SurfBuddy; and
- (d) promote the company through writing on privacy issues.

#### D. Regulatory Risks

The United States currently pursues a policy of industry self-regulation with respect to consumer privacy (as do Canada and Australia). The European Union, however, has adopted a different approach. In November 1998, the European Union passed a directive that instructs its member states to adopt a stipulated privacy policy. Under this policy, companies (including Web Vendors) must receive consent from consumers prior to amassing information on these consumers.

There is a risk that the United States and other countries will develop a similar regulatory approach although the governments of these countries state that they are vehemently opposed to this type of regulation at this point in time. Further, many scholars question whether the European approach will be workable in view of the decentralized nature of the Internet (i.e., the Internet has no centralized organizational structure and consists of hundreds of thousands of computers or "routers" which rout information packets to their ultimate destination; Internet users can avoid regulatory attempts by routing their packets through computers located in jurisdictions without these regulations).

#### E. Competition

The main industry response to the self-regulation policy of the United States government has been the institution of a non-profit company called TRUSTe. TRUSTe places a kind of seal of approval on the web sites of Web Vendors that follow the privacy policy of TRUSTe. Many large Web Vendors currently have this seal of approval (represented by a TRUSTe icon). The Trust-e privacy policy, however, simply suggests

that Web Vendors disclose their privacy practices to E-Commerce Consumers Trust-e does nothing to stop the invasion of privacy conducted by most Web Vendors.

There is also a consortium of Web Vendors (called the Online Privacy Alliance) that is trying to establish a privacy framework for the Internet.

Within the last year, a number of products and services have emerged to address privacy concerns, including:

- (a) products and services permit anonymous surfing and email through a variety of different manners by such companies as Anonymizer.com, Crowds, and Onion Routing;
- (b) Digicash offers cash-like anonymity through its payment system; and
- (c) Luckman.com has created a product that disables cookies.

The bottom line is that no company does what Surfbuddy.com wants to do, but competitors are emerging to address privacy concerns of E-Commerce Consumers. This analysis highlights the need to bring our products and services to market as soon as possible (mainly since this will allow us to be identified as *the* Internet privacy company).

## ASSIGNMENT 4

Six weeks have passed since your initial meeting with Warren concerning the proposed Surfbuddy.com company.

**Venture Capital Funding:** Warren comes to your office overflowing with enthusiasm and good news. The venture capital company, Tugwald Riley, appears to be very enthusiastic over the business plan for Surfbuddy.com. However, the v.c. wants to alter the marketing strategy and believes Surfbuddy.com will need more financial resources to effectively compete in the market place. In particular, the representatives of the v.c. feel that the Surfbuddy.com can serve a small niche market in the business-to-business market (partly along the lines of Tammy's previous suggestion to Warren). Tugwald Riley has offered to inject \$500,000 of capital into Surfbuddy.com in exchange for 60% of the company. Warren wants your advice concerning this deal.

**Other news:** Warren tells you that, on the day after the v.c. proposal, Tammy and Steve became engaged - a wedding date has been set six months from now. Warren and Tammy got into another argument concerning the business – Tammy now feels certain that Warren was short-sighted to ignore the business-to-business market. She feels that Tugwald Riley's desire to pursue this market proves she was right all along. Tammy even stopped returning Warren's phone calls for a day.

### Questions

1. What do you advise Warren concerning the venture capital offer? Should the current shareholders of Surfbuddy.com accept these terms?
2. Surfbuddy.com will need to hire several more individuals to implement the business plan? How can they attract talent without spending all of their potential funding from the venture capitalists?
3. What is the relationship between an interest rate, a discount rate and present value?
4. Read the attached story on valuation entitled "The Old Man and the Tree." What is the difference between determining financial value by looking to the present value of earnings over time (the capitalization method) and using the present value of expected stream of future dividends (the cash flow method)?
5. The Old Man and the Tree story suggests that valuation is part art and part science. Do you think this is true?

## ASSIGNMENT 5

Eight weeks have passed since your initial meeting with Warren concerning the proposed Surfbuddy.com company.

**Negotiating with the Venture Capitalist:** Warren shopped his business plan to another venture capitalist in San Diego, which expressed interest in Surfbuddy.com. Warren used this expression of interest as leverage to bargain for a better deal with Tugwald Riley. Tugwald Riley ultimately agreed to invest \$450,000 in Surfbuddy.com in exchange for 49% of common shares in the company. The remaining 51% interest is divided equally among the founders who each take a 17% interest in the company.

