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Europe's ISPs Fill Their War Chests

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The leading access providers are going public to get ready for the consolidation ahead.

Anywhere you turn in Europe these days it seems a huge ISP is going public.

Last year, it was Freeserve in England, then Tiscali in Italy and Terra in Spain. This spring, the action's even hotter. In mid-March two ISPs debuted back-to-back: Liberty Surf in Paris and World Online in Amsterdam, though the latter's IPO hit the skids. But the biggest offer yet comes April 17 in Frankfurt, when T-Online, a **Deutsche Telekom** (DT) spinoff that ranks as the world's second-largest ISP, will float 10 percent of a company valued at a staggering $20 billion to $40 billion.

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In the U.S., the ISP business is foundering, with even midsize operators like Espernet eyeing the sharks circling their hard-hit ships. In the buzzwords of the U.S. Net world, ISP has long been surpassed by business-to-business and broadband. In Europe, however, ISPs are being touted as one of the new economy's next boom markets.

"Any ISP owner can see there's a lot of funny money out there," says Philip Lakelin, a senior analyst for Analysys consulting group in Cambridge, England. "And they're all saying, why not?"

But there's also a lot of fear. Everyone knows a shakeout's coming. "The ISPs who are doing floats are all gearing up for a fight," says Scott Smith of Yankee Group's London office. "Basically, they're arming for battle, going to the market for cash to carry out acquisitions."

Among those expected to survive is Freeserve, which revolutionized Britain's access pricing, then proved ISPs could make a killing by quadrupling in value after its IPO. Likewise, since going public late last year Terra has achieved a valuation of more than $20,000 per subscriber, the highest figure of any ISP; it now trades at five times its initial list price. Italy's Tiscali scored a similar bonanza: Its shares currently trade at roughly 20 times their initial value last October. And although today's IPO markets have started to cool, more ISPs are still preparing to go public.

If Internet service providers have ridden particularly high in Europe, it's in part because unlimited-usage plans have been slower to materialize there than in the U.S., creating an epoch of incredible revenues generated from access charges. This is especially true for ISPs spun off from their country's previously government-controlled telcos - such as Telefonica's Terra, **France Telecom** (FTE)'s Wanadoo and **Telecom Italia** (TIM)'s 2 million-user Tin.it, which goes public this summer. These outfits managed to collect three fees from customers: monthly subscriptions, connect-time fees paid to the ISP, and per-minute phone charges to the telco.

But in the last year or so, that lucrative model has come to an end as aggressive, independent ISPs started offering better-priced packages. The long-term trend, says Phil Dwyer of Jupiter Communications, is toward plans with either unmetered usage or no subscription fee, and possibly both, though that seems a form of financial hara-kiri.

While cheap pricing models may drive up the ISP customer base, they will also slash revenue from access fees. As a result, many of these companies will be fighting for survival over the next few years. Analysys' Lakelin points out that in the next stage of Europe's new economy, access will become a commodity, acting as a conduit to the real online markets in goods and services. So Internet service providers need to collect some cash based on their past success - and fast.

"ISPs in Europe have always been valued very highly because there was more of an ability to extract fees from customers than in the States," says Yankee's Smith. "But no one thinks they can sustain those high valuations now."

In order to not go the way of the dinosaur, the European ISPs will need to evolve. With their swollen post-IPO coffers, they will almost certainly go on shopping sprees, buying content companies, e-commerce channels - and each other. Terra, for example, has made inroads into commerce by buying a stake in a Dublin-based Internet bank called First-e.

"ISPs could be crucial in European e-commerce," observes Bert Siebrand, a tech analyst for Amsterdam's SNS Securities. "Europeans don't shop with credit cards as much as Americans, and retailers hate paying 4 percent to MasterCard and Visa. So there's a real opportunity for ISPs to work with e-commerce providers as partners offering secure payment methods."

Another change is providing content. When Telefonica recently bought Dutch TV-production firm Endemol, the producer of the hit show *Big Brother,* one clear motive was to supply content to Terra.

Of course, few people will actually pay for content - besides actionable stuff like porn and stock tips - so advertising is a critical part of Europe's new ISP business model. And most business partners - whether advertisers or merchants - will flock to the ISPs with the biggest market share.

"People have to act fast now," says Niko Waesche, a venture capitalist with Munich-based Global Retail Partners. "The options are to be big or be swallowed."

With the Old World's number of Internet users estimated by **Forrester Research** (FORR) to grow from 60 million to 170 million in the next few years, every ISP going public has to harbor similar Pan-European ambitions. But tactics vary.

World Online is carpet bombing installation CDs and buying up small ISPs all over Europe. Freeserve is expanding across the English Channel into France, while France's Liberty Surf has returned the favor by targeting British users. Terra has bet big on the Spanish-language market in South America. T-Online went the old-style route in February and bought France's second-largest ISP, Club-Internet - adding a half-million users when it signed the deal.

Expect more of this, analysts say, since it's far easier to buy locals than break into a foreign market.

Who will win the battle? Certainly not a single entity, because the cultural differences in Europe make it a hard market to dominate. Most analysts nonetheless predict a major consolidation, with the rich getting richer.

"If there are six companies left standing after the shakeout, at least half will be these old government telecoms," says Therese Torris, an analyst who tracks Internet service providers for Forrester Europe. "Many of these insurgent companies have very short-term views and are just too leveraged to last."

Naturally, the newer independents won't just roll over. "If they move very fast to secure broadband services and acquire content, they have a chance," says Siebrand. "A few will take their IPO money, really develop solid new models and build market share. But the others at a certain moment will just sell out in despair."

The do-or-die aggressive pricing of the independents also will no doubt incite replays of Freeserve forcing British Telecom to slash its once extortionary connection rates. And that could mean great things for the European users, at least while the price wars last.

Still, staying alive will require deep pockets - an advantage for the Internet service providers that are backed by former government-monopoly telcos. As shown by Terra's past stock surge and the anticipation for the T-Online floatation, investors really love these spinoffs. Yet there's irony here.

Says Torris, "The parent companies were all built up with taxpayer money. So in a way people are rushing to the market to buy their own property."

ISPs Expand Their Horizons

The race is on to acquire or be acquired.

VIEW POP UP CHART

Marc Spiegler is based in Zurich, Switzerland, and has written about technology and culture for Wired, Civilization *and* Salon.

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