**Need for Additional Capital:** In order to effectively compete in the Internet business-to-business market, Surfbuddy.com will need additional financial resources to develop its product and market the initial Beta prototype of the Surfbuddy. The Surfbuddy protect will be marketed to Internet portals such as Yahoo!. This business plan appears to be consistent with the market trends where portals are outsourcing their various services to third party suppliers and where these portals are engaged in a death struggle under the view that only a few of the strongest will ultimately survive as the Internet becomes an established commercial medium. The Surfbuddy will be pitched to the portals as a mechanism to differentiate themselves from other portals because Surfbuddy protects the privacy interests of web surfers. Warren wants to borrow the additional funds, but is unsure how he should proceed. He forecasts a need for an additional \$500,000 to hire a software engineer to animate the Surfbuddy, for additional computers with specialized graphic programs, and for marketing to attract attention to the new product.

**New Board of Directors:** Under the deal negotiated with Tugwald Riley, there will be five directors of Surfbuddy.com comprised of the three founders and two members of Tugwald Riley. There is plenty of legal work to be done to formalize the business structure and prepare additional documentation such as employment agreements, non-competition agreements and non-disclosure agreements. But there is a problem. The contacts at Tugwald Riley insist that you are dropped as counsel to Surfbuddy.com. Tugwald Riley wants to use an established law firm – Hughs & Nastie – to act as the lawyer for the company. Tugwald Riley considers you to be too inexperienced and wants a law firm they are already familiar with and which has legal experience with helping start-up Internet companies.

### Questions

6. Warren tells you of Tugwald Riley's desire to oust you as counsel. What do you do?
7. Under the proposed structure, what will be the debt/equity ratio for Surfbuddy.com?
8. Why is debt a cheaper financing alternative when compared to equity? If debt is a cheaper financing mechanism than equity, why ever use equity?

## ASSIGNMENT 6

Five months have passed since your initial meeting with Warren.

**Beta Product Launch:** Two weeks ago, Surfbuddy.com finalized its first complete prototype called Surfbuddy 1.0, a talking animated character – the Surfbuddy - that accompanies the web surfer along her journey through cyberspace and provides some “identity management” functions to web surfers including the ability to reject cookies and remain private from web vendors. Surfbuddy.com began permitting consumers to download Surfbuddy free of charge from the company’s web site. Product development on the second prototype continues although the v.c. funding and bank loans have almost dried up.

**Press Coverage:** Several local/regional newspapers, one national newspaper and two national magazines covered Surfbuddy.com’s product launch after Warren issued press releases to the media. The press coverage has generally been favorable with a magazine called Generation Whatever enthusing that the Surfbuddy “is the best thing on the Web since Homer the Talking Mule.” Surfbuddy.com’s home page registers approximately five hundred thousand hits per day and a total of fifty thousand individuals have downloaded Surfbuddy 1.0. The buzz is on.

**It’s Squeeze-Out Time:** Warren comes into your office in a state of panic. He tells you something has gone horribly wrong. Tammy, Steve and the board members from Tugwald Riley want to oust Warren from the corporation. Warren tells you Tammy is behind the intended coup d’état because she has been unhappy with Warren ever since the two clashed over the business plan.

Tammy has told Warren it is not fair that she and Steve have been slaving away on the coding of Surfbuddy 1.0 while Warren doesn’t have any real technical expertise. Further, she insists the company needs a C.E.O. with significant experience in the market Surfbuddy.com is trying to penetrate. Warren received a formal letter from the remaining board members asking him to tender his resignation as C.E.O. and informing him that he ought to tender his common shares (Warren currently owns 17% of the common shares of the company) to the company and that these shares will be redeemed at their fair market value. If Warren is unwilling to comply with the request, the letter indicates the corporation may take steps to squeeze out Warren’s shareholding.

Warren does not want to step down as C.E.O. and does not want to sell his shares. Further, Surfbuddy.com has lost hundreds of thousands of dollars on paper and Warren is unsure how much his shares will be worth. Warren wants your help to fight back. He reminds you how he went to bat for you when Tugwald Riley tried to switch to another law firm. You realize Warren is responsible for ensuring that you continue to act as counsel to Surfbuddy.com (although part of the legal work by necessity must be farmed out to Hughs & Nastie).

## Questions

1. Should you help Warren to maintain his current position as C.E.O. as well as his ownership interest in Surfbuddy.com? In hindsight, what type of legal agreement would have protected Warren against the coup attempt?
2. How much would Warren's shares be worth? What valuation techniques would maximize the estimated value of the shares?
3. Can Warren insist that Surfbuddy.com distribute dividends to its shareholders?
4. Does a firm's dividend policy have any impact on the value of a company?

## ASSIGNMENT 7

Ten months have passed since your initial meeting with Warren.

**New CEO:** Warren reached a negotiated settlement with the rest of the board of directors of Surfbuddy.com. Warren agreed to would accept a demotion to Vice-President of Marketing in order to maintain his ownership interest in Surfbuddy.com. A new CEO—Bif Wellington—was hired to replace Warren. Bif, after a twenty year career with Silicon Graphics, successfully ran two Internet start-up companies prior to joining Surfbuddy.com. Bif has significant pre-existing business relationships and contacts with many Silicon Valley firms.

**Financing:** Tugwald Riley invested an additional \$1 million in Surfbuddy.com soon after Bif joined the company. Surfbuddy.com hired fifteen people to handle customer service, three new software engineers, and a CFO.

**R & D Continues:** Two weeks ago, Surfbuddy 3.0 was launched. The new and improved Surfbuddy now interacts with web users by “talking” to them using an audio program. Surfbuddy 3.0 also possesses an artificial intelligence function that tracks the web user’s choices as she surfs the Internet: Surfbuddy can now be set to surf by himself and report back with information or web site links he “thinks” the user wants to see. Two hundred thousand Surfbuddy 3.0s have been downloaded free of charge from Surfbuddy.com’s home page.

**Big Deal:** Bif negotiated an arrangement with the second most popular portal on the Web, a company called Yeeha! Yeeha! licensed the Surfbuddy in order to provide the product free of charge to web surfers who use Yeeha! as a portal to get to other web sites. Yeeha! hopes that the provision of Surfbuddy 3.0 on its home page will attract additional traffic (and hence higher advertisement revenues). Under the arrangement, Surfbuddy.com must continue to support the Surfbuddy product and provide Yeeha! with any additional technological updates.

Warren, who is partly relieved to have handed over the reins, thinks this deal should significantly increase the amount of web users who surf with Surfbuddy. Warren tells you Bif plans on taking the company public within six months.

### Questions

1. Should you somehow invest in Surfbuddy.com? Would this be a breach of your professional responsibility ethics? Should you accept shares in the company (instead of cash) in exchange for your legal fees?
2. Are capital markets efficient? What is meant by “efficiency”? Can individuals subvert the market in order to reap above-normal returns?

## ASSIGNMENT 8

One and a half years have passed since your initial meeting with Warren.

**Expansion of Business:** Surfbuddy.com now employs forty individuals in customer support, ten software engineers and an additional fifteen individuals in various capacities. The company moved into new office facilities in University Park. The launch of Surfbuddy 6.0 proved to be a great success and Surfbuddy.com now dominates the identity management market of the Internet. Surfbuddy 6.0 is represented on the web user's desktop as a fully animated, talking, interacting character that can respond to a multitude of user demands. Surfbuddy 6.0 has become an industry standard and most large ISPs and portals offer the product free of charge to their customers. Surfbuddy.com has even struck a merchandising deal with a toy manufacturer that puts out a line of Surfbuddy dolls targeted at young children. The company has been approached by a TV production company to produce a Surfbuddy cartoon for ABC's Saturday morning line-up.

**Sales and Profits:** In the most recent fiscal quarter, Surfbuddy.com enjoyed \$6 million in revenues from licensing and advertising fees. In this same quarter, however, the company incurred \$10 million in expenses generating losses in the millions of dollars.

**Initial Public Offering:** Surfbuddy.com went public last week on the NASDAQ and its stock did surprisingly well. Analysts were particularly impressed with the large losses suffered by the business. The stock opened at a price of \$18 per share, reached a high of \$42 per share and closed the day at \$30 per share. With ten million shares outstanding, the company's market capitalization is \$300 million.

**Alls Well That Ends Well:** Tammy and Steve were married two weeks ago and Tammy asked Warren to be the co-best man at the marriage. Warren gladly agreed. Each of the founders currently owns roughly \$30 million worth of stock in Surfbuddy.com; Warren was listed by the Union-Tribune as one of San Diego's most eligible bachelors. Warren tells you he's thinking of quitting his job as vice-president of Surfbuddy.com although he wants to maintain most of his ownership interest. It's just that Warren has this great idea for a new Internet product and he'd love to start-up another company and make a go of it.

### Questions

1. How can Internet companies be possibly worth what the market says they are worth? Does the Internet render old stock valuation models obsolete?
2. Do recent innovations such as on-line trading make the market more volatile?
3. Is the new information economy all hype? If not, how are new technologies contributing to productivity improvements and general economic wealth?



